



INTERNATIONAL MONETARY FUND—THE WORLD BANK

WEST BANK AND GAZA

ECONOMIC DEVELOPMENTS IN 2006—A FIRST ASSESSMENT

MARCH 2007

After having experienced a modest recovery in 2003–05, the Palestinian economy suffered another decline in 2006, as a result of the domestic and international political difficulties. Although hard data are scarce, real GDP is estimated to have fallen within a range of 5 to 10 percent in 2006, less than initially had been feared, but still leaving average real per capita GDP at almost 40 percent below its 1999 level. Stronger-than-expected official and private inflows have helped prevent a much sharper decline in incomes and consumption in 2006, thus cushioning the overall contraction. But with a larger decline in investment, from an already low level, this also signals a further hollowing out of the Palestinian economy and an increase in its dependency on foreign aid.

I. INTRODUCTION

1. **This note focuses on developments in economic activity and incomes in West Bank and Gaza (WBG) in 2006.** It is obvious that 2006 has been a difficult year for the Palestinian economy and the population. The political difficulties, which often resulted in violence, have caused much hardship on the Palestinian people, as has been extensively reported by various UN agencies and NGOs.¹ This note aims to offer a first assessment of how the overall economy fared under these difficult circumstances. It should be noted at the outset that economic data for WBG are limited, and some of those that are available are of poor quality, or the quality may have worsened as a result of last year’s difficulties. Consequently, this note only presents a broad picture of overall trends, rather than exact outcomes.

2. **Economic developments in WBG in 2006 were heavily influenced by political events.** The Hamas-led Palestinian Authority (PA) government that was formed in March, following Hamas’ victory in the January 2006 parliamentary elections, was confronted with a diplomatic and financial isolation by the international community. Internally, tensions repeatedly flared up between various Palestinian factions, as did tensions with Israel, culminating in June with the re-entry of the Israeli military into Gaza in response to the kidnapping of an Israeli soldier by Palestinian militants. Restrictions on movement and access imposed by Israel were intensified significantly during 2006, particularly in Gaza, severely limiting the flow of goods and people. Israel also detained several Hamas ministers and members of parliament, complicating the government’s ability to function, and since March 2006 has withheld most of the indirect taxes—so-called clearance revenues—it collects on behalf of the PA, thus contributing to a severe fiscal crisis.

3. **The worsening political and security situation has clearly been detrimental to economic growth.** Production has been lost due to outright destruction of physical

¹ See, for example, the UN’s Office for the Coordination of Humanitarian Affairs in the Occupied Palestinian Territories “The Humanitarian Monitor”, at <http://www.ochaopt.org>

infrastructure and assets, or dampened by the numerous closures and checkpoints, the shortage of funds to finance government spending, as well as by the increased uncertainty about the Palestinian territories' prospects.

II. OVERALL ECONOMIC ACTIVITY

4. **World Bank and IMF staff estimates of economic growth in WBG are predominantly based on the expenditure approach.** This is the basic economic identity that Gross Domestic Product (GDP) equals consumption, investment, and the difference between exports and imports of goods and services. As noted above, available and reliable data are scarce, and estimates for some of these components had to be based on other indicators that were available.

Government consumption and investment

5. **Government consumption is estimated to have fallen considerably in real terms in 2006, reflecting the PA's dire fiscal situation.**² Resources available to fund the government's recurrent expenditures—taxes, and domestic and external financing—fell sharply, by more than one third in 2006 compared to the previous year. External support received in 2006 reached almost \$750 million, more than twice the amount received in 2005, as donors developed ways to by-pass the Hamas-led government. This was not sufficient to offset a sharp drop in tax revenues, however—largely as a result of Israel withholding clearance revenues—and banks reducing their exposure to the PA. Most of the available resources were used for payments to government employees and to finance fuel imports and utilities. Other operating expenditures and transfers were significantly reduced. Due to the shortage of funds, government employees are estimated to have received on average only about 50–55 percent of their normal incomes in 2006.³ The only partial payment of government wages, however, resulted in growing numbers of staff not showing up for work during the year, culminating in widespread strikes by civil servants, starting in September. Thus, in real terms, government consumption (and production of government services) is estimated to have fallen by about 10 percent in 2006, based on workdays lost and the reduction in good and services acquired by the PA.⁴

6. **Government investment is estimated to have declined even more than government consumption.** While the international community endeavoured to cushion the

² See IMF, "West Bank and Gaza: Fiscal Performance in 2006", March 2007, at <http://www.imf.org/wbg> for a more detailed discussion of public finance developments in 2006.

