INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT TO THE AD HOC LIAISON COMMITTEE[1]

April 5, 2016

KEY ISSUES

Context: The political situation is increasingly precarious, with the flare up in tensions since September 2015 posing another test for the Israeli-Palestinian peace process. With chances of direct negotiations receding, recent diplomatic initiatives are shifting focus to a multilateral approach. Limited progress on domestic political reconciliation does not augur well for a breakthrough in the near term. Despite some recovery, humanitarian conditions in Gaza remain severe, compounded by slow inflows of donor aid and restrictions on imports of 'dual usage' construction materials.

Outlook and risks: Uncertainty continues to cloud the already difficult economic outlook. Assuming that recent violence does not escalate dramatically, real GDP growth in the West Bank and Gaza (WBG) will likely reach 3.2 percent in 2016 and around 3½ percent over the medium term—insufficient to boost per capita incomes and reduce unemployment. A resumption of hostilities or increased violence pose the main risks that would further weaken economic activity, and shortfalls in budget support would jeopardize the already fragile fiscal position. Strained correspondent banking relations are potential source of concern. However, improved economic cooperation between the Palestinian Authority and Government of Israel could strengthen significantly the fiscal position, and restarting the peace process would brighten prospects for eventual economic and fiscal sustainability.

Key policy recommendations: Despite determined fiscal consolidation efforts, the downcast outlook for donor aid implies a large financing gap in 2016. The authorities can help fill the gap by limiting the wage bill increase, reining in fuel subsidies, promptly raising government fees, and broadening the tax base while improving collection. However, economic cooperation with Israel and increased donor aid will be vital to avoid further arrears accumulation. Sustained reforms to ensure a robust regulatory framework and strengthen institutions, along with a more strategic approach to aid management, better aligned with budget priorities, will be essential to create the conditions for private-sector led growth and catalyze increased donor support.

[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 and Catherine Pattillo

Discussions were held in East Jerusalem and Ramallah during February 3–11, 2016, and the report was updated with subsequent developments. The staff team comprised Christoph Duenwald (head, outgoing), Karen Ongley (head, incoming), Priscilla Toffano, Anna Unigovskaya (all MCD), Ragnar Gudmundsson (IMF Resident Representative), and Hania Qassis (IMF Resident Representative Office). The mission met Finance Minister Bishara, Palestine Monetary Authority Governor Shawwa, other senior officials, donors and private sector representatives. The mission prepared a concluding statement and issued a press release. Ramsey Andrawis, Cecilia Pineda, and Vanessa Panaligan also contributed to producing this report.

CONTENTS

POLITICAL CONTEXT

1. **The political environment is increasingly precarious, with the two-state solution perceived to be under threat.** Continued settlement expansion in the West Bank and East Jerusalem, the demolition or confiscation of buildings, and lone wolf attacks following clashes at Al Aqsa Mosque/Temple Mount in September 2015 have exacerbated existing constraints on economic activity. However, our interlocutors suggest that continued security coordination between the Palestinian Authority (PA) and the Government of Israel (GoI) has, thus far, helped prevent the violence from escalating further. While a possible increase in permits for Palestinian workers in Israel and ongoing dialogue between finance ministries may help ease tensions, the situation remains highly volatile.

2. **Domestic reconciliation also remains stalled and living conditions in Gaza continue deteriorating.** While recent discussions between Fatah and Hamas in Doha raised hopes of a breakthrough that could set the stage for new parliamentary elections, for most observers hope has not yet translated into optimism. Humanitarian conditions in Gaza remain severe, compounded by slow inflows of donor aid and restrictions on imports of 'dual usage' construction materials.[2] Recent additions to the list of 'dual usage' goods that present a security risk may further impact reconstruction and infrastructure projects. The weak economic recovery, worsening living conditions and ongoing political strains could prove a volatile mix, heightening concerns about the potential for renewed conflict.

3. **With chances of direct negotiations receding, the international community is increasingly focused on possible multilateral approaches.** One donor-proposed option is an international summit for later this year that would bring together the PA, GoI, and various international stakeholders, including the U.S., EU, and Arab countries. Another would be a United Nations Security Council resolution on the two-state solution that would seek to move forward the peace process. Such initiatives aim to preserve engagement in an increasingly challenging regional environment, where donors face rising pressure to channel scarce resources to other causes, including the Syrian refugee crisis.

RECENT ECONOMIC DEVELOPMENTS

4. **2015 was a difficult year for the economy.** Real GDP growth in the West Bank slowed to an estimated 2.7 percent[3] (from 5.3 percent in 2014), as investment remained weak, donor aid declined, and the suspension of clearance revenue transfers early in the year undermined confidence. The Gazan economy continued its recovery from the devastating 2014 war, albeit at a slower-than-expected pace of around 5 percent, reflecting delays in donor support and restrictions

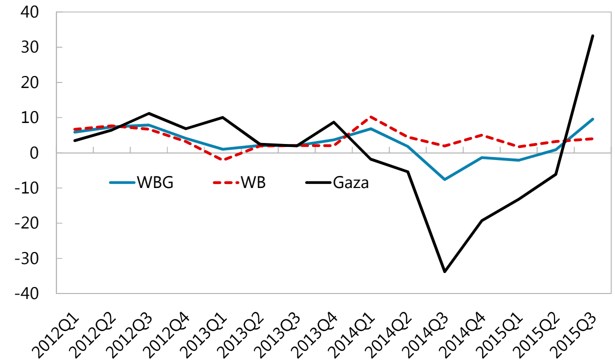
[2] As of December 2015, 39 percent of the amounts pledged to support Gaza during the October 2014 Cairo conference had been disbursed.

[3] Data for 2015 are still preliminary.

on imports of 'dual usage' construction materials. Private consumption was the main driver of growth in both regions, with activity in the construction and trade sectors accelerating toward the end of the year, particularly as damaged houses in Gaza were repaired.

Real GDP Growth, 2012–15

(In y-o-y percent change)



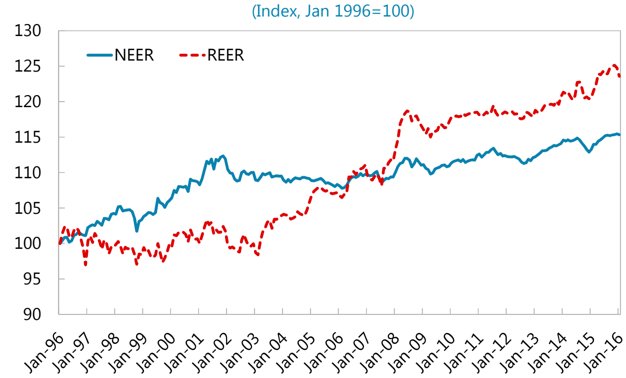
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

5. Persistently high unemployment rates, especially among youth and recent graduates,[4] risk compounding political strains. Unemployment in the West Bank increased from 17.7 percent at end-2014 to 18.7 percent at end-2015, despite increased employment of Palestinians in Israel and settlements,[5] whereas the unemployment rate in Gaza declined from 44 to 38.4 percent as reconstruction intensified during the latter part of 2015. More broadly, too many people are excluded from the labor market and overall labor force participation remained stagnant at 45.8 percent in 2015, with low participation by women, and a high share of students in the working-age population.

6. Inflation remained subdued, slowing to 0.7 percent in January in keeping with deflation in Israel and falling global commodity prices. Prices increased in January by 1.6 percent in the West Bank, but only 0.3 percent in Gaza. Core (non-food) inflation remained negative at -0.3 percent for the second consecutive month, possibly indicating weakening economic activity. Staff estimates that the real effective exchange rate appreciated by 2.5 percent over the 12 months to January 2016, continuing the trend of the past decade and adding to the range of factors that weigh on competitiveness.

Effective Exchange Rate

(Index, Jan 1996=100)



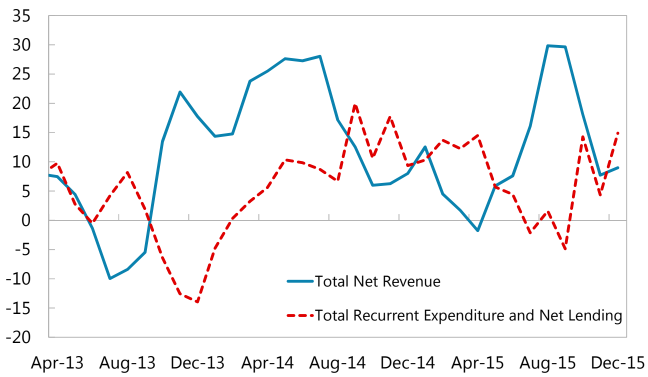
Note: An increase indicates appreciation.
Sources: Haver; INS; and IMF staff calculations.

7. Despite challenging economic circumstances, the PA achieved a further decline in the recurrent fiscal deficit in 2015. Reflecting good overall revenue performance and wage restraint, the overall fiscal deficit declined from 12.5 percent of GDP in 2014 to an estimated 11.7 percent in 2015.

[4] Youth unemployment stands at around 30 percent in the West Bank and close to 60 percent in Gaza; and almost one in three graduates is unemployed in WBG.

[5] Currently, 11.8 percent of Palestinians from the West Bank are employed in Israel and settlements. Israel has granted 68,500 permits for Palestinians to work in Israel and this quota was increased by 7,000 in March 2016.

Revenue and Expenditure Growth
(In y–o–y percent change, rolling 3-month period)



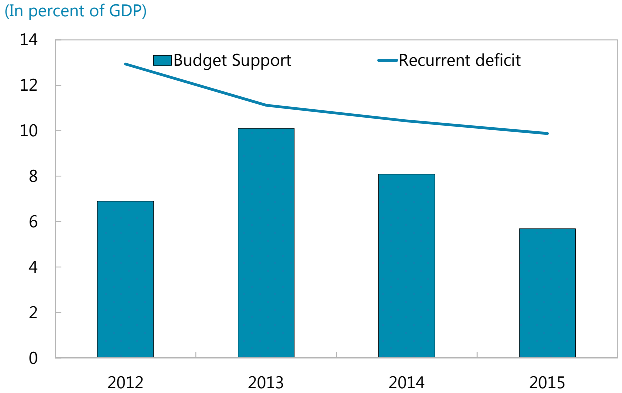
Source: Ministry of Finance.

