INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

August 31, 2017

KEY ISSUES

Mounting political frictions are overshadowing attempts to revive peace talks. Details of a path forward on the peace process remain elusive and attention has shifted to preventing further violence after tensions flared in July. Domestic political frictions have deepened and Hamas did not participate in the May 2017 municipal elections in the West Bank. The difficult decision by the PA to reduce expenditures in Gaza has intensified tense domestic relations amid regional complexities.

The economic outlook is increasingly fragile. Deteriorating infrastructure and recent expenditure cuts point to lower growth in Gaza. Persistent instability and conflict have eroded the economy's productive base and stunted growth potential. GDP growth is projected to slow to 3 percent over the medium term, too low to remedy economic imbalances and meaningfully improve living standards. Elevated—and tightly coupled—risks could jeopardize the outlook, including: increased fragmentation, deepening political divisions, steeper declines in donor support, strained correspondent bank relations, and rising discontent that could fuel unrest.

The central challenge is to revive growth and generate sufficient jobs for a burgeoning population. Continued fiscal adjustment is needed to narrow persistent financing gaps and create space to help rehabilitate the economy's productive capacity. The priority in 2017 is to reduce the nearly $600 million financing gap by consolidating revenue gains and containing non-priority recurrent spending. Over the medium term, public financial management reforms can help sustain efforts to reduce the recurrent deficit. Engagement by Israel and increased donor aid remain vital to striking a balance between achieving fiscal sustainability and investing in growth. Reducing the fiscal financing demands on banks, together with proactively managing financial risks, will enable the financial sector to better support private sector activity.

[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
Juha Kähkönen (MCD) and Sanjaya Panth (SPR)

Discussions were held in East Jerusalem and Ramallah during July 11–20, 2017, and the report was updated to reflect subsequent developments. The staff team comprised Karen Ongley (head), Gregory Basile, Priscilla Toffano, 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. Cecilia Pineda and Mustafa Farzad also contributed to producing this report.

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POLITICAL SETTING

1. Mounting political frictions and security concerns are overshadowing attempts to relaunch peace talks.

- President Abbas' visit to Washington in early May 2017, followed by President Trump's visit to Israel and the West Bank later that month, helped revive the prospect of peace talks between the Government of Israel (GoI) and Palestinian Authority (PA). While details of a path forward remain elusive, other international stakeholders reiterated their commitment to a two-state solution. Notwithstanding UN Security Council resolution 2334, settlement activities have continued. Widespread support for a hunger strike by Palestinian prisoners in April/May illustrates the political fragilities and higher risk of social unrest. Attention has since shifted to preventing further violence after tensions flared over access to the Al Aqsa Mosque in July.

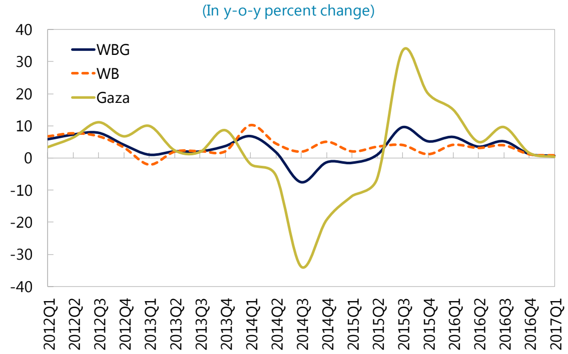
- Deepening frictions between the PA and de facto authorities in Gaza cloud the domestic political environment. Hamas decided not to participate in the May 2017 municipal elections in the West Bank, which were characterized by a low overall voter turnout. Difficult decisions by the PA to reduce expenditures in Gaza have intensified strains amidst tense domestic relations and regional complexities. Reduced electricity supply and water shortages have exacerbated the alarming humanitarian situation in Gaza.

2. The PA and GoI have resumed high-level discussions on economic issues. Following the May Ad Hoc Liaison Committee (AHLC) meeting, the Ministers of Finance met to exchange views on promoting growth and fiscal sustainability, with subsequent meetings involving the PA's Prime Minister. Senior technical discussions between both ministries are now slated to take place monthly and have begun yielding some results, with Israel transferring health stamp and equalization levy payments accumulated since September 2016. They also made some progress in the energy sector (the Jenin interim power purchase agreement) and water sector (signing the Red Sea-Dead Sea pipeline project). Other contentious issues include: (i) settlement expansion, including the first official settlement since 1992 at Amihai; (ii) movement and access restrictions in the West Bank; (iii) the near-total blockade of Gaza; and (iv) the PA's payments to families of prisoners and 'martyrs'.

RECENT DEVELOPMENTS

3. **Economic growth slowed in the first quarter of 2017.** While trade helped growth in the West Bank, slowing private consumption—the lion's share of GDP—saw growth ebb to 0.8 percent (year-on-year) in 2017Q1. Growth in Gaza dipped to 0.4 percent (year-on-year) as donor-funded reconstruction decelerated sharply.

Real GDP Growth, 2012–Q1/17
(In y-o-y percent change)



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

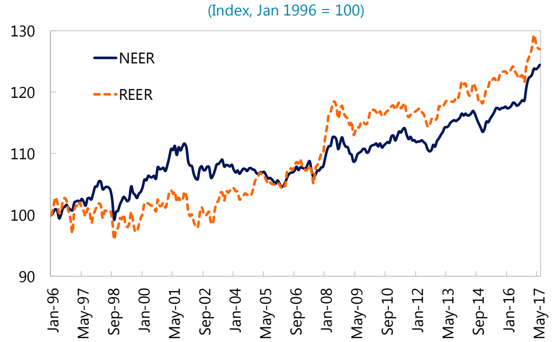
4. **Labor market conditions remain bleak**, reflecting demographic pressures and economic slack. After easing in late 2016, the unemployment rate in the West Bank increased by almost 4 percentage points to 20.5 percent at end-June, despite the large number of Palestinians employed in Israel and settlements (18.6 percent of West Bank employment). In Gaza, where 70 percent of the population depends on international assistance, unemployment edged up further to 44 percent and youth unemployment is stubbornly high (approaching two-thirds). The overall participation rate remains low, with a large gender gap (over 70 percent for men, but under 20 percent for women).

Labor Market Developments
(In percent)

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

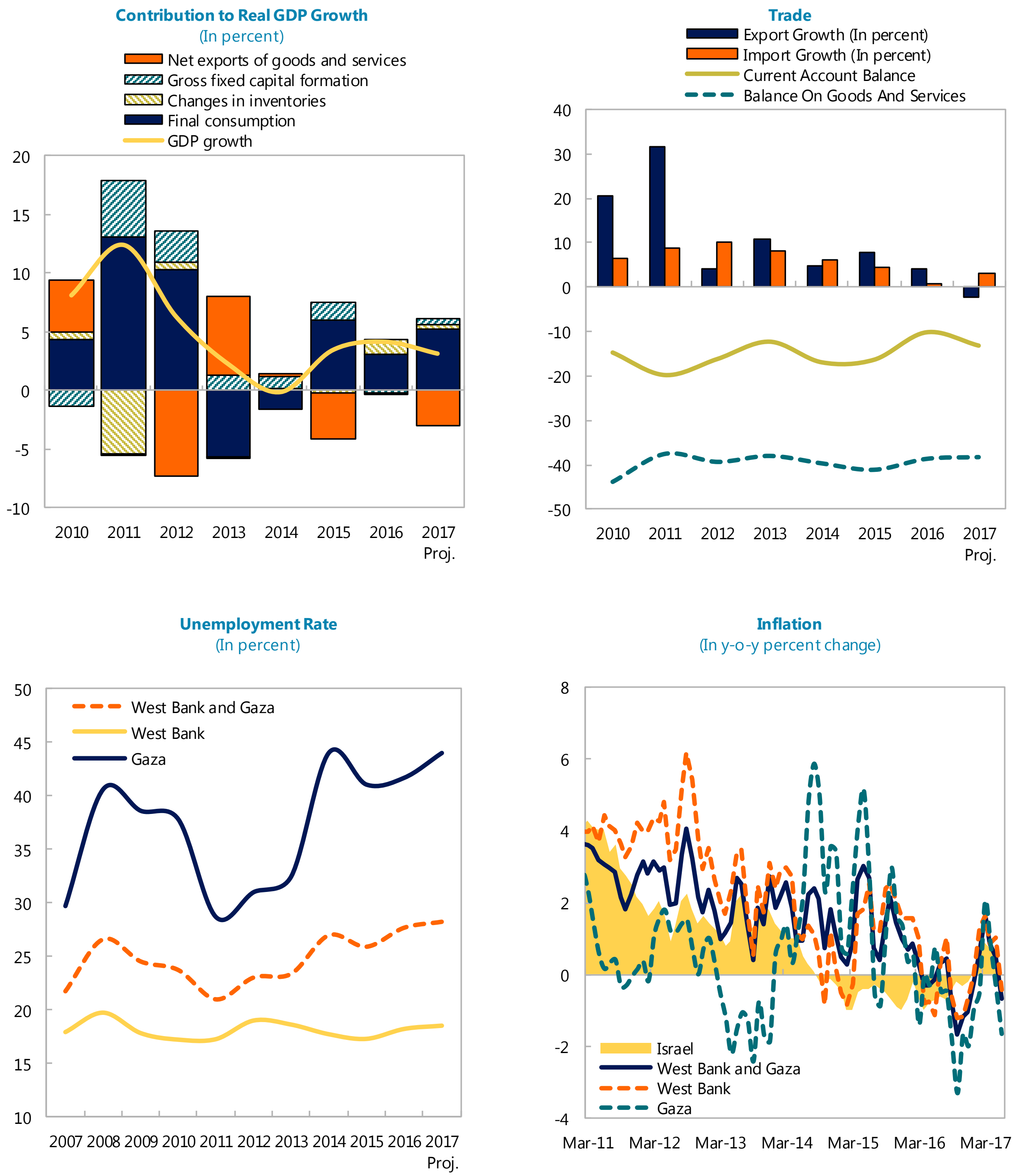
5. **Inflationary pressures remain subdued.** Following deflation in 2016, inflation moved into positive territory in early 2017, before returning to deflation mid-year. Overall prices declined by 0.7 percent in June (year-on-year), reflecting food prices and deflation in Israel driven by the appreciating shekel. The real effective exchange rate continued to appreciate, adding at the margin to the non-price factors (ongoing restrictions and political uncertainties) that dominate competitiveness concerns.

Effective Exchange Rate
(Index, Jan 1996 = 100)



Notes: An increase indicates appreciation. Weights based on 2015 trade data.
Sources: Haver Analytics, Information Notice System; and IMF staff calculations.

Figure 1. West Bank and Gaza: Recent Economic Developments, 2007–17



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

6. Fiscal performance was better than expected in the first half of 2017. Total revenues held up well relative to the same period last year. Ongoing efforts to improve tax administration bore fruit, with higher domestic taxes compensating for weaker non-tax revenue (excluding an exceptional payment for the new telecom license). Transfers of clearance revenues (CRs) increased by almost 6 percent relative to 2016H1, excluding the ad hoc settlement of clearance revenues in both March 2017 (NIS 130 million) and March-April 2016 (NIS 570 million). Recurrent spending was about 3 percent lower than the first half of 2016, reflecting late approval of the 2017 budget and the initial impact of decisions to limit payments to Gaza. This includes rolling back allowances for PA employees, retrenching more than 6,100 civil servants, and reducing subsidies for electricity Israel provides Gaza. Thus, the overall deficit declined to an annualized 6.7 percent of GDP, lower than the budgeted deficit.

7. However, budget financing remained tight. The authorities continued efforts to clear the stock of arrears to private sector suppliers, with gross payments of around NIS 1 billion. At the same time, low external budget support (in line with the budgeted 20 percent decline compared to 2016) and high amortization of domestic debt, saw the recurrence of arrears. Net arrears accumulation reached NIS 373 million at end-June.

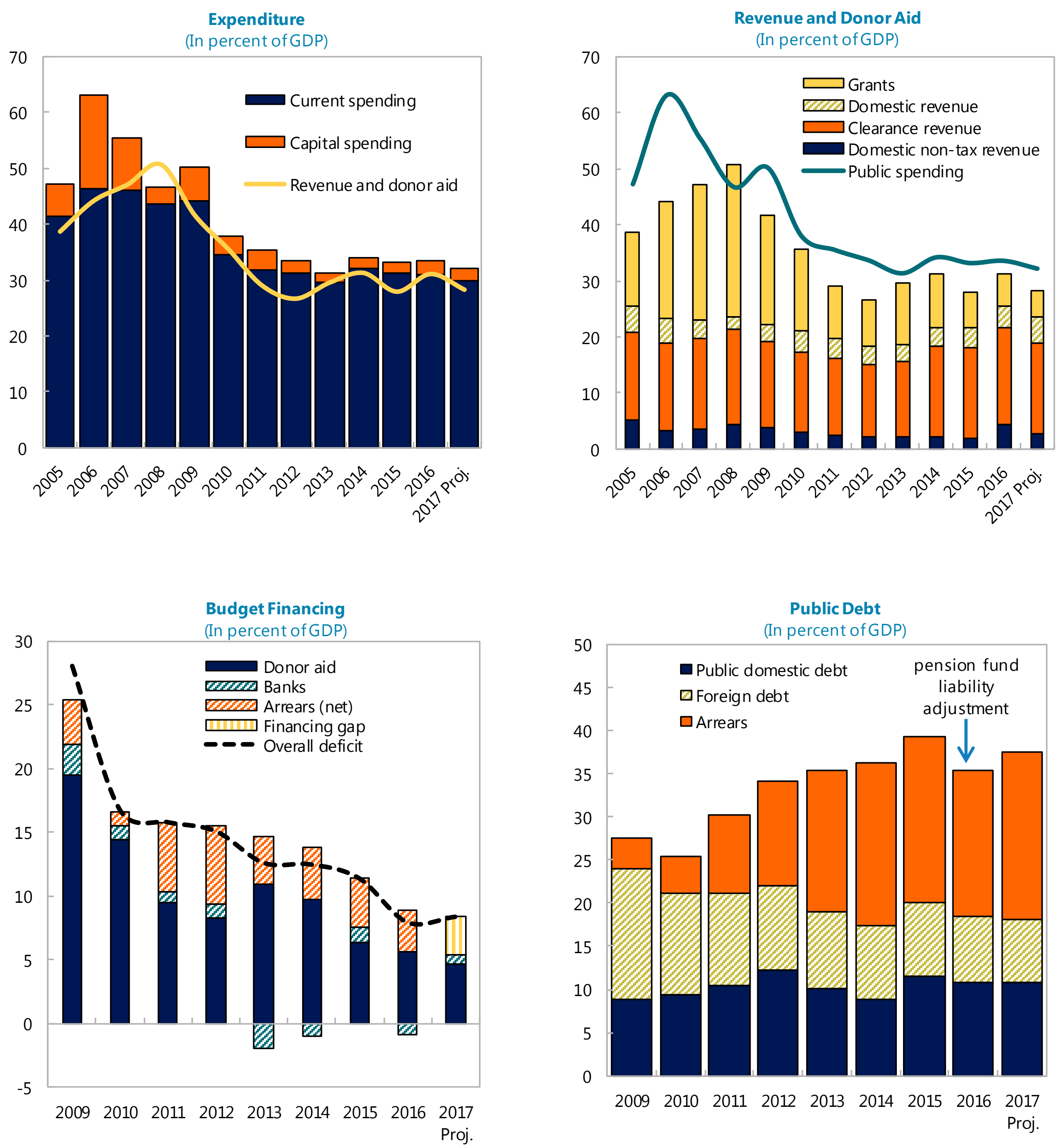
West Bank and Gaza: Fiscal Performance, January–June 2017
(In millions of NIS, unless otherwise specified)

