RECENT EXPERIENCE AND PROSPECTS OF THE ECONOMY OF THE WEST BANK AND GAZA[1]

STAFF REPORT PREPARED FOR THE MEETING OF THE AD HOC LIAISON COMMITTEE

Brussels, March 19, 2013

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I. EXECUTIVE SUMMARY

Relative to the already difficult situation when the AHLC met in September 2012, the economy and public finances of West Bank and Gaza (WBG) have deteriorated further. The economy is hobbled by persistent restrictions and increasing political uncertainty. The liquidity crisis has deepened, with large increases in arrears and domestic debt, affecting core government operations. Urgent actions are needed—by the Palestinian Authority (PA), by the Government of Israel, and by donors—to stabilize the fiscal position and rekindle economic growth over time.

The WBG finds itself in a far more precarious situation than six months ago:

- Economic activity has slowed and unemployment has increased to almost a quarter of the labor force at end-2012, with youth unemployment particularly high.

- The liquidity crisis has deepened and the public finances are on an unsustainable path. Domestic sources of financing are drying up, with both the bank and non-bank private sector increasingly reluctant to finance the government. With transfer of clearance revenues held up repeatedly and donor aid insufficient to cover the fiscal deficits, wage payments have been repeatedly delayed and arrears continue to increase, with adverse effects on institution building and social stability. If left unchecked, these trends will ultimately lead some to question the legitimacy of the PA and undermine its ability to govern effectively.

- Israeli restrictions on movement and access are virtually unchanged and continue to hamper growth prospects in the WBG.

- Political uncertainty has increased. The military confrontation between Hamas and Israel last November, continued settlement expansion, and recent outbreaks of unrest in the West Bank underline the common view that prospects for peace remain dim. In addition, unrest in the region deepens the sense of gloom.

The WBG economy weakened in 2012, with a slowdown in growth and a rise in unemployment. Real GDP growth has declined from an annual average of about 11 percent in 2010–11 to 6 percent in 2012 (January–September) reflecting shortfalls in aid, lack of easing of restrictions on movement and access, and increased political uncertainty. Moreover, the fragile regional economic and political environment continued to further dampen the WBG's export and foreign investment prospects.

The economic outlook is for a further weakening of growth and risks are tilted to the downside. Real GDP growth in the WBG is projected to decline to 5 percent in 2013, far below recent growth rates, with a continuing downward trend in subsequent years. Underlying this outlook is the economic impact of virtually unchanged controls on internal movement in the West Bank, the persistence of obstacles to export and import in the West Bank and the virtual closure of Gaza, and, to a lesser extent, fiscal retrenchment. While the WBG's global economic linkages are limited by the Israeli trade restrictions, the regional downturn and rise in political turmoil further dampens the economic outlook. Absent a revival of the peace process, risks are mostly on the downside, given that persistent restrictions in the WBG and shortfalls in aid could lead to a faster deterioration in the macroeconomic environment, resulting in wider fiscal deficits and arrears accumulation. The withholding of Israeli revenue transfers and lower-than-expected donor aid are additional risks, with similar consequences for growth and the fiscal position.

The PA's fiscal situation is increasingly precarious, with mounting domestic payment arrears, including on public sector wages, and rising domestic bank debt. In 2012, substantial aid shortfalls and worse-than expected revenue and expenditure outturns led to large arrears accumulation (nearly 6 percent of GDP) to the private sector, the public pension fund, and wages, with bank loans to the PA rising to $1.4 billion. The liquidity crisis has started to affect government operations, threatening some of the institutional improvements made in recent years (especially in the area of public financial management) and eroding public confidence in the PA. For 2013, the draft budget (which will be finalized by end-March) targets a recurrent deficit of $1.3 billion (on commitment basis), which, combined with expected donor financing of $1 billion and payment of wage arrears, implies a financing gap of $0.4 billion. The financing gap could be even higher if aid falls short or if Israel requires repayment of clearance revenue advances provided in 2012.

Efforts by the PA to rein in the deficit should be accompanied by increased donor assistance and enhanced economic cooperation with Israel. With WBG's private sector weak, a sharp public sector retrenchment to cover the financing gap would further weaken the economy and raise already-high social tensions. That said, domestic financing constraints are becoming binding and there is a high risk that the hoped for additional donor assistance will not materialize, given fiscal problems in the donor countries and competing demands for aid. As a result, additional fiscal adjustment (over and above the draft budget) by the PA is necessary.

With revenues largely outside the PA's direct control, the fiscal adjustment should focus on the expenditure side, with additional contingency measures in case fiscal risks materialize. Staff recommends a cap on expenditure commitments to accommodate the tighter financing constraint, including in the 2013 budget through freezes in wages and promotions, compression of operational spending, rationalization of allowances, postponement of non-essential development projects, while making room for expanding coverage of the cash transfer program to protect poor and vulnerable households. On the revenue side, the budget should increase selected fees to strengthen cost recovery. The financing gap would be commensurately higher (and perhaps reach $0.7 billion) if certain risks were to materialize, including a shortfall in donor support for projects—as has happened in past years—or if the Government of Israel requires repayment of revenue advances and electricity debts that it claims are outstanding. These risks should be mitigated by devising a contingency plan containing further measures to avoid across-the-board expenditure compression. Separately, the Palestine Monetary Authority (PMA) needs to carefully monitor and guard against financial stability risks that could arise from the banks' increasing exposure to the PA at a time of weakening public finances.