- Revenue increased from 21.6 percent of GDP in 2014 to 22.3 percent of GDP in 2015, reflecting improved clearance revenues and the authorities' tax administration efforts. About nine thousand additional small taxpayers were registered during 2015. Nontax revenue, however, declined by 0.1 percentage point of GDP as there were no transfers to the budget from the Palestinian Investment Fund and the planned increase in government fees and charges was postponed. The fuel tax refund ("fuel subsidy") declined by 0.1 percentage point to 1 percent of GDP in 2015, which was less than budgeted as the authorities increased fuel subsidies for Gaza.

- Recurrent expenditure increased slightly from 32 percent of GDP in 2014 to 32.2 percent in 2015, reflecting higher-than-budgeted spending on goods and services and net lending (electricity). At the same time, the authorities reduced the wage bill as a share of GDP by restricting wage growth to less than 2 percent.[6] There were no significant appropriations for Gaza from the PA budget, and development spending was less than 2 percent of GDP.

8. **However, the sharp drop in donor budget support posed a difficult financing situation, further pushing up public debt.** Direct budget support, which had represented close to one quarter of recurrent expenditure in 2014, declined by about one third in 2015, reaching its lowest nominal level since 2008. Competing needs, including for Gaza, likely played a role in diverting donors' financing from PA budget support. The resulting gap was financed through higher domestic bank borrowing and an accumulation of arrears. This saw an uptick in overall public debt (including arrears) to $5.4 billion or 43 percent of GDP, with domestic borrowing from banks rising to $1.5 billion from $1.1 billion at end-2014, and increasing the risks to debt sustainability (Annex II). Overall arrears increased by almost NIS 1.9 billion (or around $480 million) on a net basis, after about NIS 900 million was repaid to private sector suppliers. Arrears to the Pension Fund constituted about half of the total arrears, with the remainder being to private suppliers and local governments.

Recurrent Deficit and Budget Support
(In percent of GDP)



Sources: Ministry of Finance; and IMF staff calculations.

[6] In 2015, the PA implemented the mandatory 1.25 percent annual salary increase, but not the cost of living adjustment.

Arrears Accumulation, 2009–15							
	2009	2010	2011	2012	2013	2014	2015
	(In millions of NIS)						
Net accumulation	**988**	**333**	**2,174**	**2,706**	**1,680**	**1,762**	**1,876**
Gross accumulation (+)	988	333	2,174	2,706	1,680	2,766	2,793
Contributions to the pension fund:	526	357	947	1,152	1,250	1,249	1,159
of which : employee's share 1/	171	185	374	544	612	570	603
government's share	355	172	573	608	638	680	556
Wage arrears 1/	---	---	---	272	-232	---	---
Other arrears	514	37	992	802	676	1,530	1,670
Nonwage expenditures 2/	460	92	353	439	582	1,032	1,036
Net lending	77	-103	---	---	---	---	---
Development projects 3/	118	88	270	124	66	351	206
Tax refund	-140	-39	368	239	27	147	335
Transfers of earmarked revenue 4/	n/a	n/a	n/a	n/a	n/a	n/a	93
Repayment (-)						-1,004	-917

Sources: Ministry of Finance, and IMF staff estimates.

1/ Item classified under wage expenditures.
2/ Including to private sector suppliers.
3/ Item classified under development projects.
4/ Property taxes and transportation fees collected on behalf of local governments.

9. While the financial sector is generally healthy, there are a number of potential risk factors.

- Nonperforming loans (NPLs) remained low, just above 2 percent of total loans at end-2015, and prudential ratios remain high by international standards (Table 4). The capital adequacy ratio also remains comfortable, although it has been trending down for several years. At the same time, banks have significant exposure to the public sector, with loans to the PA and its employees comprising 42.5 percent of domestic bank credit at end-December.

- Credit to the private sector grew by nearly 19 percent in 2015, exceeding deposit growth of around 8 percent. While staff's analysis does not point to a credit boom, the concentration of credit in a few sectors—real estate, construction and consumption—needs to be monitored as they are approaching the PMA's threshold.[7] Anecdotal evidence also points to increased lending by non-bank entities, currently outside the regulatory perimeter, to the construction sector.

- As the banking system operates in three currencies whose supply is controlled by foreign central banks, it is exposed to liquidity, solvency and currency mismatch risks. Palestinian banks have long experienced challenges in managing liquidity, with Israeli banks providing them with limited cash services.[8] Some Israeli banks have recently warned, citing AML/CFT concerns, that they might sever banking relations with Palestinian banks (unless they receive a de facto official

[7] IMF, September 2015 Report to the AHLC, Annex II, *Rapid Credit Growth in the West Bank and Gaza: How Much Should We Worry?*.

[8] The Bank of Israel (BoI) sets a limit of NIS 300 million per month on the amount of NIS cash transfers it accepts from Palestinian banks, with the stated goal to combat money laundering and financing of terrorism. However, at times during 2015, the BoI accepted cash deposits in excess of this limit in response to requests by the PMA.

guarantee to avoid exposure in the event of any anti-terrorism or money laundering lawsuits). This could undermine the functioning of the payment system and reduce Israel-WBG trade.

OUTLOOK AND RISKS

10. The economic outlook is fraught with uncertainty. Staff's baseline assumes the political impasse and Israeli restrictions continue, but that recent episodic violence will not escalate into a full-fledged conflict. On that basis, GDP growth is projected to reach 3.2 percent in 2016 (2.7 percent in the West Bank and 5 percent in Gaza), and to average about 3½ percent in the medium term. In Gaza, real GDP is unlikely to return to pre-conflict levels until 2018, a year later than previously estimated. Inflation will likely remain subdued, on account of low inflation in Israel, no marked uptick in international oil prices and relatively weak economic activity.

11. However, the status quo will not boost per capita incomes and reduce unemployment, underscoring the critical importance of a political breakthrough. An estimated quarter of a million young people will enter the labor market during 2015–18. Assuming an elasticity of employment with respect to output of around one in the medium term,[9] average annual growth of 4.5 percent would be required to absorb the expanding labor force. A continuation of the current conditions would likely see growth hover around 3½ percent in the medium term. Any significant improvement in medium-term prospects therefore hinges on the peace process and donor engagement.

12. As donor support falters and political tensions persist, economic management and prospects for the PA's longer term viability are increasingly at risk. While concrete steps toward domestic political reconciliation could help boost the outlook, risks are predominantly on the downside (see Annex I). Absent broader political dialogue, ongoing violence could escalate, leading to another war in Gaza and/or a political and security crisis in the West Bank. In Gaza, reconstruction could slow further if donors' aid falls short of commitments or if restrictions intensify. Further shortfalls in budget support or the inability to contain spending could undermine an already fragile fiscal position, leading to additional arrears (possibly compromising private creditors' ability to service loans and associated risks to the banking sector), a fall in private demand and, in the extreme, a breakdown of government services. Fiscal risks emanating from litigation in U.S. courts (*Sokolow vs. Palestine Liberation Organization*) have receded until the PA's appeal is decided.[10] However, heightened risks concerning Israeli correspondent banking relationships could prove detrimental to the payments system and private economic activity (that has so far proved remarkably resilient).

[9] As estimated in *The Link Between Growth, Employment, and Unemployment in the West Bank and Gaza*, Udo Kock and Hania Qassis, IMF Selected Issues Paper, September 2013.

[10] Oral arguments in the Sokolow litigation are currently scheduled for mid-April and, although the timing is uncertain, the case could be decided months after that (possibly in mid-late 2016).

POLICY DISCUSSIONS

A. Near-Term Fiscal Policy

13. With discussions focusing on the 2016 budget, staff welcomed the authorities' commitment to fiscal discipline.[11] The budget targets a further reduction in the recurrent fiscal deficit, of nearly 15 percent, based on: (i) higher projected clearance revenue and a continued increase in non-tax revenue; and (ii) a decline in recurrent expenditure, driven by ambitious efforts to reduce fuel subsidies, net lending (associated with electricity outlays), and spending on goods and services, while keeping growth in the wage bill to 3 percent. The authorities aim to raise development spending by more than 50 percent, of which over two-thirds is budgeted to be donor-financed. The government intends to use domestic bank financing to repay about $250 million of arrears to the private sector, and to further reduce accumulation of arrears to the Pension Fund by doubling its contributions to the fund in 2016. However, with projected donor budget support broadly unchanged from 2015 (around $750 million net of development financing), this would result in a budgeted financing gap of about $400 million.

Budget 2016

	2014	2015		Budget 2016	
	NIS million	NIS million	% change from 2014	NIS million	% change from 2015
Net revenues	9,817	10,712	9.1	11,189	4.5
Recurrent expenditures and net lending	14,556	15,453	6.2	15,212	-1.6
Wage expenditures	7,336	7,439	1.4	7,662	3.0
Nonwage expenditures	6,198	6,844	10.4	6,700	-2.1
o/w: Goods and services	2,333	2,530	8.5	2,056	-18.7
Net lending	1,022	1,169	14.4	850	-27.3
Development expenditures	938	893	-4.7	1,365	52.8
o/w Gaza reconstruction	--	131	--	...	--
Recurrent balance	-4,739	-4,741	0.1	-4,023	-15.2
Overall balance	-5,676	-5,635	-0.7	-5,388	-4.4
Overall balance (cash, including development expenditures)	-2,910	-2,934	0.8	-6,363	116.8
Total financing	5,676	5,635	-0.7	5,388	-4.4
External financing for recurrent expenditures	3,676	2,757	-25.0	2,925	6.1
External financing for development expenditures	726	347	-52.2	956	175.2
Domestic financing	1,311	2,572	96.1	1,507	-41.4
Net domestic bank financing	-469	676	--	975	--
Arrears (net)	1,762	1,876	--	-975	--
Residual/financing gap	18	20	--	1,507	--

Sources: Ministry of Finance; and IMF staff calculations.