	2016	2017		
		Budget	January-June execution	
			in m. NIS	year / year (%)
Net revenues	13,276	13,451	6,487	*7.3*
Gross domestic revenues	4,701	5,041	2,240	*17.3*
Tax revenues	2,392	3,141	1,486	*12.6*
Nontax revenues	2,309	1,900	754	*27.9*
Clearance revenues	8,930	8,780	4,429	*9.6*
Less tax refunds	355	370	182	*27.6*
Recurrent expenditures and net lending[1]	16,137	16,147	7,809	*(5.6)*
Wage expenditures	7,837	8,093	3,953	*1.7*
Nonwage expenditures	7,270	7,104	3,309	*(9.0)*
Net lending	1,029	950	546	*8.3*
Development expenditures[1]	1,287	1,639	460	*(10.8)*
Overall balance[1]	-4,148	-4,335	-1,782	*(16.5)*
Total financing	4,148	4,335	1,782	*N/A*
External Financing	2,848	2,496	1,158	*(16.9)*
Domestic financing	1,300	1,839	624	*N/A*
Net domestic bank financing	-415	0	151	(15.5)
Net arrears	1,697	-1,170	373	*N/A*
Residual/financing gap	18	3,009	99	*N/A*

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

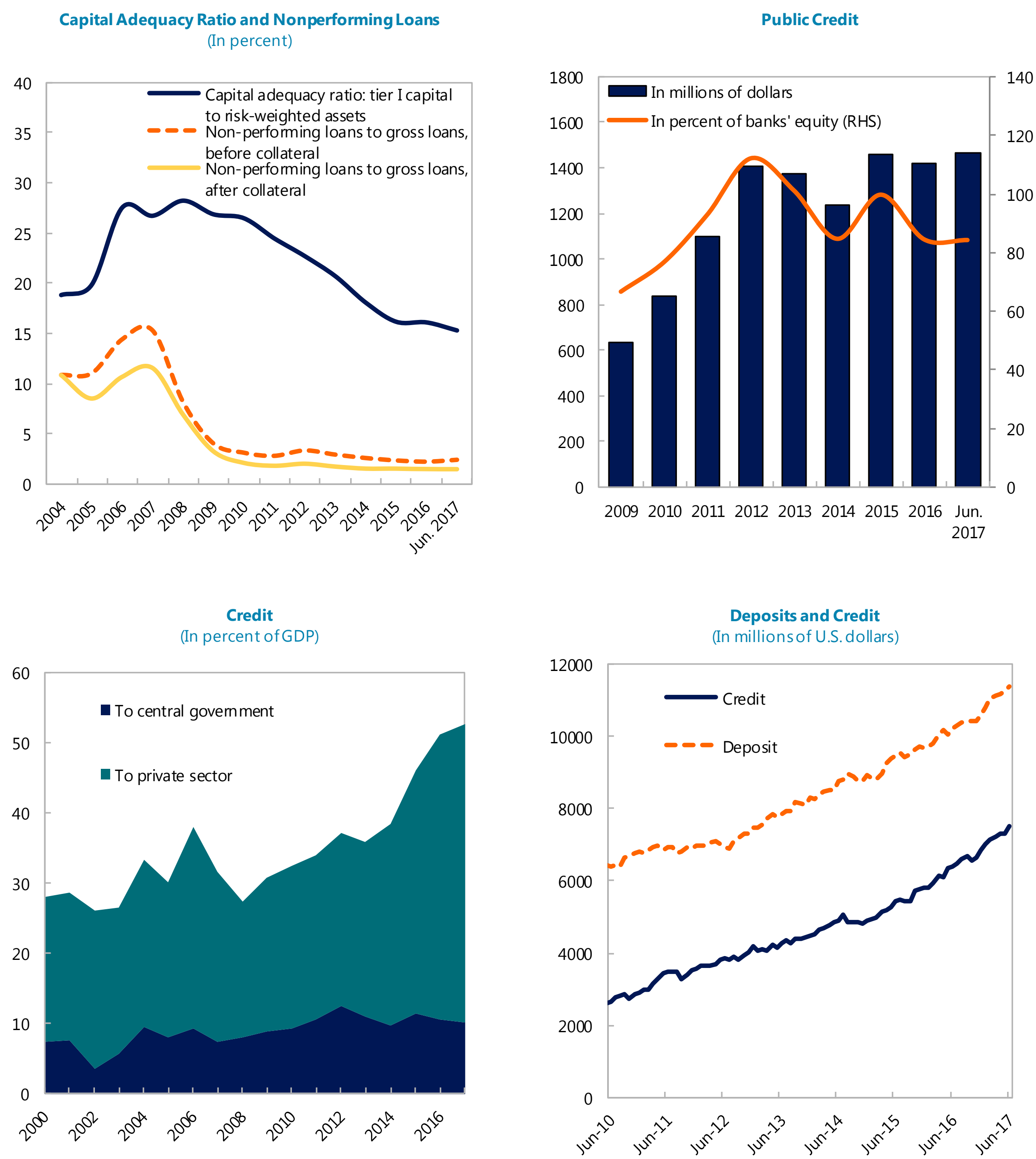
[1] Commitment basis.

Figure 2. West Bank and Gaza: Fiscal Sector Indicators, 2005–17



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

Figure 3. West Bank and Gaza: Financial Sector Data, 2000–June 2017



Source: Palestine Monetary Authority.

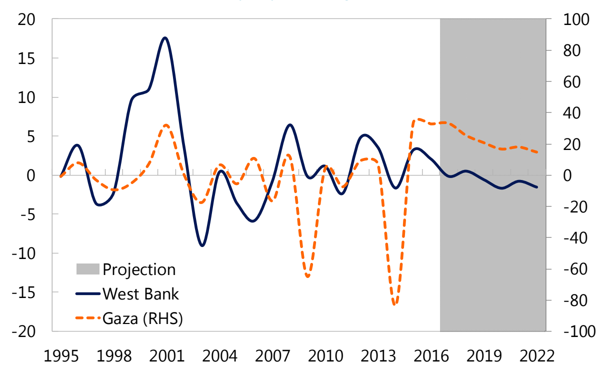
8. Financial sector strains are becoming more evident. Credit to the private sector continues to grow rapidly (22 percent year-on-year through June), and is concentrated in consumption, construction, and trade. Banks' lending to the PA remains below the regulatory limit, although credit to PA employees and holdings of promissory notes almost double banks' exposure to the public sector. Prudential ratios comply with international standards, although NPLs have increased slightly (averaging 2.4 percent of total loans) and the capital adequacy ratio continued its steady decline (reaching 16.2 in 2017Q2). The new *Central Bank Law*, drafted in consultation with IMF staff, is awaiting Presidential approval, and a new *Electronic Transaction Law* was approved in July. Banks operating in the West Bank continue to experience challenges in managing excess liquidity, with Israeli banks providing limited cash services and limits on transferring shekel cash to the Bank of Israel (BoI).[2]

9. The authorities are continuing work to preserve Israeli-Palestinian correspondent bank relationships (CBRs). As part of a wider agenda to strengthen WBG's anti-money laundering and combating the financing of terrorism (AML/CFT) regime, the authorities have: (i) made further amendments to the 2015 AML/CFT law and related regulations, guided by IMF technical assistance (TA); (ii) launched a National Risk Assessment (NRA), with World Bank support; and (iii) published a manual to help banks and money changers identify AML/CFT risks. The temporary financial and judicial assurances proposed by Israel in January to help preserve CBRs are not yet in place.

OUTLOOK AND RISKS

10. WBG's growth potential is stunted by a dearth of productive capital. Protracted periods of instability and conflict-related destruction have eroded the capital base, most profoundly in Gaza, and the inhospitable investment environment has impeded the economy's ability to recover (Annex III). With public investment among the lowest in the world and private investment directed largely toward construction, the economy faces an enormous challenge in expanding its productive base and raising growth potential.

Capital-Labor Ratio
(In y-o-y percent growth)



Sources: Penn World Table, UNRWA, and IMF staff calculations.

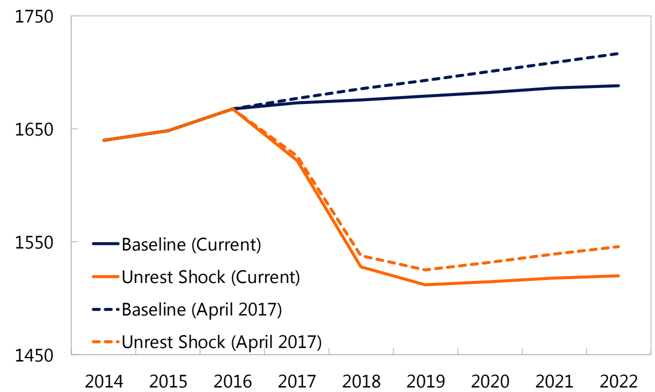
11. Moreover, recent events point to a more difficult outlook. The situation in Gaza has become increasingly challenging—against the backdrop of deteriorating infrastructure and weak provision of social services, recent expenditure cuts point to lower growth of around 4 percent in the medium term. While lower growth in 2017Q1 and recent tensions underscore uncertainties, the West Bank is still projected to grow by 2.7 percent, buoyed in part by consumption of workers

[2] The BoI sets monthly limits on the amount of NIS cash transfers it accepts from banks operating in the West Bank, with the stated goal to combat money laundering and the financing of terrorism. However, the BoI periodically accepts amounts above this limit in response to requests by the PMA.

earning salaries in Israel. Given the larger weight of the West Bank economy, staff estimate overall GDP growth to ease to around 3 percent over the medium term (down from 3.3 percent as projected in April), too low to remedy economic imbalances or meaningfully improve living standards.

12. Elevated—and tightly coupled—risks could further jeopardize the outlook (Annex I). Increased fragmentation among WBG's regions could further constrain economic activity. Deepening political divisions and recent Gaza-related measures could exacerbate tensions, with possible financial and economic spillovers into the West Bank. A steeper decline in donor support could compromise fiscal sustainability, public investment, and service delivery. Finally, severing CBRs could undermine the functioning of the payment system and economic activity. Amidst these pressures, rising discontent could fuel increased unrest and immobilize the economy.[3]

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



Source: IMF staff calculations.

POLICY DISCUSSION—SHARING THE CHALLENGE OF DEVELOPMENT WITH THE PRIVATE SECTOR

Years of conflict and political uncertainty have had a profound effect on WBG's growth potential. Reviving the economy's productive capacity and raising living standards for the growing population will require closing the investment gap. While lasting improvements in the investment climate ultimately require progress towards peace, discussions focused on the mix of policies within the authorities' control that could lay the foundation for stronger private sector-led growth. The authorities and staff also discussed the role Israel and donors can play, including facilitating access to markets and alleviating constraints on public investment.

A. Unlocking Private Sector-led Growth

13. Staff and the authorities agreed it is imperative that the private sector becomes a stronger driver of growth and jobs. The authorities noted the opportunities inherent in a young and educated population, while acknowledging the daunting task of generating sufficient jobs for the burgeoning workforce (Box 1). Staff underscored the need for comprehensive reforms to improve the investment climate, rather than relying on targeted incentives. Staff and the authorities nonetheless recognized that political uncertainty remains the top obstacle to boosting private

[3] The possible impact of an illustrative unrest scenario was outline in Box 1 of IMF staff's April 2017 *Report to the AHLC*.

investment.[4] Ventures that require significant upfront physical investments and take decades to break even (e.g., electricity generation) are particularly vulnerable. Fully unlocking the potential of the private sector depends on a breakthrough on the peace process.

Box 1. Demographic Challenges and Opportunities in West Bank and Gaza

The projected doubling of WBG's population to 10 million by 2050 poses a significant challenge.[1] With almost 40 percent of the population currently under the age of 15, the working age share of the population will continue to rise to around two-thirds.

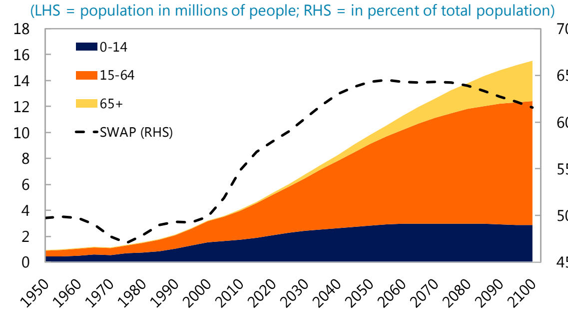
The economy will need to generate more than 2 million jobs by 2050 to absorb new entrants to the labor market.[2] While this implicitly assumes higher female labor force participation, it does not account for people currently unemployed. Existing labor market rigidities magnify this task. Unemployment is stubbornly high at 29 percent (and nearly 40 percent for young people), despite low participation (46 percent overall in 2016).