³ In nominal terms the national accounts include as part of government consumption the government wage bill on an accrual basis, i.e., wages due, as long as employees remain on the payroll.

⁴ It is estimated that half of the civil service was on strike for 2½ months and that absentee rates of civil servants averaged 20 percent in the other months following March 2006.

impact of the PA government's financial and diplomatic isolation on the population, donors sharply cut back on financing development projects. Project financing is estimated to have fallen by almost half in 2006, to about \$180 million, compared to some \$330 million in 2005. A considerable part of the funds available to finance development projects is typically used to finance imports of goods and services. Hence, the immediate net impact on output in WBG has been more limited. The impact will be felt more over the medium term in terms of lower growth rates than otherwise would have been possible.

7. **The fiscal crisis had significant ripple effects.** In 2005, government expenditures equalled almost half of GDP, with wages accounting for half of this. Moreover, about one quarter to one third of the population is directly dependent on a PA wage earner in the family or on a government transfer. This dependence is particularly high among the poorest segments of the population, and is also higher in Gaza than in the West Bank. With almost half of the government wage bill not paid—i.e., workers not receiving the equivalent of about one eighth of GDP—the impact on private consumption, all other things equal, would have been large. Beneficiaries of various social safety net schemes are believed to have received an even smaller share of what was due to them. Similarly, the PA government reportedly has accumulated sizable arrears to private sector suppliers—in turn affecting their financial health and spending—although no accurate data are available. Furthermore, the strikes at the end of the year will have had some impact on the private sector and the public sector itself, as it became difficult, for example, to obtain necessary documents and licenses.

Private consumption and investment

8. **Private consumption is estimated to have fallen in 2006, although not by as much as had been feared.** In the absence of a full household survey, there is no direct estimate of private consumption, but other indicators suggest that the decline in real private consumption has not been as strong as suggested by the non-payment of government wages and benefits alone. As in previous crises, many Palestinians seem to have found ways to deal with adversity, including by selling assets, using whatever savings they have left, increasing their indebtedness (including unpaid bills), and support from family members abroad. Increased humanitarian assistance appears to have helped maintain consumption levels as well.

9. **One indication that the decline in consumption may have been relatively modest is provided by banking sector data, which show that deposits continued to grow in 2006.** Private sector deposits increased by about 7 percent in 2006, an even higher growth rate than in 2005, when deposits increased by 2 percent. A breakdown between businesses and households is not available, but the continued expansion of deposits appears to reflect strong financial inflows from abroad. No comprehensive data are available on remittances either, but interviews with commercial banks indicated that private inflows from abroad have indeed picked up considerably in 2006. Also, banks continued to extend credit to the private sector, albeit at a much slower pace than in 2005. In 2006, credit to the private sector increased by about 7½ percent, compared to an increase of more than 27 percent in 2005. To some extent,

this may reflect an increased need for distress financing, as businesses and households tried to compensate for non-paying customers and employers.

10. **Another indicator is the labor market, which surprisingly witnessed an increase in overall employment in 2006.** According to the Palestinian Central Bureau of Statistics (PCBS) average employment in WBG increased by 33,000 workers in 2006, reaching a total of about 666,000 workers—an increase of 5 percent over 2005 (Table 1). Employment increased in the trade, services, and public sectors, and fell in agriculture and construction. The largest part of the increase, however, was concentrated in the public sector and workers less-than-full employed, including unpaid family members. Also, the increase in employment was insufficient to absorb the growth in the labour force, which grew by 6 percent, and the overall unemployment rate edged up slightly to 23.6 percent in 2006, compared with 23.5 percent in 2005.

11. **A third indicator is the fairly modest decline in imports in 2006.** A large portion of consumer goods in WBG are imported and, vice versa, a large part of imports are consumer goods. Available trade data (see below) show only a limited decline in real terms in the import of goods and services from Israel, which is WBG's main trading partner. Import levels also will have remained relatively strong thanks to the higher levels of humanitarian support.

12. **Little is known about private investment.** The increased insecurity is bound to have had an adverse effect on investment decisions. Investment had fallen sharply after the start of the second intifada and had not yet recovered fully in more recent years. As such, with private investment still at a relatively depressed level, it is estimated to have fallen again, although not by as much as during 2000–01. But with overall activity sustained mainly by consumption—in part financed by external support, the sale of assets, or incurring debts—any decline in investment implies that the Palestinian economy will be less able to generate future growth.