14. Staff supports fully the authorities' efforts, but the budgeted pace of expenditure consolidation may be difficult to achieve. Given past trends and weak commitment controls, staff projects spending on goods and services to increase. Similarly, while applauding the authorities' determination to control electricity outlays, staff projects a slower pace of reduction in net lending. Staff agreed with the goal of increasing development spending as a basis for more inclusive growth, but noted that it depends on a very large increase in donor financing which may not materialize. With respect to revenues, staff projects overall revenue growth broadly consistent with the budget, albeit with differences in the composition of revenue. In particular, staff is more cautious on (i) the nontax revenue increase, given delays in implementing increases in fees and charges, and (ii) the fuel tax refund reduction, given challenges faced in 2015. Staff also factors in external debt service in 2016, which is expected to reach $13 million as the repayment of World Bank loans begins.[12] On

[11] The budget was prepared on time and submitted for approval before the start of the new fiscal year.

[12] Debt service to the World Bank is projected to amount to $7 million in 2016.

current policies and with available donor support, staff projects a larger financing gap of around $550 million. With domestic bank borrowing near the limit the PMA informally targets and weak prospects for additional donor support, the financing gap risks compromising the authorities' plans to tackle the accumulation of arrears (see below).

15. Staff proposed several policy measures that could help reduce the financing gap in 2016. Although staff acknowledged that, with a potential yield of around $150–200 million, options for closing the gap without broader support and dialogue are limited.

- On the expenditure side, options include limiting growth in the wage bill to below 2 percent[13] and capitalizing on lower global fuel prices to eliminate (or at least reduce more aggressively) fuel subsidies. Targeted transfers could help defray the adverse impact of reduced subsidies on the poor. Moreover, strong measures to strengthen payment discipline in the electricity sector will be needed to achieve the budgeted reduction in net lending.
- Steps on the revenue side include further efforts to limit tax incentives and broaden the tax base, as continued gains from strengthened tax administration may become more difficult to reap. It will also be important to implement expeditiously the planned revision in government fees in the budget.

16. The authorities broadly agreed with staff's recommendations, though reiterating the difficulty of curtailing further growth of the wage bill or eliminating fuel subsidies in the current political environment. Regarding net lending, they plan to continue working with municipalities to ensure that resources collected for electricity are not misappropriated. The authorities emphasized that they intend to continue expanding the tax base by registering more taxpayers, accompanied by efforts to raise tax awareness, achieve stricter enforcement, and build capacity in tax administration. They also explained that the increase of government fees and charges was delayed to allow for a study of distributional impacts.

17. The authorities also highlighted the potential for reducing revenue shortfalls through enhanced dialogue with the GoI, noting constructive meetings in recent months. They consider that there could be significant scope to raise revenue through enhanced implementation of the Paris Protocol and are stepping up discussions with Israel (Box 1).[14] Staff supported these moves to deepen the bilateral dialogue, as potential revenue gains could be large, especially if complemented by efforts to mobilize domestic revenue and collect taxes in Gaza.[15] However, discussions and thus revenue gains may take time to bear fruit.[16] The authorities and staff also agreed that a transparent

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[13] A recent agreement with teachers' unions to fully implement salary increases approved under a previous administration in 2013 could signal difficulty in keeping the wage bill within the budgeted amount.

[14] Reflecting this dialogue, the GoI plans to transfer on a one-off basis NIS 500 million to the PA to reflect VAT claims related to Gaza and a reduced administrative fee on 2015 clearance revenue.

[15] IMF, May 2015 Report to the AHLC, Annex IV, *Revenue Potential in the West Bank and Gaza*.

[16] As such, these are not yet reflected in the PA's budget or staff's baseline.

audit of electricity sector claims of the Israel Electric Corporation (IEC) would be a crucial step toward a repayment plan that could provide greater predictability of clearance revenue transfers.[17]

Box 1. Palestinian Authority (PA) and Israel Dialogue on "Fiscal Leakages"

Economic relations between the WBG and Israel have been guided by the *Protocol on Economic Relations*—the Paris Protocol (PP)—since it was signed in 1994. Although intended as a five-year transitional agreement, the PP remains in effect.[1] It covers a range of economic issues, including import policy, taxation, revenue sharing, monetary arrangement, and labor mobility. The PP has been amended, but not regularly and several issues remain unresolved between the two parties.

The PA has recently stepped up efforts to restart a dialogue with the GoI on several aspects of PP implementation. In particular, the PA believes that current implementation creates "fiscal leakages" to Israel. Faced with increasing fiscal constraints and declining donor aid, closing these "leakages" could be an important complement to the PA's efforts to raise domestic revenues[2] and a step towards securing fiscal sustainability. The PA is prioritizing five issues:

(i) **Deductions from the salaries of Palestinian employees in Israel:** Health, social insurance, and pension deductions for Palestinian workers in Israel are expected to be transferred to the PA on a monthly basis. However, transfers have been irregular and information on deductions has not been provided in sufficient detail. The PA estimates[3] that transfers owed by Israel currently amount to NIS 1.2 billion.

(ii) **VAT on trade with Israel:** The PA's inability to collect VAT invoices in Gaza and Area C—invoices serve as a basis for claiming clearance revenues (CR) from Israel—and conduct post-clearance audits result in significant VAT losses. The PA estimates that in Gaza alone the inability to collect invoices costs NIS 400–500 million in foregone revenue per year. The PA seeks better information sharing on invoices collected by Israel.

(iii) **Border crossing fees:** Acting outside the PP, Israel raised border crossing fees for travelers in 2008 and since retained the proceeds from additional fees. Based on the PP, the PA is calling for equitable sharing of this additional revenue, for which the amount accumulated since 2008 is estimated at about NIS 240 million.

(iv) **CR handling fees:** CR has increased dramatically since Israel's 3 percent administrative handling fee was agreed under the PP. In 2015, the PA paid about NIS 250 million in handling fees, more than double 8 years ago. The PA questions the appropriateness of applying a 3 percent fee to the total amount of CR, and is seeking to lower the fee and cap the amount of total deductions.

(v) **CR handling fee for fuel:** The PA questions the justification of the 3 percent handling deduction from CR for fuel VAT and excises (representing close to 50 percent of total CR), noting that it was added as a supplement to the PP in 1996. The PA estimates the loss exceeds NIS 100 million annually.

[1] The Joint Economic Committee—with representatives of the two parties—was established to monitor PP implementation, yet in practice the Committee has met only a few times.
[2] IMF, May 2015 Report to the AHLC, Annex IV, *Revenue Potential in the West Bank and Gaza*.
[3] Estimates of these leakages could be refined as the dialogue progresses and with assistance from donor partners (including the World Bank's forthcoming report to the AHLC).

[17] Debt to the IEC stood at NIS 1.7 billion at end-2015, unchanged since end-2014. Of this, NIS 1.3 billion was debt to the Jerusalem District Electricity Company (JDECO)—for which the PA disputes responsibility since the company is majority (75 percent) private-owned.

18. The authorities outlined plans to issue promissory notes to help stem the flow of arrears to the private sector and relieve supplier's liquidity constraints. The plan foresees issuing legally enforceable promissory notes (IOUs) with 180-day maturity to private creditors who hold arrears of the PA. IOUs will be first offered to wholesale and strategic goods suppliers. The Ministry of Finance and Planning (MOFP) expects to issue up to NIS 1 billion[18] of promissory notes during 2016, and will establish a dedicated bank account to build up resources from which to repay IOUs. Given the PA's decision to issue promissory notes, rather than staff's initial suggestion of government securities, staff advised the authorities to stand ready to re-evaluate the approach if unforeseen difficulties emerge during implementation (notably regarding financing or administrative capacity constraints). To strengthen the prospects for success, staff encouraged the authorities to complement this approach with a comprehensive domestic arrears management strategy (involving stock taking, clearance, and prevention), together with public financial management (PFM) reforms to ensure a robust system of commitment controls.

B. Medium-Term Policies

19. Medium-term efforts should be geared toward securing fiscal sustainability and building a foundation for faster, more inclusive growth. The authorities concurred, emphasizing their desire to pursue a more strategic approach to macroeconomic reform and aid coordination via plans for a new National Policy Agenda (Box 2). The new macro-fiscal unit at the MOFP can play a pivotal role in supporting aid effectiveness by helping to anchor the PA's development goals in a sound budget framework.

Fiscal Policy

20. Staff and the authorities agreed that sustained fiscal reforms will be central to securing fiscal sustainability, overcoming aid dependency, and raising growth potential. This requires balanced action on both revenues and expenditures, backed by continued efforts to strengthen PFM and fiscal institutions.

- **Revenue reforms:** Staff encouraged the authorities to intensify efforts to broaden the tax base, including by further reducing tax exemptions and simplifying the tax regime for SMEs. The authorities should continue strengthening capacity of the LTU, including by improving audit methodologies and adding construction sector companies. In tax administration, expanding self-reporting, and strengthening compliance via improved audit procedures and enforcement could also yield revenue gains. Should reconciliation proceed, tax administration should be expeditiously expanded to Gaza.[19] The authorities noted that they are considering restructuring the MOFP along functional lines, which will also support more efficient tax administration.

[18] Broadly in line with the recent annual flow of private sector arrears.

[19] This could help move away from Hamas' ad hoc taxation efforts that can impinge on economic activity in Gaza.

Box 2. More Effective Aid Coordination and the New National Policy Agenda

The PA is working toward a more strategic approach to aid management and development. The new strategy will center on a National Policy Agenda (NPA) that will set out overall priorities for 2017–22. The planned NPA will be underpinned by:

- Sector strategies developed by Line Ministries, in coordination with the MOFP to ensure integration into the budget.
- A Ministerial Committee to coordinate design and implementation, supported by an Advisory Board comprising civil society organizations, the private sector and development partners.
- Yearly reviews, and a mid-term review, will ensure regular and thorough evaluation.

This approach should help to better harness donor support, advance development goals and reduce aid dependency over time.[1] In particular, staff analysis had encouraged: (i) strengthening the development agenda to help enhance PA ownership; (ii) aid coordination and alignment with NPA goals to promote ownership and improve aid effectiveness; and (iii) strong and predictable aid to complement efforts to increase capital spending and mobilize revenue.

Importantly, it also provides more focus on outcomes and accountability. The PA and development partners are reviewing aid coordination mechanisms to promote complementarities between NPA priorities and donor programs, and ensure the NPA leads to specific outcomes that can be reported via the AHLC.