Failure to generate enough new jobs will heighten risks. Insufficient job growth could compound the already high unemployment, increase poverty, and exacerbate social and economic strains. Revenues foregone from lack of job creation would add to fiscal pressures, compromising the PA's ability to invest in health and education just as needs are rising.

However, a scenario where all new labor entrants find a job could boost GDP per capita—up by 50 percent by 2030 and nearly tripling by 2050.[3] The higher share of working age population and lower projected dependency ratios could provide the basis for increased savings and investment.

Population Structure, 1950-2100

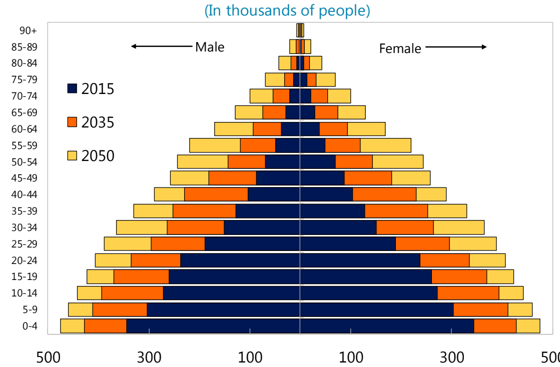
(LHS = population in millions of people; RHS = in percent of total population)



Note: SWAP = Share of working age population.
Sources: United Nations' Department of Economic and Social Affairs, Population Division (2015); World Population Prospects: The 2015 Revision, DVD Edition; and IMF staff calculations.

Population Structure, 2015-2050

(In thousands of people)



Source: United Nations' Department of Economic and Social Affairs, Population Division.

To capitalize on WBG's demographic dividend, policies should focus on creating the conditions for private sector-led growth. Re-orienting the budget from current to capital spending will be essential to facilitate investment in infrastructure and more effective service delivery (including health). Improving the quality of education spending will also be crucial to equip the growing workforce with the skills required by the market. Reforms to improve the business environment can help reduce obstacles to investment (foreign and domestic), and better position the private sector to create jobs. A package of such policies will be instrumental in improving the prospects for inclusive growth and managing the demographic change under way, particularly if combined with an easing of restrictions or progress toward peace.

Prepared by Hania Qassis.

[1] United Nations Department of Economic and Social Affairs, *World Population Prospects*, July 2015. Based on the UN's medium fertility scenario.

[2] UNFPA, *Palestine 2030: Demographic Change: Opportunities for Development*, December 2016.

[3] IMF, *How to Assess Fiscal Implications of Demographic Shifts: A Granular Approach*, How-to-Note 16/02, August 2016.

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[4] European Bank for Reconstruction and Development, European Investment Bank, and World Bank, 2016, *What's Holding Back the Private Sector in MENA? Lessons from the Enterprise Survey*, Washington DC.

14. Improved access to goods and markets is critical to private sector development. Geographic fragmentation and restrictions have made the movement of people and goods—both within, and to and from, WBG—particularly cumbersome. The authorities pointed to difficulties in obtaining inputs to production, particularly as Israel's "dual use" list has expanded over the past decade. Even without a final peace outcome, there is scope lessen these obstacles with support of the GoI. Examples of where progress could be made include efforts to develop an industrial zone near Hebron and operationalize a new Israeli-run scanner on the Jordanian border.

15. Staff stressed that the PA can also take action to improve the conditions for private activity and lay the ground for bigger gains once the political horizon brightens. In addition to legal and institutional considerations, policies to improve fiscal sustainability and maintain financial stability can have a major bearing on the private sector's ability to flourish.

- Modernizing the regulatory environment, where unclear land titling, restrictive tenancy laws, and onerous requirements for starting a business are prominent impediments.[5] The authorities underlined that the Companies Law—on track to be adopted later this year—will simplify the process of incorporating businesses. They are also working to reform the tenancy, competition, and industrial property rights laws.

- Further developing institutions to facilitate trade and investment (such as the Palestine Standard Institute and Palestine Investment Promotion Agency), and ensure more efficient transactions with the public sector (e.g., public procurement, contract enforcement, and clearing arrears).

- Continuing fiscal and financial reforms to: (i) shift the composition of public expenditure to create space to invest in education and infrastructure (including energy and water, for which donor support will be crucial); (ii) address the build-up of arrears and the associated costs for private suppliers; and (iii) promote sound, market-based access to finance.

Staff noted the mooted electricity sector reform covers most of these points to varying degrees. They urged the authorities to finalize a new electricity provision and distribution agreement to complement the recent Jenin sub-station interim power purchase agreement.

B. Taking Steps Toward Fiscal Sustainability

Measures to Shrink the 2017 Financing Gap

16. Staff welcomed the stronger-than-anticipated budget performance so far this year, but noted there will likely be a sizeable financing gap for 2017. The authorities emphasized their determination to outperform the budget this year, pointing to the Gaza-related measures. The cuts are projected to shave 1.5 percentage points of GDP off the 2017 deficit, and recurrent spending and net lending. Staff and authorities agreed that improvements in income tax and customs administration would endure. However, constraints on expanding the tobacco marketing scheme to

[5] World Bank, 2017, *Doing Business 2017: Equal Opportunity for All*, Washington DC.

Gaza could limit the gains in excise taxes to a ½ percentage point of GDP this year. With the large ad hoc revenues from 2016 (about 2½ percentage points of GDP) not expected to recur, total revenue will likely decline from 25.5 percent of GDP in 2016 to 23.7 percent in 2017. On this basis, staff projects a recurrent deficit of 8.4 percent of GDP. Yet, with donor financing on track to fall by 20 percent compared to 2016 (as projected in the 2017 budget), the financing gap would still reach around 4 percent of GDP. The authorities were more optimistic, suggesting the financing gap could be closer to 3½ percent of GDP, two percentage points of GDP lower than budgeted.

17. Discussions focused on ways to contain the financing gap. While additional measures could only go so far during what remains of the year, action where feasible in the near term would help lessen the gap.

- A prudent approach to spending would be vital given the possibility that Gaza-related measures could be reversed. The authorities plan to lock-in wage bill savings by maintaining a zero ceiling on net hiring. Staff encouraged them to further contain spending, focusing on reducing the cost of health referrals, continued wage bill restraint, stronger controls and targeting of social transfers to the poorest, and eliminating remaining fuel subsidies. Cooperation from the GoI would also be instrumental in the PA's ability to enhance cost recovery for key public utilities (i.e., electricity, water and sanitation).

- The authorities focused on options to boost revenues, such as raising property tax collections based on updated valuations. They also pointed to plans to raise government fees, while streamlining the overall fee structure to reduce the administrative burden on the private sector. While too soon to assess the potential revenue gain, it is unlikely to materialize before end-2017. While staff favors restoring the 20 percent corporate income tax rate and introducing a 10 percent dividend withholding tax, the authorities pointed to concerns about potential strains on the private sector.

Fiscal Measures Proposed by Staff

Measures	NIS million	% GDP
Identified financing gap in 2017	**2,165**	**4.0**
Total proposed measures	**502**	**0.9**
Return to 20 percent income tax rate	200	0.4
Introduce a 10 percent dividend withholding tax	194	0.4
Eliminate fuel tax subsidy	108	0.2
Other unidentified measures/new financing	**1,663**	**3.1**

Source: IMF staff calculations.

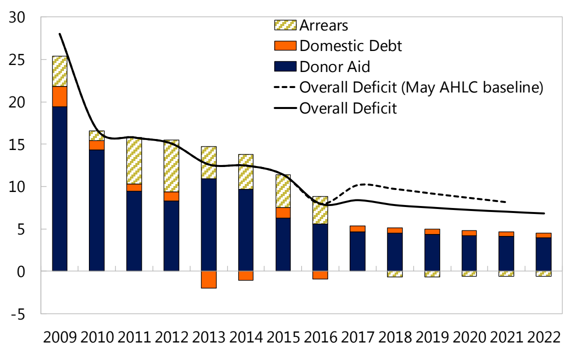
- The authorities underscored the potential to further reduce revenue leakages through deeper dialogue with the GoI. Staff welcomed the reduced volatility in CR transfers in the first half of 2017 and the resumption of high-level ministerial meetings. With CRs representing around 70 percent of PA revenues, action to reduce leakages (including scaling back the associated 3 percent administration fee) offers significant upside. Staff encouraged further progress to achieve tangible results based on fair and transparent discussions.

- Additional donor support would be instrumental in further narrowing the financing gap and limiting the accumulation of arrears. Staff pointed to unforeseen interest payments as indicative of the unpredictable cost of short-term financing, including through arrears. Developing a comprehensive arrears strategy, including accounting for all arrears and agreeing terms for their repayment, could help provide more certainty and generate a longer debt maturity profile.

The Payoffs of Medium-Term Fiscal Reforms

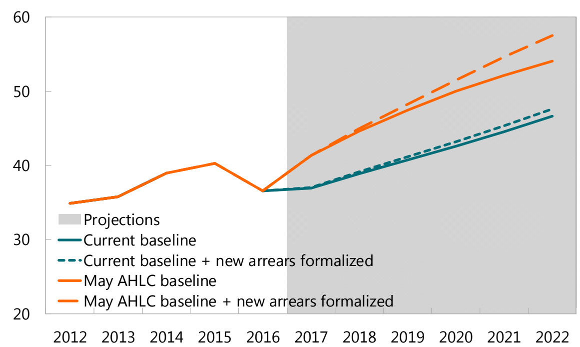
18. Large financing gaps continue to dominate the medium-term fiscal outlook, despite recent expenditure cuts. While the projected financing gaps are, on average, 1½ percentage points of GDP lower than staff's previous AHLC report, they still hover above 3 percent of GDP. Achieving fiscal sustainability remains a challenge. Even with the improved baseline, public debt will continue its upward trajectory and lower growth will make fiscal adjustment more difficult (Annex II). Moreover, important fiscal risks remain, including the possibility of constraints in fully implementing the Gaza-related measures or steeper declines in donor support.

Deficit and Financing
(In percent of GDP)



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

Gross Nominal Public Debt
(In percent of GDP)



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

19. The authorities and staff discussed the need for sustained fiscal adjustment. Based on measures already in place, the recurrent deficit is projected to decline by around 0.2 percentage points per year. However, staff suggested that additional measures could achieve an average annual reduction of a ½ percentage point of GDP and achieve a financing gap of under 2.5 percent of GDP in 2020. Focusing on reducing the recurrent deficit—through a mix of revenue and recurrent spending adjustments—is consistent with the need to shift toward donor-financed investment (particularly in infrastructure) and to limit the impact on growth.

20. It will be important for revenue reforms to focus on their effect on equitable, private sector-led growth. The authorities noted that small firms account for over half of all employment and operate mostly in the informal sector. Staff suggested that simplifying the tax treatment of small and medium-sized enterprises (SMEs) could help broaden the income tax base. Based on IMF TA, options could include: a basic presumptive "lump sum" tax for microbusinesses, a flat rate turnover tax for SMEs, and a standard set of information to be shared based on the single taxpayer identifier number (TIN). Staff cautioned against using tax holidays to incentivize foreign investment, and suggested accelerated capital depreciation as a preferred approach that promotes re-investment. Finally, while efforts to collect VAT and improve the valuation of goods imported from Israel are essential to raise CRs, any longer-run plans to transfer customs functions from the GoI to the PA will require close attention to capacity-building and regulatory reform.

21. **The authorities and staff agreed there is significant scope to control structural drivers of public expenditure over the medium term.** This will involve addressing complex policy issues (e.g., the health care referral system), and fundamental institutional reforms of the civil service (beyond the recent Gaza measures) and the public pension regime. Staff recommended reviewing the actuarial model underpinning the public pension scheme, particularly given WBG's rapidly changing demographic structure. Staff also encouraged the authorities to limit the risk of contingent liabilities stemming from losses in key public utilities by: (i) reforming the regulatory framework; and (ii) better targeting remaining subsidies. These reforms could help shift the composition of expenditure toward capital spending and help rehabilitate WBG's capital stock. The authorities also pointed to the importance of donors funding public investments to improve the composition, and effectiveness, of public expenditure.

22. **Staff commended the authorities for finalizing the new public financial management (PFM) strategy.** By helping to improve the allocation and control of resources, and the efficiency of public spending, stronger PFM systems will be instrumental in supporting fiscal adjustment. The authorities highlighted their commitment to improve PFM, including limiting the number of bank accounts and monitoring arrears. The authorities also pointed to ongoing work to complete the State Audit and Administrative Control Bureau's audits of financial statements for 2013-15. Key outstanding PFM issues include commitment controls, the accounting treatment of expenditures for commitment and accrual purposes, payment programming, debt management, and arrears recording and clearing. As the strategy's success will depend on effective implementation, coordination with, and technical and financial support from, donors will be crucial. To this end, IMF TA is planned to help develop a priority action plan and the World Bank is preparing a PFM project. Staff encouraged finalizing the re-organization of the ministry to clarify accountabilities in implementing the strategy. In that connection, staff called for clearly designating the macroeconomic forecasting function and adequately staffing the Macro-Fiscal Unit.

C. Managing Risks to Ensure Sound Financial Intermediation

23. **Staff emphasized the importance of continuing to strike the right balance between financial stability and inclusion.** The authorities pointed to progress in improving financial access to remote clients and increasing credit to SMEs (up from $500 million in 2013 to $1.5 billion in 2016). Staff welcomed these efforts, while highlighting the potential macro-financial stability risks of persistent rapid credit growth. While there is no conclusive evidence of excessive leverage, declining prudential buffers and limited policy options give little room to respond if faced with a financial shock (Box 2). The Palestine Monetary Authority (PMA) noted action under way to replenish banks' capital buffers to a minimum of $75 million by July 2018. Staff supported these efforts and suggested that further strengthening capital buffers could help manage possible shocks, including potential spillovers from Gaza. Finally, staff and the authorities agreed that the PMA's significant investments in risk-based supervision would position them well to take a more proactive stance on macro- and micro-prudential supervision.

Box 2. Reassessing Rapid Credit Growth in West Bank and Gaza

Sustained, rapid private sector credit growth in WBG is not well explained by economic activity. Bank credit to the private sector has grown by an annual average of 20 percent since 2009, more than double the rate of nominal GDP growth. The pace of credit growth shows little signs of abating, expanding at nearly 25 percent year-over-year in 2016, widening the gap with nominal GDP growth.