Table 1. West Bank and Gaza: Labor Market

	1999	2000	2001	2002	2003	2004	2005	2006
	(In thousands, unless indicated otherwise)							
Total employment	625	617	507	479	569	579	633	666
West Bank residents	454	445	376	346	398	420	452	493
Gaza residents	171	172	130	133	172	159	181	174
Of which:								
Full employment	562	561	478	447	517	528	579	597
Underemployment	63	56	28	32	52	51	55	69
Employment in Israel and settlements	136	116	70	49	54	50	63	62
Unemployed	80	100	170	217	194	212	194	206
Unemployment rate (in percent)	11.8	14.3	25.2	31.3	25.6	26.8	23.5	23.6
Unemployment in West Bank	9.6	12.3	21.5	28.3	24.0	22.9	20.3	18.6
Unemployment in Gaza	17.0	19.5	34.1	38.1	29.2	35.4	30.3	34.8

Source: PCBS.

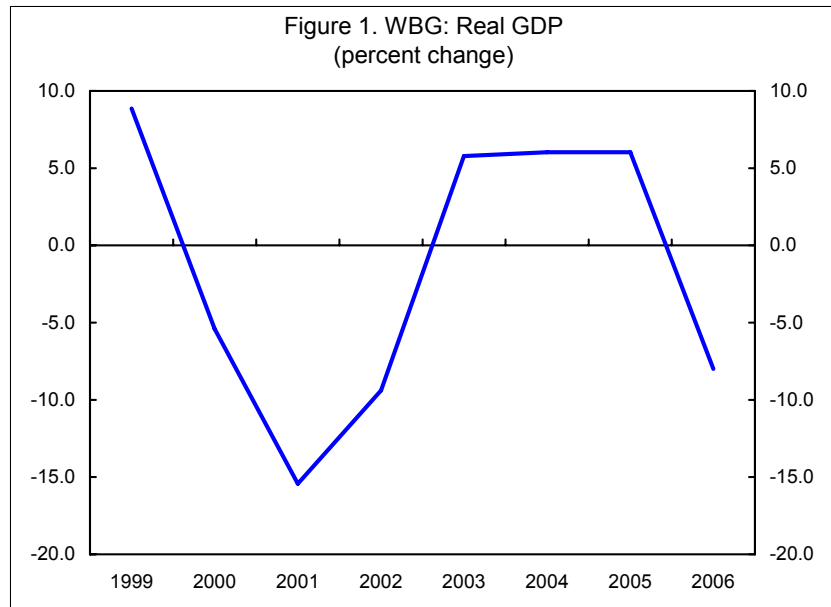
External Trade

13. **Israeli trade data show a significant decline in exports in 2006 from WBG and a smaller decline in WBG's imports.** More than half of WBG's imports and exports have Israel as their origin or destination. According to preliminary data from the Israeli Central Bureau of Statistics, the exports of goods and services from WBG to Israel fell by almost 7 percent in nominal terms in 2006, or by somewhat over 10 percent in real terms. The intensified restrictions on movement and access, particularly at the Gaza borders, have seriously limited the flow of goods (and people) in 2006. As part of the November 2005 Agreement on Movement and Access, for example, the average daily number of trucks exporting goods through Gaza's Karni crossing was targeted to increase from just under 50 in November 2005 to 150 per day by end 2005 and to 400 per day by end 2006. In 2006, however, the average daily number of trucks was only 17.⁵ Imports of goods and services from Israel, on the other hand, only fell by about 2–3 percent in real terms in 2006. The indirect taxes—customs duties and VAT—collected by Israel on behalf of the PA on Palestinian imports, which also cover imports from other countries than Israel, indicate a larger decline in overall imports of around 8 percent in real terms, suggesting a shift in imports from third countries to imports from Israel.

⁵ Based on reports on the implementation of the Agreement on Movement and Access prepared by the Office of the Quartet's Special Envoy (though April 2006) and the UN's OCHA office (after April).

An Overall Estimate

14. **Based on these pieces of information, real GDP is estimated to have fallen by some 5 to 10 percent in 2006** (Tables 2 and 3, Figure 1). The PCBS estimates that real GDP contracted by 6.6 percent in 2006, whereas World Bank and IMF estimates suggest a slightly stronger decline, by 8 percent.⁶ Given the large uncertainties and weak data, not too much weight should be given to point estimates. It is clear, though, that the much larger than expected official and private inflows, including humanitarian assistance and private remittances, have helped to avoid a major decline in available incomes and thus in spending. The stronger-than-expected inflows also largely explain why the much more dramatic economic decline projected in early 2006 did not materialize. As a



result of the inflows, private consumption and imports are estimated to have fallen only modestly in real terms. Government consumption, on the other hand, is estimated to have fallen considerably in real terms, reflecting the decline in days worked and the fiscal difficulties that forced a compression of expenditures. Exports and investment are also believed to have fallen sharply, reflecting the intensified restrictions, weakening security conditions, and growing uncertainty, as well as the shift in external assistance away from development aid toward humanitarian assistance. These trends, as mentioned, cast doubts on the medium term prospects for growth in WBG.