[1] IMF, May 2015 Report to the AHLC, Annex III, *Toward a Reduction of Aid Dependency in the West Bank and Gaza*.

- **Expenditure reforms:** Staff emphasized the need to shift the composition of expenditure to growth-friendly investments, and gradually re-orienting donor financing toward social and infrastructure investments. To support this shift, medium-term priorities include civil service, pension, and health sector reforms, and reforming intra-government fiscal relations. The World Bank's recent Public Expenditure Review found that: (i) the public sector wage bill—at 15 percent of GDP—is oversized by international standards, the structure of employment is suboptimal, and public wages are excessive; (ii) the pension system is not sustainable and efforts are urgently needed to raise the retirement age and reduce pension benefits; and (iii) high health spending of 5 percent of GDP reflects abuses in the health referrals system, excessive staffing, and high prices charged by pharmaceutical companies.[20] The authorities broadly agree with these expenditure reform priorities and, although they have yet to commit to specific actions, efforts are underway to contain health spending.

- **Fiscal structural reforms:** Staff welcomed the authorities' intention to finalize a new PFM strategy by June 2016, which should facilitate integration between the budget and NPA. Despite progress, there is a large unfinished PFM agenda. Staff was encouraged by the authorities' plans to tackle the backlog of unaudited financial statements. In the coming months, they intend to publish the 2011 audited financial statements, and to proceed with audits of 2012 and 2013 financial statements. With regard to cash management and commitment controls, the

[20] World Bank, Economic Monitoring Report to the AHLC, September 2015.

authorities started a pilot to record commitments of several line ministries and plan to implement commitment controls in all line ministries in 2017. The authorities noted their plans to publish a Citizens' Budget[21] in Spring 2016. Staff noted that other key steps to strengthen budget transparency and accountability include making operational the Public Procurement Council, and preparing and enacting an Organic Budget Law.

Financial Sector

21. Staff and the authorities agreed that proactively monitoring the financial sector would help limit the buildup of risks and ensure the system's ongoing resilience. The authorities pointed to wide-ranging improvements to the regulatory framework (Box 3), emphasizing their intention to maintain a strong regulatory environment.[22] They also restated their commitment to observe the PMA's informal limit on government borrowing from the banking sector. The authorities interpret rapid credit growth as the result of their National Financial Inclusion Strategy. Important steps of the strategy include: launching the National Switch Payment System in May 2015 to allow ATM connectivity between large banks; the planned amendment of the Banking Law to better meet SMEs' needs; and the planned Responsible Lending Regulation to more strictly regulate consumer loans and facilitate sound investment loans. However, should credit risks intensify, staff advised the PMA to stand ready to use macro-prudential measures to safeguard financial stability. Staff also encouraged the PMA to work towards incorporating non-bank entities within the regulatory perimeter, starting with their inclusion in the credit registry.

22. The authorities expressed concern regarding cash accumulation and strained correspondent banking relationships. The PMA emphasized that limits on transfers of shekel notes continue to pose problem, with the persistent accumulation of excess cash in banks. The authorities are determined to tackle potential AML/CFT risks and concerns, noting their recent membership of the MENA Financial Action Task Force and the new "Anti-Money Laundering and Terrorism Financing" law approved in December 2015. The authorities plan to produce accompanying regulations for the new legislation and hope that upcoming IMF technical assistance will support the PMA's efforts to effectively implement the law. The PMA noted it had commissioned an independent assessment of the WBG AML/CFT regime by a reputable international firm, to be completed shortly. Staff welcomed this move, particularly as time is of the essence, and also encouraged the PMA to seek a comprehensive assessment by a recognized FATF body.

[21] A Citizen's Budget aims to present key public finance information in more accessible language that is more widely understandable for the general public. It is part of the Open Budget Initiative—a global research and advocacy program—that promotes the adoption of accountable budget systems.

[22] More specifically, measures related to credit (beyond establishing the credit registry) include a 20 percent concentration threshold of total credit in any sector, limits on Loan-to-Value and Loan-to-Income ratios, and on banks' exposure to individual or government entities as percent of total capital. The PMA has also requested technical assistance on risk-based supervision and to develop an early warning system to better identify risks.

Box 3. Strengthening the Bank Regulatory Environment

Wide-ranging reforms have helped to ensure the banking system remained stable while growing rapidly. The Palestine Monetary Authority (PMA) faces major operational constraints, including: (i) lack of independent monetary policy; (ii) inability to act as a lender of last resort; and (iii) restrictions on the circulation of goods, people and money. Nonetheless, the banking system exhibits high capitalization, low NPLs and moderate profitability. Since 2008, total bank assets grew by 66 percent, deposits by 65 percent and credit more than doubled.

The banking system's resilience reflects both the PMA's financial inclusion strategy[1] and its strong regulatory framework.

- **Since 2008, the PMA has introduced a constellation of prudential regulations** governing capital, reserves, liquidity and lending ratios, credit concentration, outside placements, and open currency positions. The PMA also established a Credit Registry (2008), and an associated Credit Scoring system (2010) that was recently upgraded to provide a more comprehensive assessment including collateral of guarantors and liabilities of customers. In 2010, the PMA launched a Bounced Checks system.
- **The PMA recently expanded its macro-prudential toolkit.** In 2011, the PMA introduced stress testing and counter-cyclical capital reserve regulations. It also finalized a business continuity plan, which allowed the banking system to maintain operations in Gaza during the 2014 war and, with World Bank support, put in place a Credit Guarantee facility for affected Gazan businesses.
- **There have also been important steps to strengthening financial stability more broadly,** including creation of the Palestine Deposit Insurance Corporation (PDIC) in 2013. Also, the PMA recently signed various Memoranda of Understanding with other countries' supervisory bodies to strengthen cross-border coordination and improve the exchange of information on the banking system.
- **The PMA is also strengthening the AML/CFT regime**, recently joining the MENAFATF and approving new AML/CFT legislation in December 2015. The plan to finalize the electronic check payment project will help reduce large cash transactions.

The PMA plans to adopt additional measures in 2016 to further increase the banking system's resilience, including: implementing Basel II in March; approving the new Central Bank law by end year; finalizing a manual to improve risk-based supervision (based on IMF technical assistance); a project on responsible lending regulation; expanding the financial inclusion strategy; and amending the Banking Law to accommodate SMEs' needs.

[1] IMF, September 2015 Report to the AHLC, Annex Box 1, *Financial Inclusion in West Bank and Gaza*.

Structural Policies

23. Notwithstanding political constraints, persevering with efforts to enhance the regulatory environment and promote exports can provide a platform for future growth. Staff welcomed recent measures, including: (i) approving the 2014 instructions for the Financial Leasing Law; (ii) implementing the Moveable Asset Registry; (iii) launching a National Export Strategy; and (iv) establishing a National Export Council.[23] The authorities emphasized their plans to modernize

[23] The authorities' efforts also center on achieving WTO observer status, with a view to building capacity in trade administration and policy.

the business environment, by approving in 2016 the new Companies Law and the Secured Transaction Law—the latter is expected to boost the private sector's access to credit by formalizing the use of collateral. Looking forward, staff and the authorities agreed that additional measures are needed to reduce the cost and time it takes to start a business.[24] Moreover, progress is needed on land registration, with only 30–35 percent of land currently registered in the West Bank, hindering private investment and potential revenue gains from property fees and taxes.

STAFF APPRAISAL

24. **The economic outlook is fraught with uncertainty, with an increasingly precarious political situation undermining prospects for economic progress.** The Israeli-Palestinian peace process is under threat following the flare up in tensions since September 2015 and continued settlement expansion. Despite a number of attempts, domestic reconciliation has still not materialized. Assuming these conditions continue, but violence does not escalate further, growth is projected to average about 3½ percent in the medium term—insufficient to boost per capita incomes or generate adequate job opportunities. Without prospects for reducing the current high unemployment rates, particularly among youth and recent graduates, domestic political strains and the risk of social unrest will likely persist. A deterioration in the political or security situation could further weaken activity, and shortfalls in budget support would jeopardize the already fragile fiscal position, posing the main risks to the outlook. Strained correspondent banking relations are also a potential source of concern. On the upside, a breakthrough in the peace process could considerably brighten economic prospects.

25. **The authorities have managed these challenging circumstances well, although strains are evident.** The overall deficit declined in 2015, maintaining the trend fiscal consolidation of the past several years, driven by strong revenue performance combined with spending restraint. In particular, the authorities limited the increase in the wage bill to well below 2 percent for the year as a whole. However, a significant decline in donor budget support by almost one-third caused a shortfall in financing that contributed to the accumulation of new arrears. At the same time, the authorities managed to clear some arrears to the private sector.

26. **Without a breakthrough on the political front, effectively managing the budget and achieving further fiscal consolidation will become increasingly difficult.** The 2016 budget demonstrates the authorities' determination to achieve a further reduction in the deficit. Nevertheless, the downcast outlook for donor aid implies another large financing gap in 2016. While the PA could take a number of fiscal measures—such as limiting growth in the wage bill, scaling back fuel subsidies, strengthening payment discipline in the electricity sector, and further efforts to limit tax incentives and broaden the tax base—staff recognizes these will not be sufficient to close the gap. The financing gap poses a challenge for the authorities' plans to issue promissory notes. Staff supports the goal of stemming the flow of arrears to the private sector, but if this is to be

[24] WBG's overall rank on the World Bank's Doing Business index declined to 129 in 2016 from 127 the year before. The deterioration was most evident in 'starting a business' for which WBG dropped from 159th to 170th (of 189).

successful (and not compromise the authorities' bank financing objectives), additional budget financing will be needed. We also urge the authorities to implement their promissory note strategy alongside a comprehensive domestic arrears management strategy.