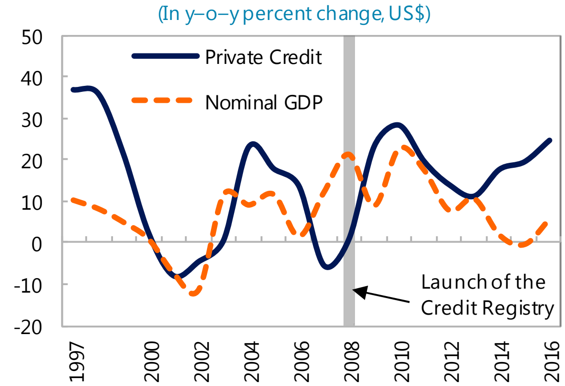
Increased financial inclusion may explain some of this gap. For much of the past decade, WBG has also experienced rapid deposit growth and deepening financial markets. While domestic credit to the private sector as a share of GDP remains well below most regional peers, the difference has narrowed since 2013.

Yet, this does not preclude a buildup of macro-financial risks, including the potential emergence of a credit boom linked to excessive leverage and asset price bubbles, with attendant risks for macro-financial stability. Similar fears arose for regional peers during their phases of rapid private sector credit growth.[1]

There is no conclusive statistical evidence of a credit boom forming. Using an HP-filtered trend of credit to the private sector, staff find that the rise of credit to the economy is not out of line with the trend growth. However, this analysis is sensitive to the sample period, with the strong growth of the past 4 years pulling up the trend. Excluding these years from the trend calculation would produce less favorable results.

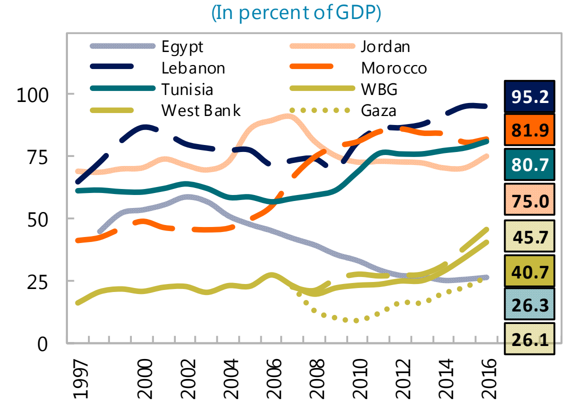
However, this provides limited comfort about potential risks, as statistical analysis is known to miss credit booms associated with financial crises. In WBG, private sector credit remains highly concentrated in a few sectors, with a significant share financing consumption and other non-productive activities.

Growth of Private Credit and Nominal GDP
(In y–o–y percent change, US$)



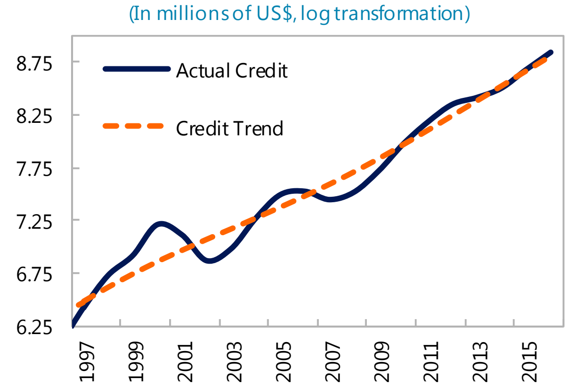
Sources: National authorities; and IMF staff calculations.

Credit to the Private Sector
(In percent of GDP)



Source: IMF staff calculations.

Growth of Total Credit Relative to Trend
(In millions of US$, log transformation)

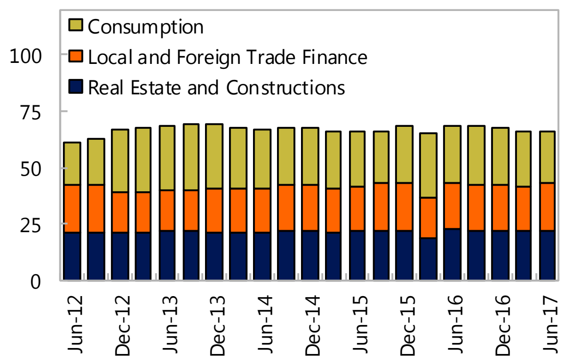


Sources: National authorities; and IMF staff calculations.

Box 2. Reassessing Rapid Credit Growth in West Bank and Gaza (concluded)

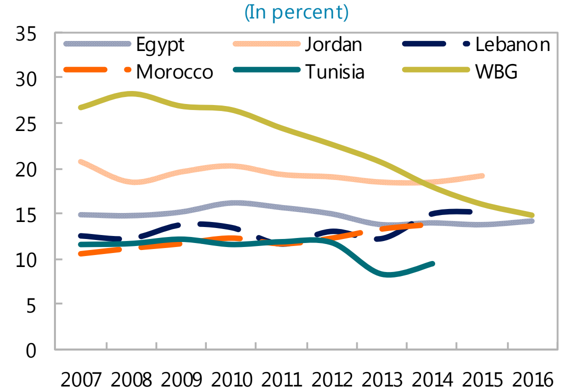
The erosion of banks' buffers and WBG's limited policy options, therefore, warrant active risk management. Sustained credit growth has seen a commensurate steady decline in capital adequacy to a 10-year low. The banking sector also remains heavily exposed to the public sector. With no independent monetary policy, no access to capital markets, and ongoing fiscal constraints, there is little ability to recapitalize the banking system in the event of a shock. In this context, the PMA's efforts to raise minimum bank capital—first to $75 million and eventually $100 million—and give more attention to financial stability are well placed.

Concentration of Private Credit
(In percent of total private credit)



Source: Palestine Monetary Authority.

Capital Adequacy Ratio
(In percent)



Source: Regional Economic Outlook.

Prepared by Gregory Basile and Priscilla Toffano.
[1] Morocco Article IV (2009) and Tunisia Article IV (2009).

24. **Discussions also focused on risks from credit concentration and banks' exposure to the PA.** Staff and authorities agreed that the large direct and indirect exposure to the public sector remains a dominant prudential risk. Together with the large share of bank credit for consumption and construction, this could impinge on banks' ability to support productive private sector investments. Faced with large and persistent financing gaps, it will be important to ensure that banks continue to observe the regulatory limit. The PMA noted the recently introduced 5 percent risk weight for loans to the PA, and plans to increase it steadily to 20 percent by 2020. In addition to monitoring credit concentration limits, staff suggested that non-bank lending, and the relationship between credit and informal activity in the construction sector warrant close attention. The PMA's efforts to use the credit registry more efficiently should help.

25. The integrated nature of the Palestinian and Israeli financial systems pose two additional unique risks.

- The authorities noted that Israeli-Palestinian CBRs remain under threat. Given the potential adverse economic impact,[6] staff welcomed the authorities' sustained efforts to enhance the AML/CFT regime with ongoing IMF TA (Box 3) and by accelerating work on the NRA in preparation for the MENAFATF evaluation scheduled for 2020. While acknowledging ongoing work to finalize details of the Israeli authorities' temporary solution to strained CBRs, staff cautioned the PA to avoid providing financial guarantees that could jeopardize fiscal sustainability—particularly given interconnected sovereign and financial risks. Staff support the ongoing dialogue between both parties to find a long-term solution.

Box 3. Reforming West Bank and Gaza's AML/CFT Framework

In recent years, the WBG authorities have accelerated efforts to reform their AML/CFT framework. With a view to adhering to international standards, WBG adopted in 2015 a new AML/CFT law (replacing the 2007 AML law) and a decree to implement targeted financial sanctions. They also joined the regional Financial Action Task Force-style body (MENAFATF). As Israeli-Palestinian correspondent bank relations became increasingly strained in 2016, the WBG authorities stepped up these reform efforts, with further updates to the AML/CFT law and instructions for reporting entities, and requesting its first AML/CFT assessment (scheduled by MENAFATF for 2020).

The authorities have engaged international partners to bolster these reforms. The IMF commenced a multi-year technical assistance (TA) project in mid-2016 to help further strengthen WBG's CFT legal framework. The authorities also initiated in early 2017 a National Risk Assessment (NRA), with support from the World Bank.

There has been good progress under the IMF TA, the scope of which includes reviewing the CFT legislation, the framework to implement targeted financial sanctions and the instructions on preventive measures. The authorities produced draft amendments of the 2015 AML/CFT law and relevant CFT provisions in the penal code. In 2016, they issued new AML/CFT instructions for reporting entities, with a guidebook and a reporting form to be used upon ML/TF suspicion. IMF staff reviewed the AML/CFT law, the amendments to the penal code, and the decree to implement targeted financial sanctions. At a workshop in Jordan in May 2017, staff and the authorities discussed further possible refinements to these documents, including: criminalizing terrorist financing; implementing the United Nations Security Council Resolutions 1373 and 1267 on targeted financial sanctions and the designation process; preventive measures; operational independence of the financial intelligence unit; cross-border declarations; and confiscation measures, as well as priority areas for further enhancing the framework.

Prospects for a more robust AML/CFT framework in the medium term are encouraging. Following the Jordan workshop, the authorities are continuing to actively engage with IMF staff on legislative drafting, and their NRA work will help map AML/CFT vulnerabilities and identify priority areas for risk mitigation. The authorities' work plan includes two key actions for 2018: enacting a new AML/CFT law, and adopting new regulations on targeted financial sanctions.

Prepared by Arz El Murr and Anusree Garg (both LEG).

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

- The PMA emphasized that limits on transferring shekel banknotes continue to create liquidity risks and opportunity costs associated with the excess cash building up in banks. Staff supported joint work by the PMA and BoI toward revising the monthly cash transfer limit from banks operating in the West Bank. Staff analysis also suggests that the sources of cash flowing into the West Bank provide a basis for raising the limit. The new *Electronic Transaction Law* should help alleviate cash pressures by providing the framework to promote cashless transactions. However, as this will take time to bear fruit, staff saw more near-term promise in efforts to introduce electronic wage payments for Palestinians working in Israel, but noted implementation delays in the Israeli payment system.

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26. Prolonged periods of conflict and political uncertainty have taken a toll on WBG's development prospects. The erosion of the capital stock has stunted the economy's growth potential. Moreover, recent developments have made the economic outlook increasingly fragile, particularly with deteriorating infrastructure and recent expenditure cuts pointing to lower growth in Gaza. Over the medium term, stagnating GDP growth will remain insufficient to generate job opportunities or meaningfully improve people's lives, particularly with looming demographic challenges. Not only have risks become more elevated, but there is an increasing likelihood of risks fueling one another. Along with other economic and political risks, rising discontent could fuel unrest and immobilize the economy.

27. Transitioning from public sector to private sector-led growth will be critical to capitalize on WBG's demographic dividend. A breakthrough on the peace process will be needed to fully unlock the potential of the private sector. However, steps toward improved access to goods and markets could be possible, if restrictions were eased with the cooperation of the GoI. The PA can take independent action on several fronts to begin building the foundation for stronger and more inclusive growth, including: (i) modernizing the regulatory environment; (ii) further developing institutions to facilitate trade and investment; and (iii) continuing fiscal and financial reforms.

28. Despite stronger-than-expected fiscal performance in the first half of the year, a sizeable financing gap will remain for 2017. With tax administration reforms bearing fruit, together with Gaza-related spending cuts (projected to save 1.5 percentage points of GDP this year), the overall deficit is anticipated to reach 8.4 percent of GDP, lower than previously projected. However, with donor aid on track to decline—as budgeted—by 20 percent compared to 2016, a financing gap of 4 percent of GDP will remain in 2017. While there is a limit to how much progress can be made during the remainder of the year, additional measures in the near term can help narrow this gap. Efforts to contain spending could focus on reducing the cost of health referrals, continued wage bill restraint, and better targeting of social transfers. This could be complemented by restoring the top corporate income tax rate, introducing a dividend withholding tax, and eliminating fuel tax subsidies. Given broader fiscal risks, the authorities are also working on plans to boost revenues through reforming the government fee structure and property tax collections.

29. Continued reforms will be essential to secure fiscal sustainability over the medium term. Further fiscal adjustment—through a balanced mix of revenue and spending measures—can help narrow persistent financing gaps and create space to invest in rehabilitating the economy's productive capacity. It will be important to supplement tax administration efforts with judicious tax policy reforms (e.g., simplifying the tax treatment of SMEs). Plans to step up PFM reforms can bolster these efforts by improving the allocation and efficiency of public spending. Moreover, rebalancing spending will require broad civil service and pension reforms, beyond the cuts and retrenchments in Gaza. While the impact of this mix of reforms may only be visible over time, they can also amplify efforts to support private sector-driven growth. In this respect, the PA can leverage PFM reforms to catalyze donor support that can underpin the shift toward investment spending, particularly in energy and other infrastructure. Close cooperation with Israel is vital to enable the PA to strike a balance between achieving fiscal sustainability and investing in growth.

30. While financial sector policies are broadly sound, the evolution of certain prudential ratios warrant proactive monitoring. Ratios tracking exposure to the public sector and credit expansion together with decreasing capital buffers, point to potential vulnerabilities for Palestinian banks. The PMA's efforts to raise minimum bank capital are an important step toward strengthening buffers to help manage possible shocks and better enable the financial sector to support private sector activity. The significant investment in risk-based supervision would position the authorities to take a more assertive stance on macro- and micro-prudential supervision. Meanwhile, cooperation between the PMA and BoI on analyzing sources of excess NIS cash in WBG is improving prospects for resolving this issue. Continuous dialogue with the GoI, together with efforts to strengthen the AML/CFT regime, will be crucial to devise a long-term solution to strained CBRs. However, the PA should resist pressures to provide financial guarantees that could jeopardize fiscal sustainability.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2015–22

(Per capita GDP: $2,813; 2016)

(Poverty rate: 16 percent in the West Bank and 39 percent in Gaza Strip; 2014 est.)