⁶ The PCBS estimates production in the various sectors of the economy at factor cost and adds indirect taxes minus subsidies to arrive at GDP at market prices. According to the PCBS, the decline in real GDP stems largely from reduced production of public services (by 8 percent) and lower indirect taxes and customs duties (by over 25 percent), while non-public sectors only show a very modest decline of less than 1 percent. The PCBS production estimates are mainly based on employment data, however, which may have resulted in an overestimation of real output, while indirect taxes and customs duties have fallen much less according to other estimates.

Table 2. West Bank and Gaza: Real GDP

	1999	2000	2001	2002	2003	2004	2005	2006
	(percentage change)							
Real GDP	8.9	-5.4	-15.4	-9.4	5.8	6.0	6.0	-8.0
Consumption	8.3	-1.9	-6.7	-7.7	4.5	8.6	5.6	-5.0
Private	8.3	-4.4	-5.4	-8.5	6.0	8.5	5.6	-4.0
Public	8.4	9.4	-11.6	-4.3	-1.6	9.5	5.7	-9.4
Investment	33.9	-27.0	-44.6	9.4	18.0	0.6	2.0	-24.8
Private	36.0	-26.5	-52.1	8.7	16.9	0.4	1.4	-15.0
Public	25.5	-29.4	-9.9	11.1	20.6	1.2	3.3	-47.1
Exports	3.7	-6.8	-34.7	-13.0	-4.0	13.5	8.2	-11.6
Imports	19.1	-13.9	-18.1	-2.0	4.8	9.9	4.4	-8.8
Change in inventories	62.3	-73.5	-8.9	-36.7	--	--	--	--
Real GNI	8.4	-6.8	-20.1	-9.1	6.6	4.3	6.8	-7.6
Real GDI	7.8	-3.5	-4.4	-3.8	-0.4	4.4	5.2	0.0
Real GDP per capita	4.4	-9.3	-18.7	-12.6	2.1	2.5	2.5	-11.0
Real GDI per capita	3.4	-7.4	-8.1	-7.2	-3.8	0.9	1.8	-3.2

Source: PCBS; and IMF and World Bank staff estimates.

Table 3. West Bank and Gaza: National Accounts

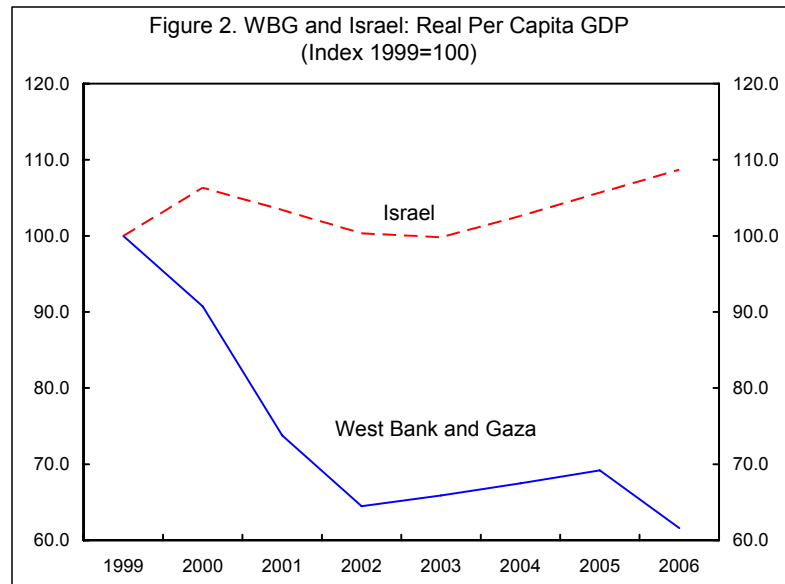
	1999	2000	2001	2002	2003	2004	2005	2006
	(In millions of US dollars)							
Nominal GDP	4,517	4,442	3,746	3,156	3,624	4,077	4,478	4,394
Consumption	5,532	5,586	5,115	4,446	5,032	5,797	6,407	6,491
Private	4,488	4,413	4,096	3,532	4,054	4,600	5,029	5,037
Public	1,044	1,173	1,018	914	978	1,197	1,378	1,454
Investment	1,725	1,359	739	758	972	1,024	1,081	848
Private	1,408	1,117	525	535	680	714	750	665
Public	318	242	214	223	292	310	331	183
Exports	892	867	560	465	465	535	588	534
Imports	3,805	3,404	2,704	2,536	2,844	3,279	3,597	3,479
Change in inventories	150	41	37	22	0	0	0	0
Nominal GNI	5,454	5,274	4,193	3,546	4,105	4,534	5,017	4,929
Nominal GDI	5,853	5,860	5,557	4,985	5,395	5,951	6,486	6,859
Nominal GDI per capita	1,938	1,861	1,697	1,469	1,535	1,636	1,724	1,764

Source: PCBS; and IMF and World Bank staff estimates.