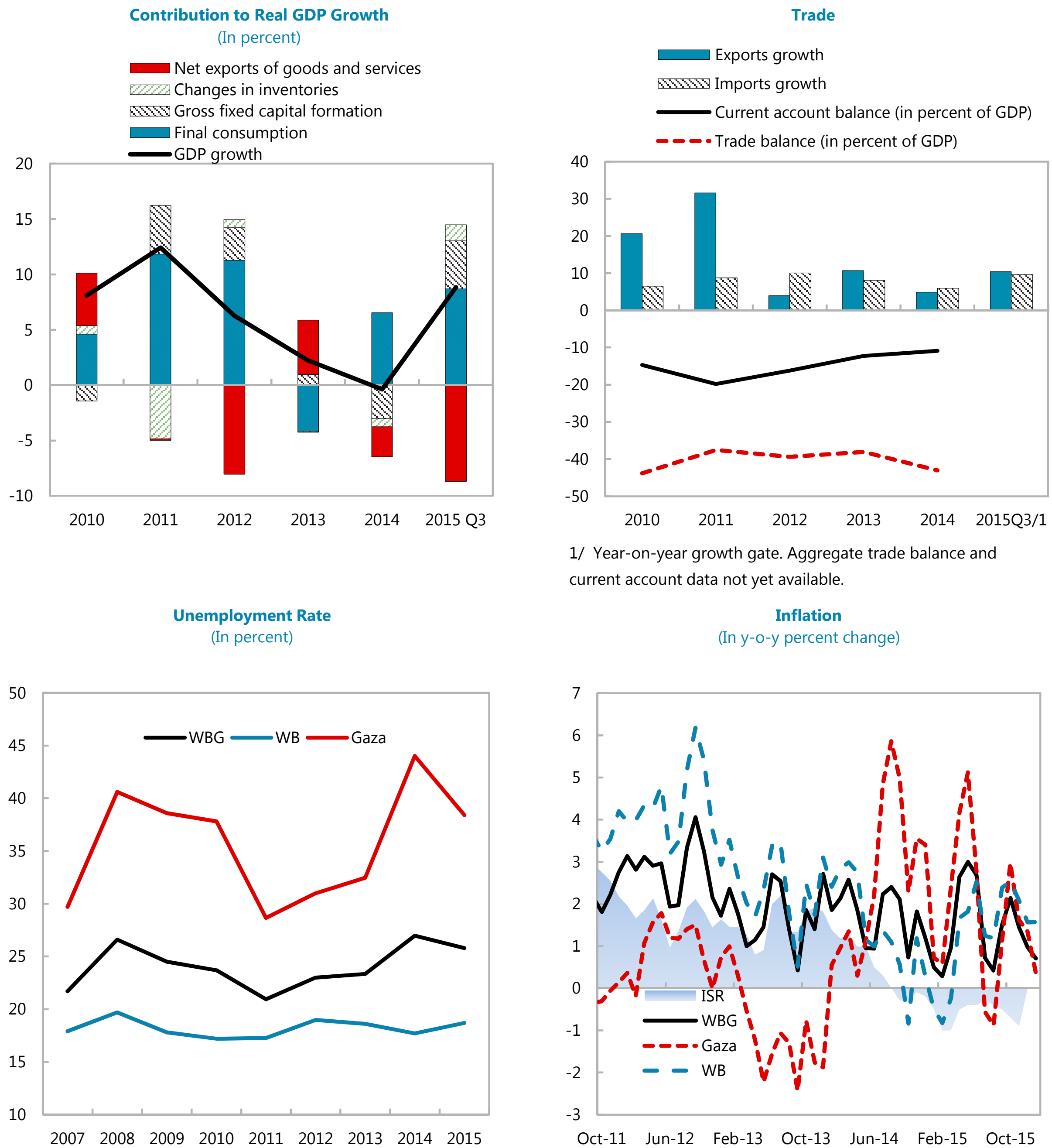
27. **These pressures also highlight the urgent need to improve economic cooperation between the PA and GoI.** The PA should sustain its efforts to continue a productive dialogue with the GoI on outstanding issues linked to implementing the Paris Protocol. The potential additional revenue would contribute to fiscal sustainability and facilitate a shift toward growth-friendly expenditure over the medium term. Moreover, reaching a common understanding on electricity sector debts, based on a transparent audit, could facilitate agreement on a repayment plan and facilitate greater predictability of revenues. This, in turn, would provide conditions more conducive to effective fiscal policy management.

28. **Maintaining the health and resilience of the financial sector is a priority.** Given the significant exposure of banks to the public sector and rapid credit growth to the private sector, the authorities' commitment to maintain a strong regulatory environment is particularly important. The recent expansion of the macro-prudential toolkit better positions the PMA to safeguard financial stability should risks intensify. At the same time, the PMA should work to bring non-bank entities into the credit registry and finalize the project on electronic check clearing. Given emerging strains on Israeli-Palestinian corresponding banking relations, the PA should continue with plans to implement the new "Anti-Money Laundering and Terrorism Financing" law and continue to seek expert technical support to demonstrate adherence to international best practice.

29. **Continued progress on reforms to strengthen institutions will be essential to create the conditions for private sector-led growth and catalyze increased donor support.** The authorities' plans to take a more strategic approach to aid management, including the formulation of a 2017–22 National Policy Agenda, and to pursue fiscal structural reforms will be particularly important. Priorities should focus on the finalization of a new PFM strategy, civil service and pension reform, and continued efforts to broaden the tax base, including through the design of a special tax regime for small and medium-sized enterprises.

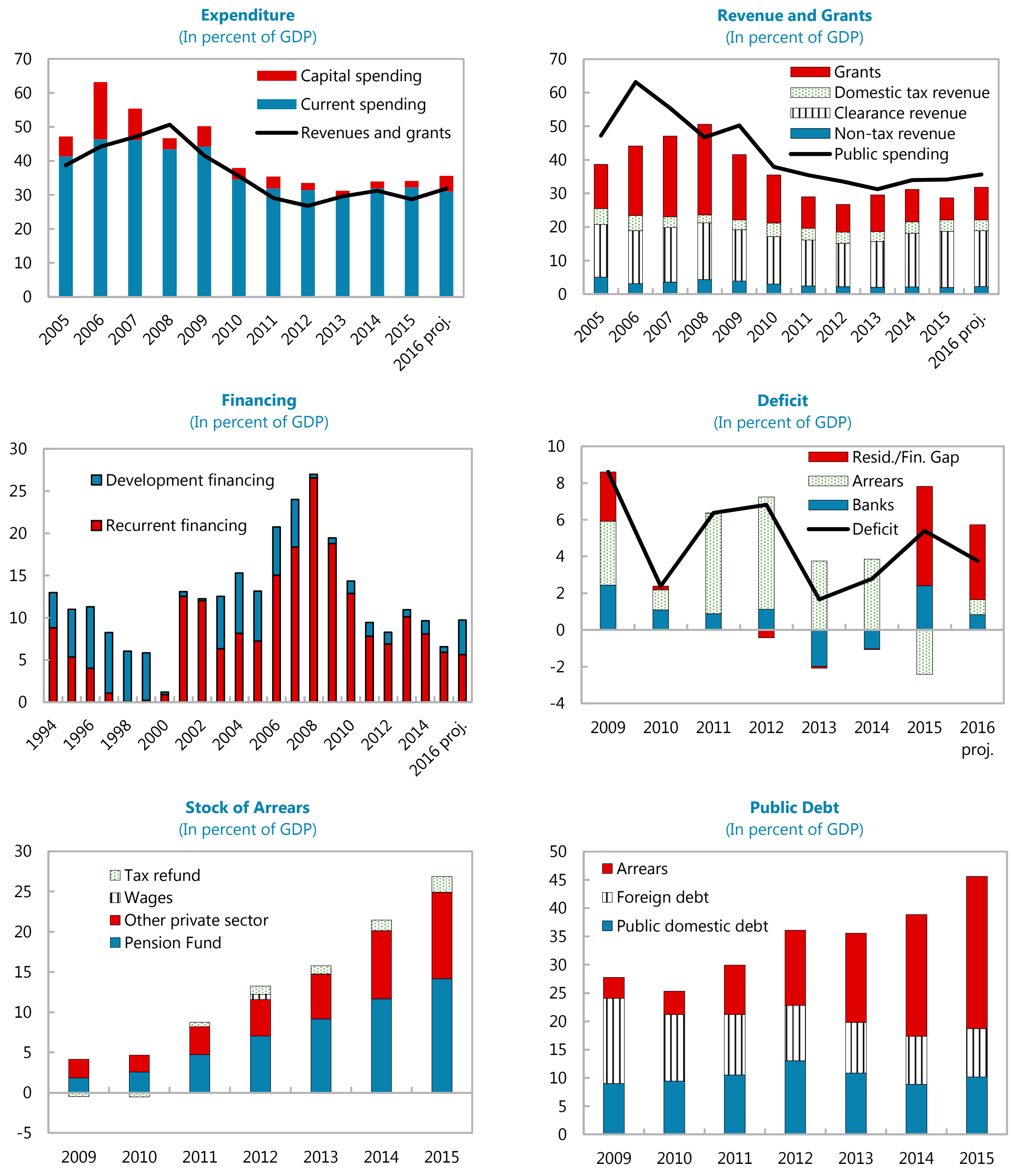
30. **Sustained reforms and a more strategic approach to development by the PA will provide a stronger basis for donor engagement.** As measures alone will not be enough to close the large financing gap projected for 2016, scaled up donor budget support for the PA is urgently needed. Beyond 2016, the focus needs to shift to a more viable financing model based on further fiscal consolidation and re-orienting government outlays towards productivity-enhancing investment in human capital and infrastructure that can help boost growth potential. Enhanced donor support and aid coordination, as well as efforts to reduce restrictions that prevent the economy from becoming self-reliant, will be necessary for such efforts to succeed.