			Projections					
	2015	2016	2017	2018	2019	2020	2021	2022
Output and prices			(Annual percentage change)					
Real GDP (2004 market prices)	3.4	4.1	3.1	3.0	3.0	3.0	3.0	3.0
West Bank	2.6	3.0	2.7	2.7	2.7	2.7	2.7	2.7
Gaza	6.1	7.7	4.5	4.0	4.0	4.0	4.0	4.0
CPI inflation rate (end-of-period)	1.0	-1.0	1.2	2.0	2.0	2.0	2.0	2.0
CPI inflation rate (period average)	1.4	-0.2	0.5	1.6	2.0	2.0	2.0	2.0
Investment and saving			(In percent of GDP)					
Gross capital formation, *of which:*	21.1	20.9	19.3	19.0	19.0	18.8	18.7	18.6
Public	4.7	5.2	4.6	4.7	4.6	4.7	4.7	4.7
Private	16.3	15.8	14.8	14.3	14.3	14.1	14.0	13.9
Gross national savings, *of which:*	4.8	11.0	6.3	5.8	5.5	5.5	5.4	5.4
Public	-4.0	-1.0	-2.6	-2.2	-2.0	-1.9	-1.8	-1.7
Private	8.8	12.0	8.8	8.0	7.5	7.3	7.2	7.1
Saving-investment balance	-16.3	-9.9	-13.1	-13.2	-13.4	-13.3	-13.3	-13.3
Public finances 1/			(In percent of GDP)					
Revenues	21.7	25.5	23.7	23.7	23.8	23.8	23.8	23.8
Recurrent expenditures and net lending	31.3	31.0	29.7	29.2	29.0	28.7	28.5	28.3
Wage expenditures	15.1	15.1	13.7	13.3	13.3	13.2	13.1	13.0
Nonwage expenditures	13.9	14.0	14.4	14.5	14.5	14.5	14.5	14.5
Net lending	2.4	2.0	1.6	1.4	1.2	1.1	0.9	0.8
Recurrent balance (commitment, before external support)	-9.6	-5.5	-6.1	-5.5	-5.2	-4.9	-4.7	-4.5
Recurrent balance (cash, before external support)	-4.5	-1.1	-6.8	-6.2	-5.8	-5.5	-5.3	-5.1
Development expenditures	1.8	2.5	2.3	2.3	2.3	2.3	2.3	2.3
(In millions of U.S. dollars)	230	335	333	348	364	380	397	414
Overall balance (commitment, before external support)	-11.4	-8.0	-8.4	-7.8	-7.5	-7.2	-7.0	-6.8
Total external support, including for development expenditures	6.3	5.6	4.7	4.5	4.4	4.2	4.1	4.0
(In millions of U.S. dollars)	799	760	666	674	683	692	702	711
External support for recurrent expenditure (in millions of U.S. dollars)	709	603	500	500	500	500	500	500
Financing gap (in millions of U.S. dollars)	...	...	580	544	539	540	548	553
In percent of GDP	...	...	4.0	3.6	3.4	3.3	3.2	3.1
Monetary sector 2/			(Annual percentage change)					
Credit to the private sector	19.2	20.0	15.0	14.0	13.0	13.0	12.0	12.0
Private sector deposits	7.3	9.0	8.3	8.1	8.0	8.1	8.1	8.1
External sector			(In percent of GDP)					
Current account balance (excluding official transfers)	-21.8	-14.4	-16.6	-16.5	-16.6	-16.4	-16.2	-16.1
Current account balance (including official transfers)	-16.3	-9.9	-13.1	-13.2	-13.4	-13.3	-13.3	-13.3
Exports of goods and nonfactor services	18.4	17.9	16.6	16.6	16.7	16.8	16.8	16.9
Import of goods and nonfactor services	59.3	56.1	54.8	54.8	55.2	55.2	55.2	55.2
Net factor income	13.5	11.6	11.9	11.9	11.9	11.8	11.8	11.8
Net current transfers	11.2	16.6	13.2	13.1	13.2	13.3	13.3	13.2
Private transfers	5.6	12.1	9.7	9.8	10.0	10.2	10.4	10.4
Official transfers	5.6	4.5	3.5	3.3	3.2	3.1	2.9	2.8
Memorandum items:								
Nominal GDP (in millions of U.S. dollars)	12,713	13,551	14,324	14,994	15,685	16,378	17,118	17,817
Per capita nominal GDP (U.S. dollars)	2,715	2,813	2,892	2,943	2,994	3,040	3,091	3,129
Unemployment rate	26	26	28	29	30	31	31	31
Al Quds stock market index (annual percentage change)	6.0	n.a.	...	...	...	...	...	...

Sources: West Bank and Gaza authorities; World Bank; 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, 2015–20

			Budget	Projections			
	2015	2016	2017	2017	2018	2019	2020
			(In millions NIS)				
Net revenues	10,712	13,276	13,451	12,654	13,327	14,073	14,837
Gross domestic revenues	3,323	4,701	5,041	4,225	4,457	4,707	4,970
Tax revenues	2,354	2,392	3,141	2,792	2,943	3,113	3,294
Nontax revenues	969	2,309	1,900	1,433	1,515	1,593	1,676
Nontax revenues (cash)	969	2,291	1,900	1,433	1,515	1,593	1,676
Of which: arrears	…	18…	…	…	…	…	…
Clearance revenues (accrued)	7,988	8,930	8,780	8,651	9,056	9,518	10,005
Clearance revenues (cash)	7,953	8,872	8,780	8,651	9,056	9,518	10,005
Of which: arrears	35	58	…	…	…	…	…
Less tax refunds 1/	599	355	370	222	187	152	137
Of which: arrears	335	-17	…	…	…	…	…
Of which : fuel tax refund (fuel subsidy)	494	244	0	108	67	26	4
Recurrent expenditures and net lending (commitment)	15,453	16,137	16,147	15,904	16,419	17,145	17,909
Of which: arrears	2,194	2,366	-1,170	-373	-375	-378	-381
Wage expenditures (commitment)	7,439	7,837	8,093	7,337	7,499	7,848	8,216
Of which : arrears	603	505	…	…	…	…	…
Nonwage expenditures (commitment)	6,844	7,270	7,104	7,698	8,161	8,588	9,034
Of which: arrears	1,592	1,860	-1,170	-373	-375	-378	-381
Net lending	1,169	1,029	950	869	759	709	659
Development expenditures (commitment)	893	1,287	1,639	1,242	1,305	1,375	1,448
Of which: arrears	206	463	…	…	…	…	…
Recurrent balance (commitment, excl. development expenditure)	-4,741	-2,861	-2,696	-3,250	-3,093	-3,073	-3,072
Overall balance (commitment)	-5,635	-4,148	-4,335	-4,492	-4,398	-4,448	-4,520
Total financing	5,635	4,148	4,335	4,492	4,398	4,448	4,520
Net domestic bank financing	677	-415	…	373	375	378	381
External debt repayment	-43	-71	…	-160	-168	-164	-171
External financing for recurrent expenditures	2,757	2,318	1,950	1,867	1,875	1,888	1,903
External financing for development expenditures	347	602	546	621	653	691	731
Arrears accumulation (net)	1,876	1,697	-1,170	-373	-375	-378	-381
Of which: repayment	-917	-1,215	-1,170	-373	-375	-378	-381
Residual/financing gap	20	18	3,009	2,165	2,039	2,033	2,056
			(In millions U.S. dollars)				
Net revenues	2,756	3,457	3,603	3,389	3,554	3,727	3,898
Gross domestic revenues	855	1,224	1,350	1,132	1,189	1,247	1,305
Tax revenues	606	623	841	748	785	825	865
Nontax revenues	249	601	509	384	404	422	440
Clearance revenues (accrued)	2,055	2,325	2,352	2,317	2,415	2,521	2,628
Less tax refunds	154	92	99	59	50	40	36
Recurrent expenditures and net lending (commitment)	3,976	4,202	4,325	4,260	4,379	4,541	4,705
Wage expenditures (commitment)	1,914	2,041	2,168	1,965	2,000	2,079	2,158
Nonwage expenditures (commitment)	1,761	1,893	1,903	2,062	2,177	2,275	2,373
Net lending (commitment)	301	268	254	233	202	188	173
Development expenditures (commitment)	230	335	439	333	348	364	380
Recurrent balance (commitment, excl. development expenditure)	-1,220	-745	-722	-871	-825	-814	-807
Overall balance (commitment)	-1,450	-1,080	-1,161	-1,203	-1,173	-1,178	-1,187
Total financing	1,450	1,080	1,161	1,203	1,173	1,178	1,187
Net domestic bank financing	174	-108	…	100	100	100	100
External debt repayment	-11	-18	…	-43	-45	-44	-45
External financing for recurrent expenditures	709	603	522	500	500	500	500
External financing for development expenditures	89	157	146	166	174	183	192
Arrears (net)	483	442	-313	-100	-100	-100	-100
Of which: repayment	-236	-316	-313	-100	-100	-100	-100
Residual/Financing gap	5	5	806	580	544	539	540
Memorandum items:			(In percent of GDP, unless otherwise stated)				
Revenues	21.7	25.5	25.2	23.7	23.7	23.8	23.8
Recurrent expenditures and net lending	31.3	31.0	30.2	29.7	29.2	29.0	28.7
Recurrent balance (commitment) before external support	-9.6	-5.5	-5.0	-6.1	-5.5	-5.2	-4.9
External financing for recurrent expenditures	5.6	4.5	3.6	3.5	3.3	3.2	3.1
Development expenditures (cash)	1.4	1.6	3.1	2.3	2.3	2.3	2.3
Overall balance (commitment)	-11.4	-8.0	-8.1	-8.4	-7.8	-7.5	-7.2
Overall balance (cash)	-5.9	-2.7	-10.3	-9.1	-8.5	-8.1	-7.9
Residual/financing gap	0.0	0.0	5.6	4.0	3.6	3.4	3.3
Nominal exchange rate (NIS per U.S. dollar)	3.89	3.84	…	…	…	…	…
Nominal GDP (in millions of shekels)	49,411	52,044	53,477	53,477	56,221	59,220	62,348

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

Table 3. West Bank and Gaza: Central Government Fiscal Operations, 2015–20 (GFSM 2001)

	2015	2016	Projections 2017	2018	2019	2020
	(In millions of shekels)					
Revenue	13,816	16,195	15,141	15,854	16,652	17,472
Taxes	9,743	10,967	11,221	11,812	12,479	13,162
Domestic taxes	2,354	2,392	2,792	2,943	3,113	3,294
Clearance taxes	7,988	8,930	8,651	9,056	9,518	10,005
Tax refund	-599	-355	-222	-187	-152	-137
Grants	3,105	2,919	2,487	2,528	2,579	2,635
External budget support	2,757	2,318	1,867	1,875	1,888	1,903
External development support	347	602	621	653	691	731
Other revenue	969	2,309	1,433	1,515	1,593	1,676
Of which: dividends	122	290	180	190	200	210
Expenditures	16,346	17,423	17,146	17,725	18,521	19,357
Expense	15,453	16,137	15,904	16,419	17,145	17,909
Compensation of employees 1/	7,439	7,837	7,337	7,499	7,848	8,216
Use of goods and services	2,530	2,547	2,547	2,678	2,821	2,970
Grants 2/	1,169	1,029	869	759	709	659
Other expense 3/	4,314	4,723	5,151	5,483	5,768	6,064
Net acquisition of nonfinancial assets	893	1,287	1,242	1,305	1,375	1,448
Gross operating balance	-1,637	58	-763	-565	-494	-438
Net lending / borrowing (overall balance)	-2,530	-1,229	-2,005	-1,871	-1,869	-1,885
Net financial transactions	-2,487	-1,140	-1,631	-1,871	-1,869	-1,884
Net acquisition of financial assets	…	…	…	…	…	…
Domestic						
Currency and deposits	…	…	…	…	…	…
Net incurrence of liabilities	2,468	1,122	-534	-168	-164	-171
Domestic	2,510	1,193	-373	0	0	0
Loans	634	-486	373	375	378	381
Net domestic bank financing	634	-486	373	375	378	381
Other accounts payable	1,876	1,679	-747	-375	-378	-381
Arrears (recurrent)	1,612	1,116	-747	-375	-378	-381
Arrears (capital)	206	463	…	…	…	…
Arrears (clearance)	35	58	…	…	…	…
Arrears (earmarked revenue)	93	158				
Foreign	-43	-71	-160	-168	-164	-171
Loans	-43	-71	-160	-168	-164	-171
Statistical discrepancy/financing gap	20	18	2,165	2,039	2,033	2,056
Memorandum items:						
Gross operating balance excl. grants (commitment)	-4,741	-2,861	-3,250	-3,093	-3,073	-3,072
Gross operating balance excl. grants (cash)	-3,164	-1,803	-3,997	-3,468	-3,450	-3,453
Overall balance (NLB) excl. grants (commitment)	-5,635	-4,148	-4,492	-4,398	-4,448	-4,520
Overall balance (NLB) excl. grants (cash)	-3,851	-2,627	-5,239	-4,773	-4,825	-4,901
Revenue (percent of GDP)	28.0	31.1	28.3	28.2	28.1	28.0
Expenditure (percent of GDP)	33.1	33.5	32.1	31.5	31.3	31.0
Expense (percent of GDP)	31.3	31.0	29.7	29.2	29.0	28.7
Wage expenditure (percent of GDP)	15.1	15.1	13.7	13.3	13.3	13.2
Nonwage expenditures (percent of GDP)	5.1	4.9	4.8	4.8	4.8	4.8
GOB (commitment) excluding grants (percent of GDP)	-9.6	-5.5	-6.1	-5.5	-5.2	-4.9
GOB (cash) excluding grants (percent of GDP)	-6.4	-3.5	-7.5	-6.2	-5.8	-5.5
External support (recurrent)	5.6	4.5	3.5	3.3	3.2	3.1
in millions of NIS	2,757	2,318	1,867	1,875	1,888	1,903
NLB (commitment) excluding grants (percent of GDP)	-11.4	-8.0	-8.4	-7.8	-7.5	-7.2
NLB (cash) excluding grants (percent of GDP)	-7.8	-5.0	-9.8	-8.5	-8.1	-7.9
Total external support (in millions of shekels)	3,105	2,919	2,487	2,528	2,579	2,635
Nominal GDP (in millions of shekels)	49,411	52,044	53,477	56,221	59,220	62,348
Exchange rate	3.9	3.8	…	…	…	…

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, 2011–17

	Dec-11	Dec-12	Dec-13	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
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	16.3	16.2
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	17.1	16.8
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	14.9	15.2
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	15.4	15.5
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	2.2	2.4
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	4.3	5.0
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	63.7	60.2
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	1.4	1.6
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	15.2	16.7
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	70.2	68.8
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	63.5	61.4
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	52.7	52.8
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	34.0	31.3
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	65.2	58.9
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	41.0	37.7

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. Risk Assessment Matrix[1]

Nature/Sources of Risk	Relative Likelihood	Expected Impact If Realized	Policies to Mitigate Risks
Domestic Risks			
Economic fragmentation due to pressures from the persistent divergence between the Gazan and West Bank economies or from settlement expansion	***High***	***High*** Further erosion of geographic control or increased restrictions on access and movement would shrink the productive resources available to the Palestinian economy. The permanent negative impact on growth would jeopardize the longer run economic viability of a Palestinian state and could fuel unrest.	Sound macroeconomic management could help instill confidence. However, economic policies can do little to mitigate geo-political risks.
Escalation of violence due to widespread discontent with the lack of a political horizon	***High***	***High*** An increase in unrest in the WBG 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, strong macroeconomic management could help instill confidence.
Deepening internal political divisions, compounded by spending cuts in Gaza	***High***	***High*** Recent Gaza-related spending cuts could precipitate deeper social and political costs that could fuel unrest and further undermine growth. If this endangers the stability of banks in Gaza, this could have economic and financial spillovers to the West Bank. More broadly, deepening political divisions could exacerbate other risks of fragmentation and unrest.	Sound macroeconomic management could help instill confidence. However, economic policies can do little to mitigate geo-political 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) Pro-growth policies, including adjusting the composition of budget spending and ensuring financial sector resilience, could over time reduce aid dependency and support fiscal sustainability.