15. **With the decline in output, real per capita GDP fell by more than 10 percent in 2006 to almost 40 percent below its pre-intifada level in 1999.** For comparison, real per capita GDP in Israel rose by almost 10 percent over the same period (Figure 2).⁷ To some

⁷ If the Palestinian economy had grown at a steady, but modest 3 percent each year since 1999, with a 3 percent annual GDP deflator, nominal GDP would have been more than \$2 billion higher in 2006.

extent, the decline in per capita GDP in WBG was cushioned by transfers from abroad, especially in 2006 when, owing to the significantly higher official and private inflows, real per capita Gross National Disposable Income (GDI) fell much less from its 2005 level, by an estimated 3 percent. Poverty levels remain high, though, and are increasing. According to surveys conducted regularly by Near Eastern Consulting (NEC), the percentage of households falling below the poverty line has risen from 50 percent in March 2006 to 66 percent at the end of the year. Similarly, the UN recently reported that while food security levels were broadly maintained in 2006, this was only achieved through increased humanitarian aid and strong solidarity among Palestinians. As individual coping mechanism, such as selling assets, incurring more debt, and support from family members abroad, may soon reach their limits, the developments in 2006 highlight that without a resumption in economic activity, an even larger amount of external support will be needed to maintain



income levels, making WBG increasingly aid dependent. A revival of the economy, needed to reduce this dependency, would require above all a major easing of restrictions on the movement of goods and people, as well as an improvement in the political and security situation.

16. **Meanwhile, inflation remained low in 2006, at 3.6 percent, and unchanged from 2005.** In general, prices in WBG largely mirror price developments in Israel. Inflation in Israel was low in 2006, in part reflecting the steady appreciation of the Israeli Shekel against the US dollar. Price increases of food and transportation (which make up more than 50 percent of the CPI basket in WBG) were the main contributors to the overall increase in prices. Inflation was moderately higher in Gaza, at just over 5 percent, due to shortages of goods and heightened security conditions that result in higher transportation costs.

III. GROWING DISPARITIES

17. **Available data point toward a growing disparity between economic and social developments in the West Bank and in the Gaza Strip.** The decline in economic activity appears to have been limited in the West Bank, but has been much more pronounced in Gaza, which has been subject to higher instability and to major closures by Israel. According to the NEC surveys, more than 75 percent of households in Gaza were considered poor by end-2006, coupled with an increase in the number of hardship cases, compared with 52 percent in

March 2006. The share of households in the West Bank considered poor, by comparison, was 59 percent by end-2006, up from 49 percent in March 2006.

18. **In the Gaza Strip, more than one-third of the labour force is now out of work, compared to less than one-fifth in the West Bank.** The overall increase in employment in WBG was entirely concentrated in the West Bank. Employment numbers there rose by 41,000 people, or some 9 percent compared to 2005, reaching 493,000.⁸ In Gaza, on the other hand, employment fell by about 7,000 workers, or by about 4 percent compared to 2005, to 174,000 in 2006. Consequently, while the unemployment rate fell in the West Bank, from 20.3 percent in 2005 to 18.6 percent in 2006, it rose significantly in Gaza, reaching 34.8 percent, compared with 30.3 percent in 2005. Also, with government employment accounting for a larger share of total employment in the Gaza Strip than in the West Bank (above 40 percent versus less than 20 percent), the population in Gaza was more affected by the government's inability to pay full wages.

19. **The economic difficulties will also have affected the poor more than others.** Low-income households typically depend more on a government income or transfer. Similarly, low income households will have less, if any, assets left to sell or have little or no access to bank or other financing. The World Food Programme and the Food and Agriculture Organization recently warned that rising unemployment and poverty were posing acute challenges to food security, leaving many households totally reliant on outside assistance.⁹

⁸ This includes some 62,000 workers finding employment in Israel and in Israeli settlements in the West Bank, 1,000 people less than in 2005. Constrained by the security situation, there was no employment of workers from Gaza in Israel.

⁹ See <http://www.wfp.org/english/?ModuleID=137&Key=2377>