Figure 1. West Bank and Gaza: Recent Economic Developments, 2010–15



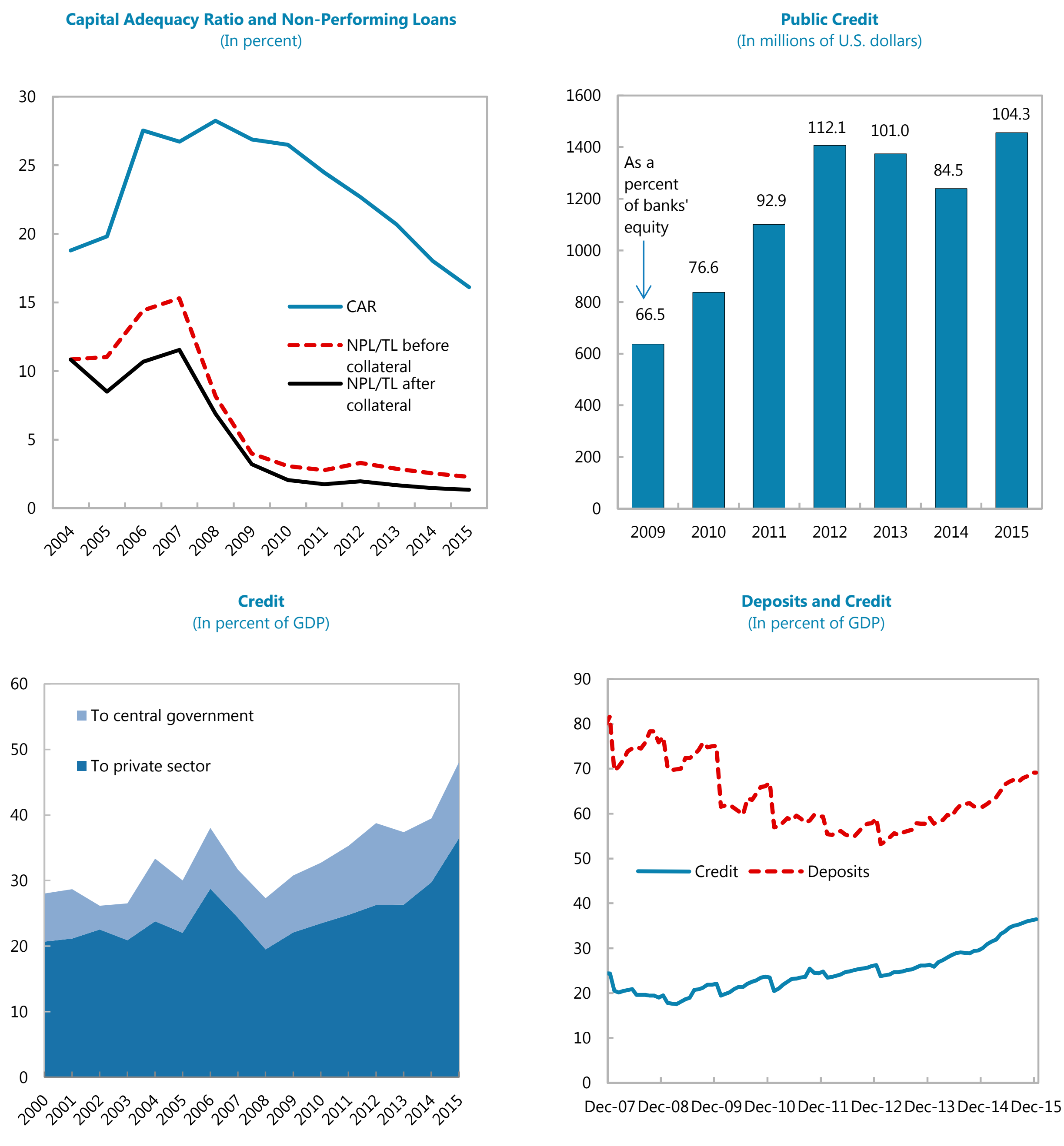
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

Figure 2. West Bank and Gaza: Fiscal Sector Indicators, 1994–2016



Source: Ministry of Finance.

Figure 3. West Bank and Gaza: Financial Sector Data, 2000–15



Sources: Palestinian authorities; and IMF staff estimates.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2013–21

(Population: 4.6 million; 2014 est.)
(Per capita GDP: $2,790; 2014)
(Poverty rate: 16 percent in the West Bank and 39 percent in Gaza Strip; 2014 est.)

			Est.	Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	2.2	-0.2	3.2	3.2	3.5	3.6	3.6	3.6	3.6
West Bank	1.0	5.3	2.7	2.7	3.0	3.1	3.0	3.0	3.0
Gaza	5.6	-15.1	5.0	5.0	5.0	5.5	5.5	5.5	5.5
CPI inflation rate (end-of-period)	2.7	1.2	1.0	2.0	1.0	1.9	2.3	2.3	2.3
CPI inflation rate (period average)	1.7	1.7	1.4	1.9	1.3	1.5	2.2	2.3	2.3
Investment and saving				(In percent of GDP)					
Gross capital formation, *of which:*	21.8	19.0	18.1	17.1	17.1	16.8	17.2	17.6	18.0
Public	3.3	3.6	3.7	3.4	3.5	3.6	3.5	3.6	3.5
Private	18.5	15.4	14.4	13.8	13.6	13.2	13.6	14.1	14.5
Gross national savings, *of which:*	9.5	11.6	12.2	12.1	11.5	10.6	9.3	9.2	7.0
Public	-1.0	-2.3	-4.1	-3.3	-2.7	-2.1	-1.5	-0.7	-0.3
Private	10.6	14.0	16.4	15.4	14.2	12.7	10.8	9.9	7.2
Saving-investment balance	-12.3	-7.4	-5.8	-5.0	-5.6	-6.2	-7.9	-8.4	-11.0
Public finances 1/				(In percent of GDP)					
Revenues	18.6	21.6	22.3	21.8	22.2	22.5	22.8	22.9	23.4
Recurrent expenditures and net lending	29.7	32.0	32.1	30.9	30.5	30.1	29.7	29.2	29.0
Wage expenditures	15.4	16.1	15.5	15.0	14.8	14.6	14.3	14.1	14.0
Nonwage expenditures	12.6	13.6	14.2	14.0	13.9	13.9	13.9	13.9	13.8
Net lending	1.7	2.3	2.4	1.9	1.8	1.6	1.4	1.3	1.1
Recurrent balance (commitment, before external support)	-11.1	-10.4	-9.9	-9.1	-8.3	-7.6	-6.9	-6.3	-5.6
Recurrent balance (cash, before external support)	-7.5	-5.1	-4.7	-11.0	-9.5	-8.7	-8.0	-7.4	-6.6
Development expenditures	1.5	2.1	1.9	1.8	1.8	1.6	1.6	1.6	1.6
(In millions of U.S. dollars)	187	262	231	242	246	216	222	216	227
Overall balance (commitment, before external support)	-12.6	-12.5	-11.7	-10.9	-10.2	-9.2	-8.5	-7.8	-7.1
Total external support, including for development expenditures	11.0	9.7	6.5	6.8	7.0	6.6	6.3	6.5	6.2
(In millions of U.S. dollars)	1,361	1,230	804	895	933	902	887	885	891
External support for recurrent expenditure (in millions of U.S. dollars)	1,255	1,027	714	757	757	757	757	757	757
In percent of GDP	10.1	8.1	5.7	5.8	5.7	5.5	5.4	5.5	5.3
Financing gap (in millions of U.S. dollars) 2/	...	...	...	554	490	418	371	262	206
In percent of GDP	...	...	...	4.2	3.7	3.1	2.7	1.9	1.4
Monetary sector 3/				(Annual percentage change)					
Credit to the private sector	11.0	17.3	20.0	15.0	13.0	12.0	12.0	11.4	11.4
Private sector deposits	10.7	7.2	7.3	6.8	6.3	5.8	5.3	4.8	4.3
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-22.4	-15.5	-11.6	-10.7	-11.2	-11.8	-13.3	-13.9	-16.3
Current account balance (including official transfers)	-12.3	-7.4	-5.8	-5.0	-5.6	-6.2	-7.9	-8.4	-11.0
Exports of goods and nonfactor services	16.7	17.1	16.8	16.1	16.4	16.5	16.5	16.2	16.2
Import of goods and nonfactor services	54.8	56.8	53.2	50.3	51.0	51.5	52.6	53.2	55.1
Net factor income	8.6	10.9	10.8	10.6	10.7	10.7	10.7	10.6	10.6
Net current transfers	17.3	21.4	19.7	18.7	18.4	18.0	17.6	18.0	17.2
Private transfers	7.1	13.3	14.0	12.9	12.7	12.5	12.2	12.5	11.9
Official transfers	10.1	8.1	5.7	5.8	5.7	5.5	5.4	5.5	5.3
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	12,419	12,697	12,459	13,158	13,364	13,640	13,997	13,663	14,309
Per capita nominal GDP (U.S. dollars)	2,809	2,790	2,661	2,732	2,698	2,677	2,672	2,536	2,584
Unemployment rate	23	27	27	28	29	29	30	30	30
Al Quds stock market index (annual percentage change)	13.4	-7.1	6.0	...	...	...	...	...	...

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

1/ Commitment basis.
2/ Financing gaps in the medium term are expected to be filled by grants that are yet to be identified.
3/ End-of-period; in U.S. dollar terms.