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 pose a liquidity risk. Terminating correspondent 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.	Sound macroeconomic management could help instill confidence. However, economic policies can do little to mitigate external geo-political risks.
Structurally weak growth in key advanced economies and significant slowdown in other large emerging economies	***High/ Medium***	***Medium*** WBG is sensitive to a slowdown in Israel (for example, via developments in Europe). Fiscal strains in donor countries could limit available 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.

[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.

Annex II. Debt Sustainability Analysis Update[1]

This annex updates debt developments since the IMF staff's April 2017 report to the Ad Hoc Liaison Committee. The debt sustainability analysis (DSA)[2] suggests that public debt will continue to rise throughout the forecast period, under the baseline scenario, as financing gaps remain sizable. The debt trajectory is particularly sensitive to both fiscal and growth shocks, highlighting sustainability concerns in an environment where there are significant risks to the already low donor aid and lackluster growth.

A. Structure of Public Debt

1. At end-2016, gross public debt[3] stood at 36 percent of GDP. This decline from 2015 largely reflects the restatement of liabilities to the pension fund worth around $500 million. The public debt profile is characterized by the relatively large and rising share of domestic debt skewed towards short-term maturity, with low external debt on concessional terms.

- Domestic debt[4] represented the largest share at around 80 percent of total debt at end-2016. Of this, liabilities toward the pension fund and domestic banks represent the largest components, representing 33 percent and 30 percent of total debt, respectively. The significant share of domestic debt held by domestic banks points to the vulnerability to macro-financial risk transmission to the banking sector.

- External debt represents the remaining 20 percent of total debt, and is mostly to multilateral and official bilateral creditors on concessional terms (an average effective interest rate less than 0.5 percent).

Text Table 1. West Bank and Gaza: Total Debt Liabilities of the PA

(In percent of GDP)

	2012	2013	2014	2015	2016
Gross debt liabilities	36.1	37.3	35.8	40.4	36.1
Domestic debt	24.9	27.1	26.1	30.8	27.6
Private suppliers, municipalities 1/	2.4	4.5	3.7	3.4	4.3
Bank loans and overdrafts 1/	12.3	10.2	8.9	11.5	10.6
Other domestic loans	0.7	0.7	0.8	0.8	0.7
Pension fund liabilities	9.4	11.8	12.8	15.1	12.0
External debt	11.2	10.1	9.7	9.6	8.5
Memorandum item:					
Domestic debt (excl. pension fund)	15.5	15.3	13.4	15.7	15.6

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

1/ Excludes promissory notes.

[1] Prepared by Gregory Basile.

[2] This DSA uses the 2017 MAC DSA template developed by the IMF.

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

[4] Non-arrears domestic debt carries an interest rate of about 6 percent on average.

B. Macroeconomic Developments and Projections

2. The macroeconomic assumptions have changed since the April 2017 DSA. The growth outlook is less favorable, with the average growth rate projected to decline by 0.4 percent to 3 percent over the medium term. Expected average inflation has been revised down to 0.5 percent for 2017 and is expected to approach 2 percent over the medium term.

3. However, the fiscal outlook has improved somewhat, largely on account of Gaza-related spending cuts. With the part-year effect of these cuts—as well as improved tax administration and steady clearance revenues—the overall deficit in 2017 is projected to improve by more than 1½ percentage points of GDP relative to staff's April 2017 projection. Going forward, the overall deficit is expected to gradually contract by another 1½ percentage points of GDP by 2022, as full year-effects of Gaza-related cuts are realized from 2018 and revenue continues to improve gradually. Donor aid is expected to remain flat in nominal terms over the medium term (in line with projections in the 2017 budget), declining from 5 percent of GDP in 2016 to 3.2 percent of GDP by 2022.

C. Debt Sustainability

4. Gross public debt is projected to reach 46.6 percent of GDP by the end of the projection period. This is lower than the 54 percent of GDP projected in April 2017 due to the narrowing of the deficit and reduced financing needs. However, public debt continues to rise by around 10 percentage points of GDP over 5 years, reflecting the still large financing gaps and weaker growth.

5. Beyond the risks posed by a further decline in donor aid and the impact on arrears of widening financing gaps, the DSA stress test show that sustainability is most at risk from an adverse growth shock. A shock to growth during 2018–19[5] could add more than 8 percentage points of debt, with debt approaching 55 percent of GDP by 2022. A worsening fiscal balance[6] also represents a noticeable risk to the baseline, increasing end-2022 debt by almost 5 percentage points of GDP.

6. With flat donor financing, no access to markets and limits on prudent bank financing, the baseline assumes that a significant share of financing needs comes from the continuing accumulation of arrears, which are non-interest bearing. The short maturity of most domestic debt, including via accumulation of arrears, is an underlying source of sensitivity to analysis.[7] If new arrears were securitized at an interest rate similar to other domestic debt, this would push up the debt stock by 1 percentage point of GDP by end-2022. This heightens sensitivities to the interest rate, particularly as a market rate could well be higher, and effect would be more pronounced if the stock of arrears were also securitized.

[5] Real GDP growth shock reduces growth relative to the baseline by 1 standard deviation for two years.

[6] Primary balance shock is equal to the baseline minus half the 10-year historical standard deviation for two years.

[7] Due to the DSA template, accumulation of arrears due to the financing gap falls under the real interest rate portion of contribution to changes in public debt.

West Bank and Gaza Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

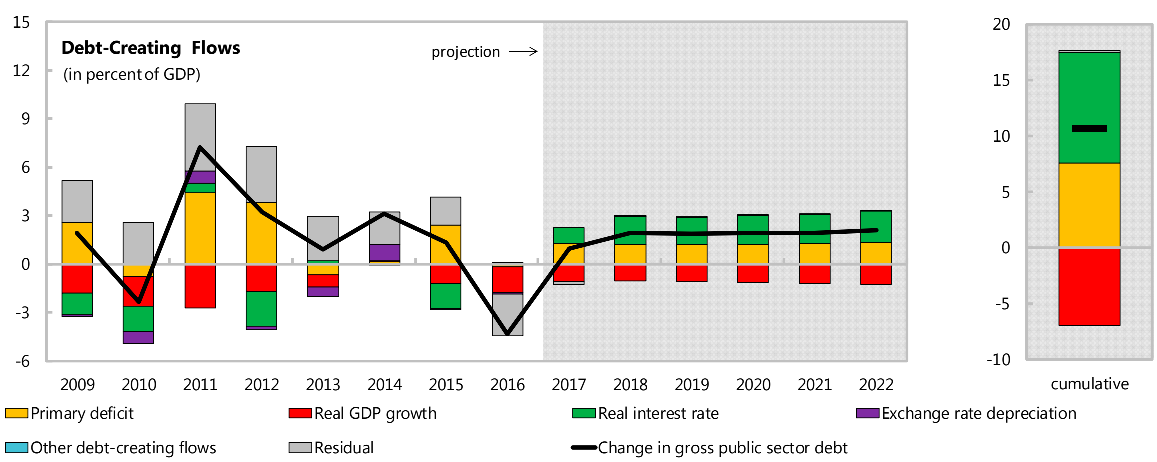
(In percent of GDP; unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2009-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	29.2	40.3	36.0	36.9	38.9	40.7	42.6	44.5	46.6
Public gross financing needs		30.5	24.4	29.6	31.4	33.3	35.5	37.7	40.1
Real GDP growth (in percent)	5.1	3.4	4.1	3.1	3.0	3.0	3.0	3.0	3.0
Inflation (GDP deflator, in percent)	3.5	5.2	1.2	-0.3	2.1	2.2	2.2	2.3	2.1
Nominal GDP growth (in percent)	8.8	8.8	5.3	2.8	5.1	5.3	5.3	5.5	5.1
Effective interest rate (in percent) [3/]	1.6	1.0	1.5	2.4	7.0	6.9	6.9	6.9	6.9

Contribution to Changes in Public Debt

	Actual			Projections							
	2009-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [8/]
Change in gross public sector debt	1.5	1.4	-4.4	1.0	1.9	1.8	1.9	1.9	2.1	10.7	
Identified debt-creating flows	-0.6	-0.4	-1.8	1.2	1.9	1.8	1.9	1.9	2.0	10.6	
Primary deficit	1.6	2.4	-0.2	1.3	1.2	1.2	1.2	1.3	1.3	7.6	0.7
Primary (noninterest) revenue and grants	37.3	28.0	31.1	28.3	28.2	28.1	28.0	27.9	27.8	168.3	
Primary (noninterest) expenditure	33.9	30.4	30.9	29.6	29.4	29.3	29.3	29.1	29.1	175.8	
Automatic debt dynamics [4/]	-2.2	-2.8	-1.6	-0.1	0.6	0.6	0.6	0.6	0.7	3.0	
Interest rate/growth differential [5/]	-2.2	-2.8	-1.5	-0.1	0.6	0.6	0.6	0.6	0.7	3.0	
Of which: real interest rate	-0.7	-1.6	0.1	1.0	1.7	1.7	1.8	1.8	2.0	10.0	
Of which: real GDP growth	-1.5	-1.2	-1.6	-1.1	-1.1	-1.1	-1.2	-1.2	-1.3	-6.9	
Exchange rate depreciation [6/]	0.0	0.0	-0.1	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
0 (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [7/]	2.9	1.8	-2.6	-0.2	0.0	0.1	0.1	0.1	0.1	0.1	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

4/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = 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).

5/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

6/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

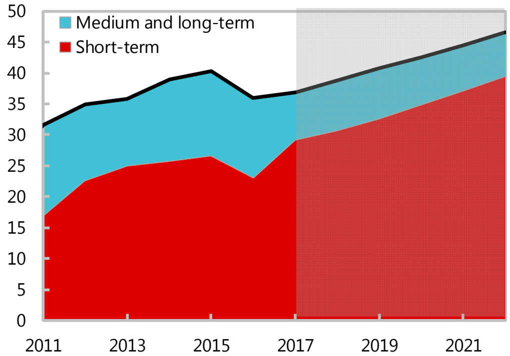
7/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

8/ 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.

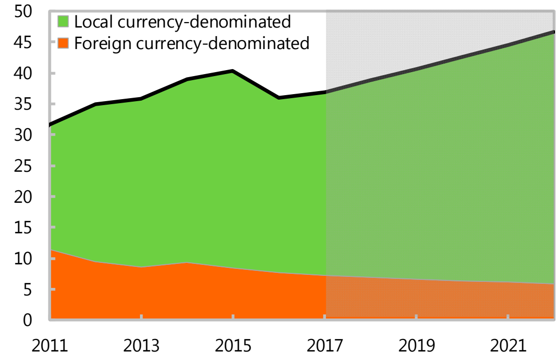
West Bank and Gaza Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



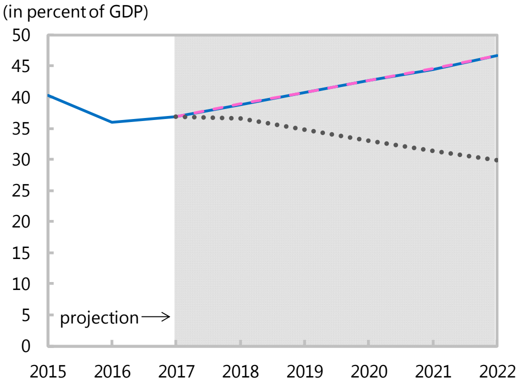
By Currency
(in percent of GDP)