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2013–19

				Budget		Projections		
	2013	2014	2015	2016	2016	2017	2018	2019
	(In millions of shekels, unless otherwise stated)							
Net revenues	8,348	9,817	10,712	11,189	11,200	11,864	12,608	13,469
Gross domestic revenues	3,078	3,114	3,323	3,393	3,325	3,514	3,726	3,977
Tax revenues	2,157	2,149	2,354	2,193	2,214	2,356	2,513	2,696
Nontax revenues	921	966	969	1,199	1,112	1,158	1,213	1,281
Of which: arrears	...	...	...	...	...	...	...	...
Clearance revenues (accrued)	6,103	7,331	7,988	8,237	8,403	8,810	9,271	9,811
Of which: arrears	14	13	35	...	...	...	...	...
Less tax refunds 1/	834	628	599	441	529	459	389	319
Of which: arrears	27	147	335	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	13,336	14,556	15,453	15,212	15,860	16,328	16,874	17,562
Of which: arrears	1,601	2,281	2,194	-975	-976	-600	-616	-634
Wage expenditures (commitment)	6,928	7,336	7,439	7,662	7,685	7,917	8,172	8,487
Of which : arrears	380	570	603	...	...	...	...	...
Nonwage expenditures (commitment)	5,648	6,198	6,844	6,700	7,174	7,461	7,802	8,224
Of which: arrears	1,221	1,712	1,592	-975	-976	-600	-616	-634
Net lending	760	1,022	1,169	850	1,000	950	900	850
Development expenditures (commitment)	674	938	893	1,365	946	983	887	937
Of which: on Gaza reconstruction	...	89	131	...	133	136	...	...
Of which: arrears	66	351	206	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-4,988	-4,739	-4,741	-4,023	-4,660	-4,463	-4,267	-4,093
Overall balance (commitment)	-5,662	-5,676	-5,635	-5,388	-5,606	-5,447	-5,154	-5,030
Total financing	5,662	5,676	5,635	5,388	5,606	5,447	5,154	5,030
Net domestic bank financing	-895	-469	676	975	976	425	425	425
External debt repayment		-38	-42		-52	-72	-76	-79
External financing for recurrent expenditures	4,532	3,676	2,757	2,925	2,955	3,030	3,110	3,201
External financing for development expenditures	383	726	347	956	539	704	594	548
Arrears accumulation (net)	1,680	1,762	1,876	-975	-976	-600	-616	-634
Of which: repayment		-1,004	-917	-975	-976	-600	-616	-634
Residual/financing gap 2/	-38	18	20	1,507	2,163	1,961	1,717	1,569
	(In millions of U.S. dollars, unless otherwise stated)							
Net revenues	2,312	2,744	2,773	2,866	2,869	2,964	3,069	3,185
Gross domestic revenues	853	870	860	869	852	878	907	941
Tax revenues	597	601	609	562	567	588	612	638
Nontax revenues	255	270	251	307	285	289	295	303
Of which: arrears	...	...	...	...	...	...	...	...
Clearance revenues (accrued)	1,690	2,049	2,068	2,110	2,153	2,201	2,257	2,320
Of which: arrears	4	4	9	...	...	...	...	...
Less tax refunds	231	176	155	113	136	115	95	76
Of which: arrears	7	41	87	...	...	...	...	...
Recurrent expenditures and net lending (commitment)	3,693	4,068	4,001	3,897	4,063	4,079	4,107	4,153
Of which: arrears	443	638	568	-250	-250	-150	-150	-150
Wage expenditures (commitment)	1,919	2,050	1,926	1,963	1,969	1,978	1,989	2,007
Of which: arrears	105	159	156	...	...	...	...	...
Nonwage expenditures (commitment)	1,564	1,732	1,772	1,716	1,838	1,864	1,899	1,945
Of which: arrears	338	478	412	-250	-250	-150	-150	-150
Net lending (commitment)	210	286	303	218	256	237	219	201
Development expenditures (commitment)	187	262	231	350	242	246	216	222
Of which: on Gaza reconstruction	...	25	34	---	34	34	...	...
Of which: arrears	18	98	53	...	...	...	...	...
Recurrent balance (commitment, excl. development expenditure)	-1,381	-1,324	-1,228	-1,031	-1,194	-1,115	-1,039	-968
Overall balance (commitment)	-1,568	-1,586	-1,459	-1,380	-1,436	-1,361	-1,255	-1,190
Total financing	1,568	1,586	1,459	1,380	1,436	1,361	1,255	1,190
Net domestic bank financing	-248	-131	175	250	250	106	103	101
External debt repayment		-10	-11	---	-13	-18	-19	-19
External financing for recurrent expenditures	1,255	1,027	714	749	757	757	757	757
External financing for development expenditures	106	203	90	245	138	176	145	130
Arrears (net)	465	493	486	-250	-250	-150	-150	-150
Of which: repayment		-281	-237	-250	-250	-150	-150	-150
Residual/Financing gap 2/	-11	5	5	386	554	490	418	371
Memorandum items:	(In percent of GDP, unless otherwise stated)							
Revenues	18.6	21.6	22.3	21.8	21.8	22.2	22.5	22.8
Recurrent expenditures and net lending	29.7	32.0	32.1	29.6	30.9	30.5	30.1	29.7
Wage expenditures	15.4	16.1	15.5	14.9	15.0	14.8	14.6	14.3
Nonwage expenditures	12.6	13.6	14.2	13.0	14.0	13.9	13.9	13.9
Net lending	1.7	2.3	2.4	1.7	1.9	1.8	1.6	1.4
Recurrent balance (commitment) before external support	-11.1	-10.4	-9.9	-7.8	-9.1	-8.3	-7.6	-6.9
External financing for recurrent expenditures	10.1	8.1	5.7	5.7	5.8	5.7	5.5	5.4
Development expenditures (cash)	1.4	1.3	1.4	2.7	1.8	1.8	1.6	1.6
Overall balance (commitment)	-12.6	-12.5	-11.7	-10.5	-10.9	-10.2	-9.2	-8.5
Overall balance (cash)	-8.9	-6.4	-6.1	-12.4	-12.8	-11.3	-10.3	-9.6
Residual/financing gap	-0.1	0.0	0.0	2.9	4.2	3.7	3.1	2.7
Nominal exchange rate (NIS per U.S. dollar)	3.61	3.58	3.86	...	...	...	...	...
Nominal GDP (in millions of shekels)	44,843	45,429	48,123	51,364	51,364	53,497	56,034	59,185

Sources: Ministry of Finance; and IMF staff projections.

1/ Includes fuel subsidies.

2/ Financing gaps in the medium term are expected to be filled by grants that are yet to be identified.

Table 3. West Bank and Gaza: Central Government Fiscal Operations, 2013–19
(GFSM 2001)

			Prel.	Projections			
	2013	2014	2015	2016	2017	2018	2019
	(In millions of shekels)						
Revenue	13,263	14,220	13,816	14,694	15,598	16,312	17,218
Taxes	7,426	8,852	9,743	10,088	10,706	11,395	12,188
Domestic taxes	2,157	2,149	2,354	2,214	2,356	2,513	2,696
Clearance taxes	6,103	7,331	7,988	8,403	8,810	9,271	9,811
Tax refund	-834	-628	-599	-529	-459	-389	-319
Grants	4,915	4,402	3,105	3,494	3,734	3,704	3,749
External budget support	4,532	3,676	2,757	2,955	3,030	3,110	3,201
External development support	383	726	347	539	704	594	548
Other revenue	921	966	969	1,112	1,158	1,213	1,281
Of which: dividends	116	121	122	140	145	152	161
Expenditures	14,009	15,494	16,346	16,806	17,311	17,761	18,499
Expense	13,336	14,556	15,453	15,860	16,328	16,874	17,562
Compensation of employees 1/	6,928	7,336	7,439	7,685	7,917	8,172	8,487
Use of goods and services	1,816	2,333	2,530	2,530	2,635	2,760	2,916
Grants 2/	760	1,022	1,169	1,000	950	900	850
Other expense 3/	3,832	3,864	4,314	4,644	4,826	5,041	5,309
Net acquisition of nonfinancial assets	674	938	893	946	983	887	937
Gross operating balance	-73	-336	-1,637	-1,166	-730	-562	-344
Net lending / borrowing (overall balance)	-746	-1,274	-2,530	-2,112	-1,713	-1,449	-1,281
Net financial transactions	-746	-1,274	-2,395	-2,112	-1,713	-1,449	-1,281
Net acquisition of financial assets	...	...	...	...	...	...	...
Domestic							
Currency and deposits	...	...	...	...	...	...	...
Net incurrence of liabilities	785	1,256	2,375	-52	-248	-268	-288
Domestic	785	1,293	2,418	0	-175	-191	-209
Loans	-895	-469	634	976	425	425	425
Net domestic bank financing	-895	-469	634	976	425	425	425
Other accounts payable	1,680	1,762	1,783	-976	-600	-616	-634
Arrears (recurrent)	1,628	1,424	1,612	-976	-600	-616	-634
Arrears (capital)	66	351	206	...	...	...	...
Arrears (clearance)	14	13	35	...	...	...	...
Foreign	...	-38	-42	-52	-72	-76	-79
Loans	...	-38	-42	-52	-72	-76	-79
Statistical discrepancy/financing gap	-38	18	20	2,163	1,961	1,717	1,569
Memorandum items:							
Gross operating balance excl. grants (commitment)	-4,988	-4,739	-4,741	-4,660	-4,463	-4,267	-4,093
Gross operating balance excl. grants (cash)	-3,374	-3,328	-3,164	-5,636	-5,064	-4,883	-4,727
Overall balance (NLB) excl. grants (commitment)	-5,662	-5,676	-5,635	-5,606	-5,447	-5,154	-5,030
Overall balance (NLB) excl. grants (cash)	-3,982	-3,914	-3,851	-6,582	-6,047	-5,770	-5,664
Revenue (percent of GDP)	29.6	31.3	28.7	28.6	29.2	29.1	29.1
Expenditure (percent of GDP)	31.2	34.1	34.0	32.7	32.4	31.7	31.3
Expense (percent of GDP)	29.7	32.0	32.1	30.9	30.5	30.1	29.7
Wage expenditure (percent of GDP)	15.4	16.1	15.5	15.0	14.8	14.6	14.3
Nonwage expenditures (percent of GDP)	4.1	5.1	5.3	4.9	4.9	4.9	4.9
GOB (commitment) excluding grants (percent of GDP)	-11.1	-10.4	-9.9	-9.1	-8.3	-7.6	-6.9
GOB (cash) excluding grants (percent of GDP)	-7.5	-7.3	-6.6	-11.0	-9.5	-8.7	-8.0
External support (recurrent)	10.1	8.1	5.7	5.8	5.7	5.5	5.4
in millions of NIS	4,532	3,676	2,757	2,955	3,030	3,110	3,201
NLB (commitment) excluding grants (percent of GDP)	-12.6	-12.5	-11.7	-10.9	-10.2	-9.2	-8.5
NLB (cash) excluding grants (percent of GDP)	-8.9	-8.6	-8.0	-12.8	-11.3	-10.3	-9.6
Total external support (in millions of shekels)	4,915	4,402	3,105	3,494	3,734	3,704	3,749
Nominal GDP (in millions of shekels)	44,843	45,429	48,123	51,364	53,497	56,034	59,185
Exchange rate	3.6	3.6	3.9	...	...	...	...