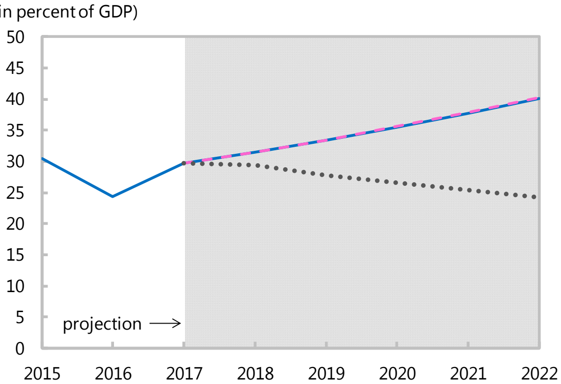
Alternative Scenarios

Baseline
Historical
Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

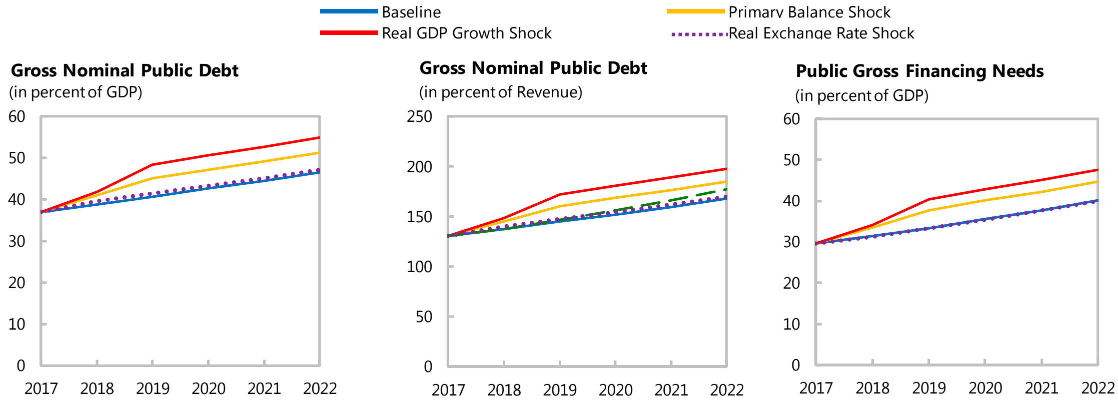
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	3.0	3.0	3.0	3.0	3.0
Inflation (GDP deflator)	-0.3	2.1	2.2	2.2	2.3	2.1
Primary Balance	-1.3	-1.2	-1.2	-1.2	-1.3	-1.3
Effective interest rate	2.4	7.0	6.9	6.9	6.9	6.9
Constant Primary Balance Scenario						
Real GDP growth	3.1	3.0	3.0	3.0	3.0	3.0
Inflation (GDP deflator)	-0.3	2.1	2.2	2.2	2.3	2.1
Primary Balance	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Effective interest rate	2.4	7.0	6.9	6.9	6.9	6.8

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	5.8	5.8	5.8	5.8	5.8
Inflation (GDP deflator)	-0.3	2.1	2.2	2.2	2.3	2.1
Primary Balance	-1.3	0.0	0.0	0.0	0.0	0.0
Effective interest rate	2.4	7.0	2.6	2.6	2.6	2.7

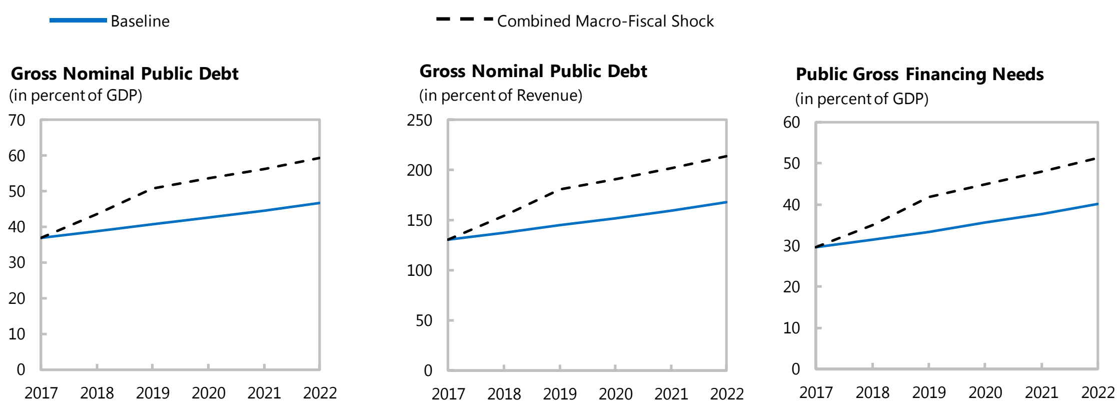
Sources: Palestinian authorities; and IMF staff.

West Bank and Gaza Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	3.0	3.0	3.0	3.0	3.0
Inflation (GDP deflator)	-0.3	2.1	2.2	2.2	2.3	2.1
Primary balance	-1.3	-3.4	-3.3	-1.2	-1.3	-1.3
Effective interest rate	2.4	7.0	7.2	7.2	6.8	6.7
Combined Shock						
Real GDP growth	3.1	-0.6	-0.5	3.0	3.0	3.0
Inflation (GDP deflator)	-0.3	1.2	1.3	2.2	2.3	2.1
Primary balance	-1.3	-3.4	-3.9	-1.2	-1.3	-1.3
Effective interest rate	2.4	7.0	8.2	8.2	8.3	8.3

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	-0.6	-0.5	3.0	3.0	3.0
Inflation (GDP deflator)	-0.3	1.2	1.3	2.2	2.3	2.1
Primary balance	-1.3	-2.6	-3.9	-1.2	-1.3	-1.3
Effective interest rate	2.4	7.0	7.1	7.3	6.8	6.8
Real Exchange Rate Shock						
Real GDP growth	3.1	3.0	3.0	3.0	3.0	3.0
Inflation (GDP deflator)	-0.3	2.4	2.2	2.2	2.3	2.1
Primary balance	-1.3	-1.2	-1.2	-1.2	-1.3	-1.3
Effective interest rate	2.4	7.0	6.8	6.8	6.8	6.7

Source: IMF staff.

West Bank and Gaza Public DSA Risk Assessment

Heat Map

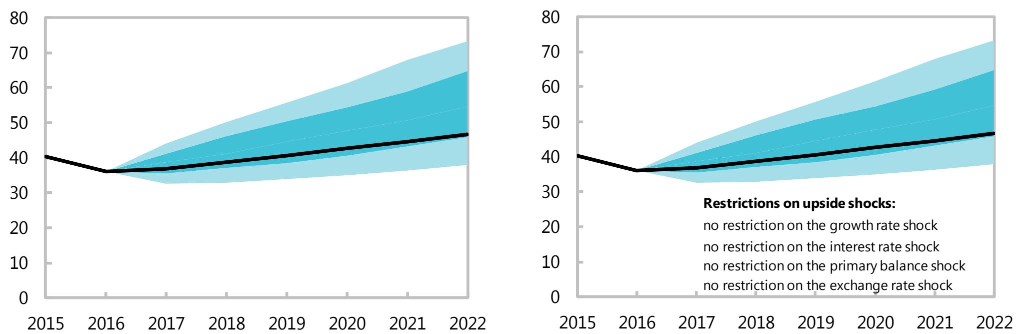
Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

Baseline   Percentiles: 10th-25th   25th-75th   75th-90th

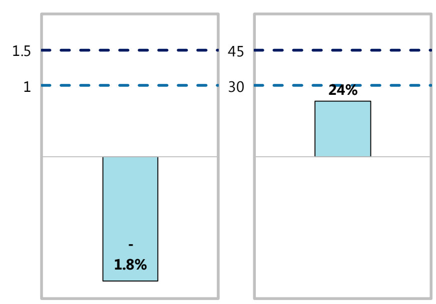
Symmetric Distribution   **Restricted (Asymmetric) Distribution**



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)

West Bank and Gaza   Lower early warning   Upper early warning



Annual Change in Short-Term Public Debt
(in percent of total)

Public Debt Held by Non-Residents
(in percent of total)

Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are: 400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

Annex III. The Cost of Conflict and Political Uncertainty for the Economy's Capacity to Grow[1]

West Bank and Gaza (WBG) has experienced a secular decline in productive capacity for much of the past two decades. Output per worker has suffered under the weight of demographic pressures, together with an insufficient capital stock. After accounting for the physical destruction of capital brought about by conflicts, the impact on capital and growth potential is even more stark—and marked by a significant divergence between the economies of Gaza and the West Bank. Rebuilding WBG's growth potential and raising living standards will require a lasting improvement in the investment climate. While this ultimately requires a breakthrough in the peace process, the authorities can still take steps to address the current investment gap and lay the groundwork for higher private sector-led growth.

A. Motivation

1. **Examining the capital stock highlights the significant negative impact that conflicts and political instability have had on WBG.** The lasting and asymmetric effects of past conflicts have constrained the Palestinian economy's productive capacity and ability to grow. Moreover, broader political uncertainties and ongoing restrictions have also impeded investment. Together, these conditions have eroded the capital stock through both physical destruction as well as unrealized capital growth. Without a sufficient level of capital stock, output per capita cannot be expected to meaningfully grow as workers are not properly furnished with the tools to increase productivity. While this annex focuses on the capital stock, boosting productivity amid growing demographic pressures will also require other structural reforms and investments in human capital (e.g., improving the quality of education spending) as noted in Box 1.

2. **Capital stock analysis also allows us to understand the different trajectories of Gaza and the West Bank.** Recurring conflict in Gaza since the mid-2000s, —as well as domestic political divisions and the near-total blockade—have created vastly different situations between the two regions. This affects the trajectory of productivity growth between the two, and therefore the scale and urgency of policy action needed in each region to rebuild the economy's productive base and raise economic growth.

B. Methodology: Accounting for Conflict when Measuring the Capital Stock

3. **We use the Perpetual Inventory Method (PIM) to determine the capital stock over time.** This uses a law of motion that adjusts the capital stock by adding investment[2] and subtracting the depreciated capital from the previous year, with an initial "assumed" capital-output ratio to give

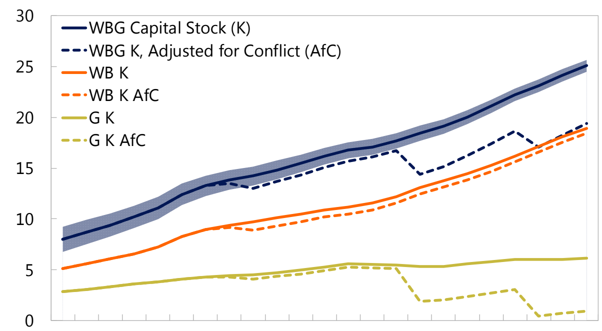
[1] Prepared by Gregory Basile.

[2] For our calculations, real investment data refers to gross fixed capital formation in 2004 U.S. dollars, and comes from authorities' national accounts data.

a base for the capital stock.[3] However, since West Bank and Gaza (WBG) has undergone periods of unrest and conflict that have destroyed existing physical capital, this approach must be modified to account for these episodes for a more accurate picture.

4. **The initial PIM-derived capital stock is adjusted to account for the destruction of physical capital** by subtracting the damage to capital that occurred during the conflict period, as measured by independent sources. We account for three specific periods: the Second Intifada (2000-02), the 2008-09 Gaza War, and the 2014 Gaza Conflict. Accounting for these conflicts provides a more accurate picture of the present-day capital stock. We also demonstrate the robustness of our measure for WBG's current capital stock by using different initial capital-output ratios (+/- 15 percent) to create a confidence band, resulting in a tight confidence interval of +/- 2 percent by 2016.

West Bank and Gaza's Capital Stock
(In billions 2004 USD)

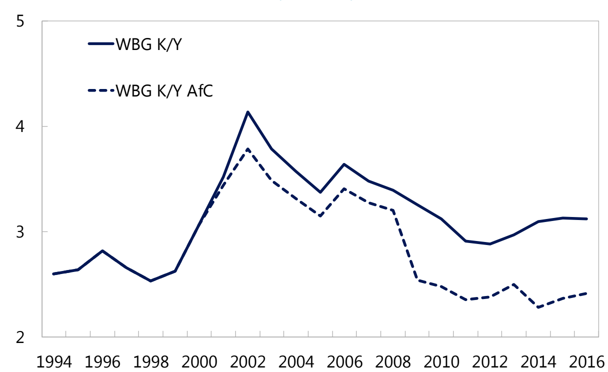


Sources: Penn World Table (PWT); United Nations Relief and Works Agency (UNRWA); and IMF staff calculations.

C. The Evolution of the Capital-Output Ratio (K/Y)

5. **WBG suffered a large decline in the capital-output ratio during the Second Intifada.** Prior to this, the capital-output ratio was largely stable. The ratio spiked at the outset of the conflict as the dramatic collapse in GDP initially outweighed the detrimental impact on capital formation. Between 2000 and 2002, GDP declined as much as 12 percent per year.[4] However, the significant slowdown in the rate of capital formation—down as much as 26 percent per year during 2000-02, or over 50 percent from 1999 to 2002—became evident as GDP recovered and the ratio declined steadily. This demonstrates WBG's increased reliance on population-led economic growth, as capital began to generate less economic growth.

West Bank and Gaza's Capital-Output Ratio
(As a ratio)



Sources: PWT; UNRWA; and IMF staff calculations.

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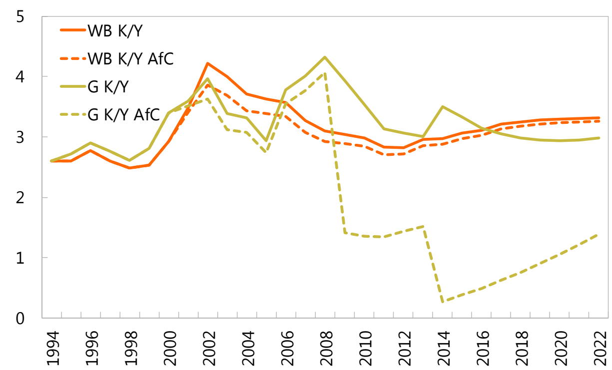
[3] See Annex in Basile, Gregory, 2016, "Conflicts and Lebanon's Capital Stock" in *Lebanon: Selected Issues* (Washington: International Monetary Fund).

[4] World Bank, 2003, *Twenty-Seven Months - Intifada, Closures and Palestinian Economic Crisis* (May).

6. Disentangling the impact on the capital-output ratio in West Bank and in Gaza demonstrates the asymmetric impact on the economy's productive base. With recent conflicts concentrated in Gaza, the region has experienced a near total collapse in its productive capacity. The 2008–09 war is estimated to have resulted in nearly $4 billion worth of damage[5]—equivalent to over 60 percent of Gaza's total capital stock. While the capital-output ratio subsequently stabilized, it suffered another blow with the 2014 conflict. Damage assessments of the 2014 conflict are in the range of $3-6 billion, depending on the source.[6] Using the midpoint of $4.5 billion, this represented an 85 percent decline in Gaza's capital stock. The marginal increase in recent years has barely made a dent, leaving Gaza's capital stock depleted and the capital-output ratio a fraction of what is was two decades ago. The West Bank did not undergo the same dramatic destruction of capital over the past decade. However, the flat capital-output ratio—particularly in an environment where growth has stagnated—is indicative of the broader constraints on boosting investment.