Sources: Ministry of Finance; 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, 2011–15

	Dec-11	Dec-12	Dec-13	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
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
Regulatory capital to risk-weighted assets	21.1	20.3	20.0	18.9	17.8	17.2	17.8	18.0
Capital adequacy (for local banks)								
Tier I capital to risk-weighted assets	24.5	22.7	20.7	18.0	17.4	16.9	16.2	16.1
Regulatory capital to risk-weighted assets	20.3	18.8	17.8	16.3	15.7	15.3	15.4	15.4
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
Nonperforming loans net of provisions to capital	3.8	4.9	4.7	4.0	4.9	4.2	4.2	3.4
Coverage ratio (provisions as percent of nonperforming loans)	60.9	60.1	59.1	61.4	58.6	63.3	63.6	67.3
Earnings and profitability								
Return on assets (ROA)	1.9	1.8	1.9	1.7	1.6	1.6	1.6	1.5
Return on equity (ROE) 2/	17.0	16.2	18.7	17.1	15.7	15.5	15.7	15.0
Interest income to gross income	71.7	72.4	74.0	72.4	71.5	70.6	71.7	72.2
Non-interest expenses to gross income	57.2	55.4	54.8	60.1	60.2	61.0	62.0	63.0
Personnel cost to non-interest expenses	55.5	53.8	53.9	51.5	53.0	52.8	51.8	51.3
Liquidity								
Liquid assets to total assets	38.2	37.5	39.5	35.4	34.1	33.4	35.9	34.2
Liquid assets to demand and savings deposits	74.4	71.6	74.7	65.9	62.9	60.0	65.3	62.3
Liquid assets to total deposits	46.9	45.8	48.1	43.2	41.8	40.0	42.9	41.0

Source: Palestine Monetary Authority.

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

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

Annex I. West Bank and Gaza—Risk Assessment Matrix[1]
Potential Deviations from the Baseline

Nature/Sources of Risk	Relative Likelihood/ Time Horizon	Expected Impact If Realized	Policies to Mitigate Risks
Structurally weak growth in key advanced and emerging economies	***High/Medium/ Medium Term***	***Medium*** The WBG is sensitive to a slowdown in Israel. Further austerity in donor countries could affect availability of aid for the PA. This could see even weaker growth, higher unemployment, and a worsening 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.
Reduced financial services by global/ regional banks ("de-risking")	***High/ Short Term***	***High*** Restrictions on cash transfers to Israel by WBG banks is already a source of liquidity risk. Severing correspondent Israeli-Palestinian banking relationships could heighten financial stability concerns and jeopardize the functioning of the WBG payment system.	(1) Instill confidence through effective implementation of the "Anti Money Laundering and Terrorism Financing" law and related regulations. (2) Seek technical support and capacity building, and an independent assessment of the WBG AML/CFT regime (possibly by the MENA Financial Action Task Force).
Heightened risk of fragmentation/security dislocation in part of the Middle East	***High/ Short Term***	***Medium/High*** Social and political unrest in the region could see a sustained diversion of donor aid away from the WBG and associated pressures on PA budget sustainability. Any direct spillover of regional instability and dislocation would increase security and economic uncertainty in WBG.	Economic policies can do little to mitigate particular risks. At best, maintaining strong domestic policies could instill some element of confidence.
Resumption of hostilities between Hamas and Israel in Gaza; escalation of violence in the West Bank	***High/ Short to Medium Term***	***High*** Resumption of the conflict would further erode the humanitarian and economic situation in Gaza. Even if the truce holds, increased unrest in the West Bank could undermine growth and lead to tightening Israeli restrictions. Some donors may scale back or withdraw support.	In the short run, economic policies can do little to mitigate particular risks. At best, maintaining strong domestic policies could instill some element of confidence.

Donor "fatigue" and reduced support from Arab donors due to falling oil prices	***Medium/ Short to Medium Term***	***High*** Budget support from Arab donors could decline due to a reduction in oil producers' income following the sharp decline in oil prices. The suspension of peace talks, if sustained, could lead other donors to reconsider their long-term commitment to supporting the PA, which could jeopardize fiscal sustainability. Budget support could also decline due to diversion of commitments to Gaza reconstruction.	(1) Instill confidence through strong domestic policies, anchored in medium-term fiscal adjustment. (2) Implement pro-growth policies, including the composition of budget spending and ensuring resilience of the financial sector, could over time reduce aid dependency and support fiscal sustainability. (3) Continue reforms to improve government institutions.
Persistently lower energy prices	***High/ Medium Term***	***Low*** Failure to capitalize on lower global fuel prices by maintaining fuel subsidies could further weaken an already fragile fiscal position.	Phase out fuel subsidies while strengthening targeted social transfers to support the poor.

[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. Updated Debt Sustainability Analysis

This debt sustainability analysis (DSA), which updates the September 2015 DSA, demonstrates that the risks to sustainability have further increased.

Assumptions: As the main macroeconomic assumptions for growth, prices, and the exchange rate remain broadly unchanged, the main difference from the previous DSA is the increase in the average financing gap over the projection period. The 0.5 percentage point increase in the financing gap, from about 3 percent to 3½ percent in the medium-term, is due to the significant drop in donor financing, possibly reflecting competing aid needs elsewhere in the region and some donor fatigue.

Debt Trajectory: Under the baseline scenario, public debt is on a rising path though the first four years, stabilizing the final year of the projected period. This now sees public debt is projected to reach 52 percent of GDP in 2020, up 9 percentage points of GDP from end-2015 and compared to a previously projected peak of 45 percent. Under shocks to the primary balance, interest rates and contingent liabilities, public debt could approach or reach around 60 percent of GDP. However, the growth shock sees public debt approaching 70 percent by the end of the projection period, with no apparent tapering of the upward trajectory.

Figure A1. West Bank and Gaza: Public Debt Sustainability: Bound Tests 1/2/
(Public debt in percent of GDP)

Sources: Palestinian authorities; and IMF staff estimates and projections.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Annex III. West Bank and Gaza—Technical Assistance by the IMF to the Palestinian Authority, 2011–16

Fund technical assistance has focused on 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 medium term priorities remain on public financial management, revenue administration, and banking supervision. Intermittent review and assistance is needed to enhance the statistical capacity especially in GFSM 2001, external sector, and national accounts expenditures side. FAD and MCM in particular are expected to continue providing TA, dependent on the authorities' commitment and progress, supported by METAC.[1]

Fiscal Sector: Since 2007, numerous reform components of a modern public financial management system have been put in place and steadily upgraded. Significant progress in PFM was made in drafting legal frameworks, adopting Single Treasury Account (STA), establishing debt management and cash planning units, modernization of budget classification and Chart of Accounts, developing computerized financial management information system (FMIS), strengthening accounting and reporting, activating internal audit departments in ministries, establishing an independent external audit agency, and establishing a macro-fiscal unit. A medium-term plan of reforms had been agreed upon in 2011 and further updated in 2012. Currently, the key objective is to consolidate the institutionalization of progress already made. Further to consolidation, approval of legislative and regulatory frameworks, review of implementation of commitment control and STA, cash planning, arrears recording and formulation of strategies for minimizing arrears, and compliance with GFSM 2001 standards need to be addressed. Since 2010, the TA efforts expanded into mobilizing revenue compliance by modernizing tax administration. A medium-term work program, recommended by the FAD, will strengthen particularly the administration of income tax and VAT for the large and medium taxpayer segments and reform the income tax and reduce tax incentives and exemptions. So far, a computerized revenue management system has been launched, a tax procedures code was approved by the Cabinet but not enacted, and the LTU, under a newly appointed director, has begun more effective work. In the medium term, the FAD TA priorities will remain the improvement of public financial management and modernization of revenue administration.

Mission Date	Mission	Date of TA Report
Mar. 19–30, 2011	Palestinian Authority Integrated Tax Administration System	Mar. 2011
Jul. 3–7, 2011	Self Assessment Preparations and Progress with its Introduction in LTU	n.a.
Sep. 14–27, 2011	Tax Audits Procedures	Oct. 2011
Sep. 28–Oct. 30, 2011	Improving Compliance with Income Tax	Dec. 2011
Dec. 1–12, 2011	Public Financial Management Progress Review	Jan. 2012
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 Administration	Aug. 2015
Aug. 23–28, 2015	Work Program for Macro-Fiscal Advisor	n.a.
Jan. 10–21, 2016	Preparation of Files for Prosecution	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 operate a high-quality reserves management system, to supervise and regulate banks, to gain capacity in introducing government securities, and to prepare for eventual introduction of an independent currency for the Palestinian economy when conditions are right. The PMA established a credit registry, instituted periodic stress testing of banks, introduced a deposit insurance scheme, and prepared plans for contingency crises management. The PMA has developed substantial capacity as a central bank toward the possibility of issuance of a national currency.		
Mission Date	**Mission**	**Date of TA Report**
Dec. 3–8, 2011	Support to the Palestine Monetary Authority Credit Registry	Dec. 2011
Dec. 8–15, 2011	Enhancing the Capacities of the Palestine Monetary Authority and Options for the Issuance of New Currency and the Monetary Policy Regime *	Mar. 2012
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 Stress Testing Framework, Consolidated and Cross Border Supervision and Contingency Crisis Management Framework	Nov. 2012
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	Contingency Planning and Crises Preparedness*	May 2015
April 5–16, 2015	Follow up on Risk Based Supervision Manual*	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.

Statistics: The TA efforts have been to implement and align existing statistical compilation and dissemination systems with the latest international statistical standards across three major datasets [government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS)] for economic policy analysis. These efforts culminated with WBG joining the IMF's Special Data Dissemination Standard (SDDS) as a subscriber in April 2012. Further work is needed in improving data consistency in ESS, developing an inter-institutional strategic plan for GFSM2001 implementation, and developing of a set of high-frequency indicators to detect economic trends and risks. In general, the transparency and timeliness of the data produced by the Palestinian Central Bureau of Statistics, Ministry of Finance, and the PMA compare favorably with countries that maintain good data management and dissemination standards.

Mission Date	**Mission**	**Date of TA Report**
Oct. 16–27, 2011	Report on the SDDS Assessment Mission	Oct. 2011
Nov. 27–Dec. 1, 2011	Balance of Payments Statistics – IIP	n.a.
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

[1] METAC – Middle East Regional Technical Assistance Center.

n.a. – not applicable.

* The reports are classified confidential.