West Bank and Gaza's Capital-Output Ratios
(As a ratio)

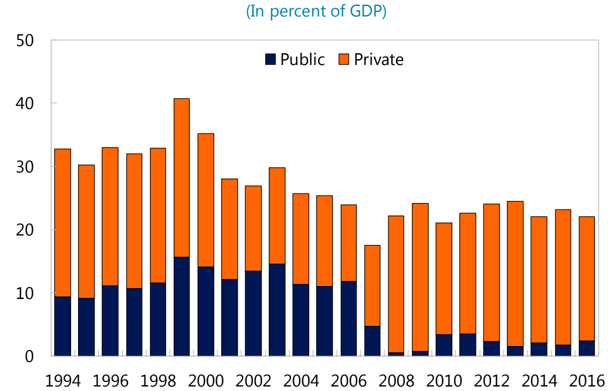


Sources: PWT, UNRWA, and IMF staff calculations.

D. West Bank and Gaza's Investment Gap

7. Anaemic rates of investment have prevented WBG from rebuilding the capital stock lost through depreciation and conflict-related destruction. Notwithstanding reconstruction efforts in Gaza since the 2014 conflict, WBG has not experienced the massive resumption of investment as expected after the end of a conflict.[7] This likely reflected the confluence of multiple barriers to investment in WBG, including: elevated political uncertainty; restrictions on movement and access (among them the decade long Gaza blockade); high

West Bank and Gaza's Investment
(In percent of GDP)



Sources: Palestinian Central Buraeu of Statistics; and IMF staff calculations.

[5] Figures cited by Ashkenas, Tse in *Assessing the Damage and Destruction in Gaza* (New York Times) are based on estimates by the United Nations Relief and Works Agency (UNRWA) and Oxfam assessments.

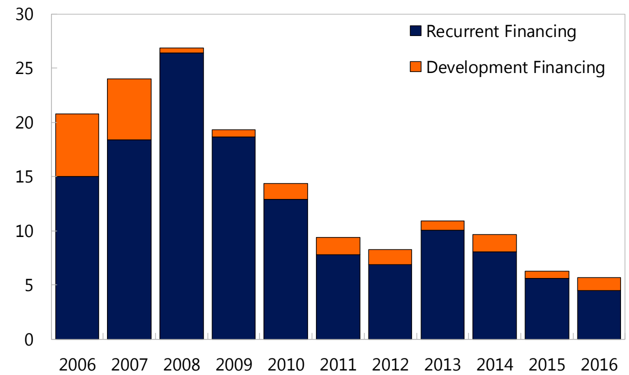
[6] Upper and lower bound estimates come from the WBG's Ministry of National Economy and the PalThink Institute for Strategic Studies, respectively. While it is inherently difficult to determine a precise damage assessment, the implications are dramatic even under conservative estimates.

[7] Rother, Björn, and others, 2016, *The Economic Impact of Conflicts and the Refugee Crisis in the Middle East and North Africa*, IMF SDN/16/08 (Washington: International Monetary Fund).

dependence on donor aid to finance development; severe fiscal financing strains; as well as regulatory weaknesses in the business environment.

8. Over the past decade, stagnant public investment has been a key driver in limiting overall investment growth. During the early to mid-2000s, private investment appeared to be most sharply affected and thus the main cause of total investment's decline. Since 2007, public investment has become the main headwind to capital stock accumulation, as it rapidly declined during 2006-08 and has remained flat since. This parallels a dramatic decline in donor financing. After averaging nearly 5 percent of GDP during 1994-2007, donor financing for development spending dropped sharply in 2008 and has since averaged around 1 percent of GDP. At the same time, donor budget support has steadily declined from over 25 percent of GDP in 2008 to around 5 percent in 2016, curtailing the authorities' ability to finance investment.

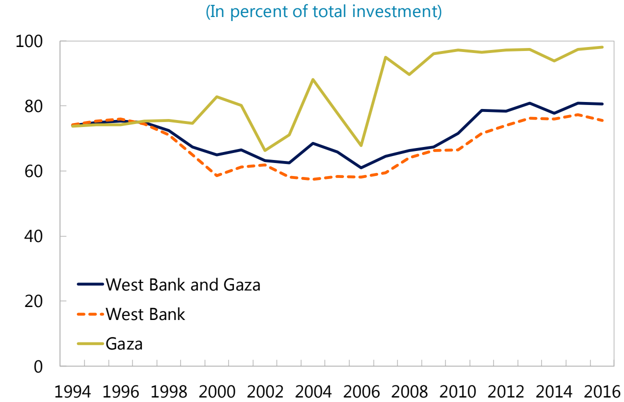
West Bank and Gaza's External Financing
(In percent of GDP)



Source: Ministry of Finance and Planning.

9. The large share of investment in less-productive assets raises doubts in its effectiveness to raise production and incomes. While private investment has held steady since 2007, the vast majority went into housing construction in the West Bank and reconstruction of destroyed buildings in Gaza. While the latter is essential (particularly from a humanitarian perspective), investment in housing is unlikely to provide the large productivity gains you would typically see with investment in infrastructure that alleviates bottlenecks or human capital. There is also the issue of potential "noise" in the investment data to the extent that donor/NGO investment activities are reflected in the increase in the level of private investment.

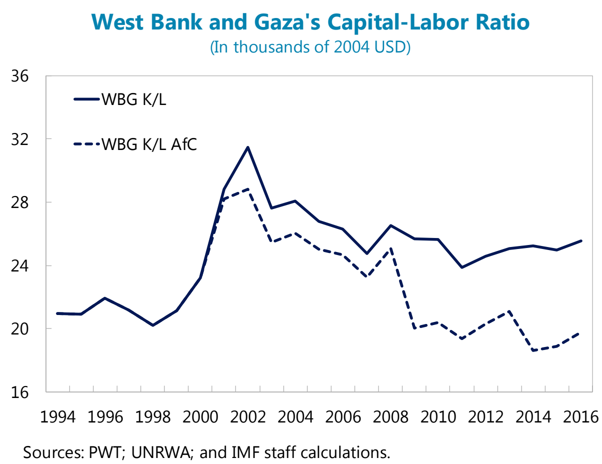
Investment in Building Construction
(In percent of total investment)



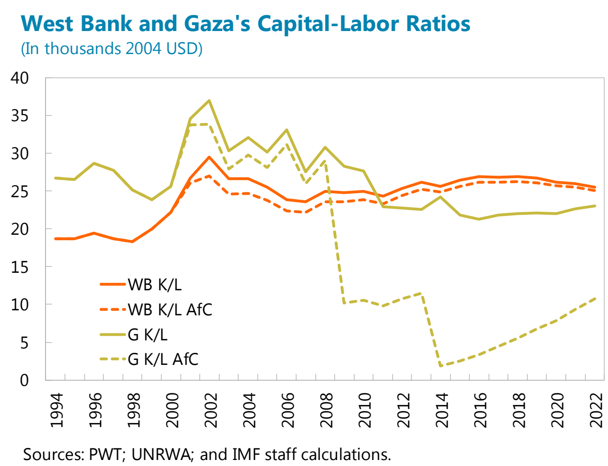
Sources: PCBS; and IMF staff calculations.

E. Declining Productivity

10. The overall economy has seen a steady decline in productivity. The Second Intifada saw an artificial and temporary boost in the capital-labor ratio as growth and employment collapsed quicker than the capital stock. After growth stabilized, a general decline has occurred that has left the current ratio below its 1990s level, once adjusting for large scale destruction. The largest factor in this decline is the 2008–09 Gaza conflict, which along with slow investment growth and other conflicts, has led to a continuous loss of productivity per labor since the early 2000s. However, even without adjusting for conflict, the large demographic pressures from the increasing working-age share of the population have had a dampening effect on the capital-labor ratio.



11. The two regions have also seen a large divergence since the mid-2000s, again with Gaza affected most severely. The West Bank has seen largely stagnant productivity growth since 2002, and the trajectory shows a return to declining productivity, with current investment being insufficient to generate lasting growth. On the otherside, the concentration of conflict in Gaza has had dire consequences, decimating productivity. While growth going forward is expected to be greater than in the West Bank, it is still insufficient to make up the losses from successive conflicts. Given that the current projections assume continued lackluster employment, any increase in the number of people employed would imply a slower capital-labor ratio recovery.



F. Conclusion

12. Years of conflict and instability have had a profound effect on the Palestinian economy's growth potential. Conflict-related destruction has eroded the capital base, most profoundly in Gaza, and the inhospitable investment environment has slowed the rate of capital accumulation. This has weighed on per capita productivity, alongside WBG's growing demographic pressures.

13. With the gloomy outlook for growth and expanding labor force, addressing the investment gap is a policy priority. Ultimately, a breakthrough in the peace process will be essential to fully unlock the potential for private sector investment. Yet, even without that, there is scope to begin improving WBG's investment climate. Improved access to markets is critical to the viability of private investment (and could be possible via dialogue with the GoI), and increased donor support can alleviate financing constraints on public investment. However, the PA can also act on several fronts to increase both public and private investment:

- **Public investment:** Rebalancing fiscal spending toward public investment, while continuing to reduce the deficit will help address the investment gap both directly and indirectly. New public investment can help address private sector bottlenecks such as electricity generation and road development/maintenance. Sustained fiscal adjustment can reduce the demands on the banking system to ensure it is better positioned to support private sector investment. In time, the authorities could consider other options, such as public-private partnerships, to further leverage private financing to improve infrastructure.

- **Private investment:** While private investment is relatively large, its growth in real terms has stagnated the last couple of years—and, in any case, it has been directed largely toward construction. Policies should focus on creating the right conditions to foster an environment more conducive for productive private investment, including: regulatory reform; public spending and tax reforms that are mindful of the impact on private sector activity (such as infrastructure spending, as noted above, or accelerated depreciation); and promoting access to finance, while maintaining stability (e.g., through maintaining credit concentration limits).

Annex IV. Technical Assistance by the IMF to the Palestinian Authority, 2012–17

The TA support has been in the areas of public financial management, revenue administration, banking supervision, and national accounts. There was also support to the recently established macro-fiscal unit within the MoF. The priorities over the medium term remain on public financial management, revenue administration, and banking supervision. There is need for intermittent review and assistance to enhance the statistical capacity especially in GFSM 2001, external sector, and national accounts expenditures side. It is expected that FAD and MCM will continue in providing TA, dependent on the authorities' commitment and progress, supported by METAC.[1]

Mission Date	Mission	Date of TA Report
Fiscal Sector: Since 2007, numerous reform components of a modern public financial management system have been put in place and steadily upgraded. Progress to date in PFM was made in drafting legal frameworks for the budget process and the organization of the ministry of finance and planning; adopting cash monitoring arrangements to move toward a Single Treasury Account (STA); establishing debt management and cash management units; modernizing the budget classification and the Chart of Accounts; developing a computerized financial management information system (FMIS); activating internal audit departments in ministries; establishing an independent and active external audit agency; and establishing a macro-fiscal unit. A new Public Financial Management Strategy 2017-22 has been adopted. Currently, the key objective is to consolidate the institutionalization of progress made, identify remaining gaps, and address them with key partners, including the IMF. Further to consolidation, approval of legislative and regulatory frameworks; review of implementation of commitment controls and cash controls; cash planning; debt management; arrears treatment 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 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 is not yet effective, a single Taxpayer Identification Number has been implemented, and the Large Taxpayer Unit 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
May 15–26, 2016	Supporting Effective Risk Management in the General Directorate of Customs Excise and VAT	May 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
April 3–13, 2017	Budget Preparation and Macro-Fiscal Forecasting	May 2017
April 30–May 11, 2017	Customs Risk Management	n.a.
August 27–31, 2017	Operationalization of the PFM reform strategy	n.a.
Monetary and Financial Systems: The TA efforts have been to support the Palestine Monetary Authority (PMA) in becoming a competent monetary authority to develop and strengthen capacity to supervise and regulate banks, introduce government securities, operate a high-quality reserves management system, and 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.		
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 the 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-based review of the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) framework	n.a.
Sept. 25–Oct. 6 ,2016	Implementing Risk Based Supervision	n.a.
May 19–22, 2017	Workshop to develop the CFT legal framework of West Bank and Gaza (in Amman, Jordan)	n.a.
Statistics: The TA efforts have focused on implementing and aligning existing statistical compilation and dissemination systems with the latest international statistical standards across three major datasets for economic policy analysis—government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS). These efforts enabled WBG to become a subscriber to the IMF's Special Data Dissemination Standard (SDDS) 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.		
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
Oct. 2–6, 2016	Producer Price Index	Dec. 2016
May 7–11, 2017	National Accounts	n.a.

[1] METAC – Middle East Regional Technical Assistance Center.
n.a. – not applicable.
* Reports classified as confidential or strictly confidential.

Annex V. Statistical Issues[1]

(As of August 9, 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 concern inconsistencies between BOP and IIP data.
National Accounts: The Palestinian Central Bureau of Statistics (PCBS) compiles and disseminates annual and quarterly GDP estimates. The annual estimates are based on 2010 and so a base year update is needed. Quarterly GDP by production are available only at constant prices (2004), while the expenditure components are calculated at the current and constant prices, since 2011. The quarterly GDP estimates require improvements. The authorities have committed to improving both source data and compilation methods. The 2013 supply and use tables will be finalized and integrated to the national accounts in the near term, enhancing the accuracy of GDP 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 a need to improve CPI and PPI compilation methods, mainly in relation to regularly updating the weights for aggregation of the indexes at a higher level, as well as updating the respective metadata.
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 some 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, to develop an accurate record of public debt on a gross and net basis, and to produce real-time detailed debt statements. 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, with MCD inputs.

Monetary and Financial Statistics: The Palestine Monetary Authority (PMA) compiles and reports to STA monthly monetary data for the central bank, other depository corporations (ODCs), and other financial corporations (OFCs) using the standardized report forms (SRFs). The SRFs data for OFCs are on a quarterly basis and include 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 11 core FSIs, 6 encouraged FSIs for deposit takers (one of which with a delay of more than a year), 2 encouraged FSI for other financial corporations (OFCs), 3 encouraged FSIs for non-financial corporations (NFCs), and 2 encouraged FSIs for real estate markets.
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*). There are some 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, participates in the Coordinated Direct Investment Survey (CDIS) with annual data for the period 2010–15, and recently started participating in the Coordinated Portfolio Investment Survey (CPIS) with semiannual data from December 2015, however, CPIS data are not fully consistent with the IIP.

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.