Concerted actions by the PA, Israel, and the international community are urgently needed to address WBG's daunting challenges. First, it is important to promptly implement the understandings reached in mid-2012 between Israel and the PA on measures to enhance the collection of clearance revenue and ensure its timely transfer to the PA, given that such revenue represents the bulk of the PA's revenue. Second, a broadening of cooperation to include an easing of Israeli restrictions on external trade and movement of goods and people in the WBG is essential to expand private sector growth and employment, and substantially reduce reliance on aid. Third, it is critical for the international community to re-engage more fully in supporting the WBG's development, in particular by providing a framework for economic cooperation between Palestinians and Israelis. In the short run, it is especially important that the PA's efforts at containing fiscal spending be complemented by the prompt disbursement of additional donor aid to avoid an excessive fiscal tightening, a further buildup of arrears and debt to commercial banks, and spending cuts that would trigger more social unrest.

Beyond immediate crisis management, structural reforms are vital to put the WBG on a higher and sustainable growth path. This will require an easing of the Israeli restrictions, improvements in the business climate, and reform of the PA's civil service, pension systems, and healthcare system.

II. Recent Economic Developments

1. **The WBG's economy continues to face serious risks, with a sharp slowdown in growth and a rise in unemployment.** The WBG's overall real GDP growth has declined from an annual average of about 11 percent in 2010–11 to 6 percent in 2012 (January–September).[2]

- The West Bank's real GDP growth has declined from an annual average of 9½ percent in 2010–11 to 5½ percent in January–September 2012, reflecting shortfalls in aid, limited easing of restrictions on movement and access[3] and increased political uncertainty. These factors, and a slowdown in mortgage lending, had a particularly negative impact on the construction sector, which was the main driver of growth in 2011, but sapped growth in 2012.

- Gaza, which accounts for about 30 percent of the WBG's total GDP, enjoyed rapid real GDP growth in 2010–11 (nearly 15 percent), driven by relaxation of Israeli restrictions on imports of consumer goods and on inputs for selected construction projects. More recently, however, growth has slowed substantially, to about 7½ percent in January–September 2012. The slowdown reflects the absence of further relaxation of restrictions since mid-2010 and interruptions in the tunnel trade with Egypt as a result of deteriorating security conditions in the Sinai. This, in turn, hurts growth in the construction sector, although this sector remains the predominant source of growth in Gaza. Agriculture suffered from more frequent power outages and unfavorable weather conditions. While data are not available, the military confrontation in November 2012 is bound to have inhibited economic activity in the fourth quarter, despite some easing of import controls on building materials into Gaza following the truce.

[2] The Palestinian Central Bureau of Statistics (PCBS) has published revised real GDP data from 2010. The revision was the result of the introduction of separate deflators for West Bank and Gaza and review and improvement of price data used for deflating national accounts data in the context WBG's subscription to the IMF's Standard Data Dissemination Standard (SDDS). As a result, real GDP growth in 2010 and 2011 in West Bank was revised upward and in Gaza downward. For the WBG as a whole, annual real GDP growth was revised from 9.8 to 9.3 percent in 2010 and from 9.9 percent to 12.2 percent in 2011. Revisions for 2012 were small.

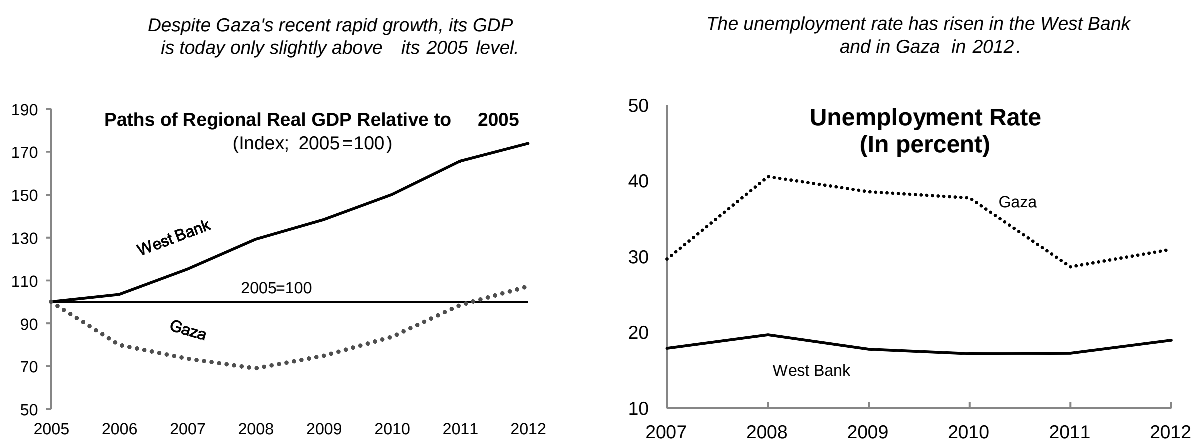
[3] According to the UN Office for the Coordination of Humanitarian Affairs (OCHA), the number of obstacles on movement within the West Bank declined from 626 at end-2009 to 500 at end-August 2010, but increased to 523 at end-2011 and 542 by end-September 2012. For details on the obstacles and non-trade barriers to the access of goods from the West Bank to Israel, see the World Bank's report "An Analysis of the Economic Restrictions Confronting the West Bank and Gaza", published on www.worldbank.org.

2. **Reflecting the decline in growth, the WBG unemployment rate rose to 23 percent in the fourth quarter of 2012, from 21 percent in the same period the year before.**

- In the West Bank, unemployment increased to 18 percent in the fourth quarter of 2012, from 17 percent in 2010 and 2011. Youth unemployment in the West Bank in the fourth quarter of 2012 increased to 28 percent from 26 percent in 2006–11. Persistently high unemployment is the result of slow employment growth in the labor-intensive tradable sectors such as manufacturing owing to the loss of market share and reduced access to imported inputs, exports, and investment in the fertile Jordan valley and other parts of area C.[4]

- In Gaza, the sharp decline in growth in 2012 pushed unemployment to 32 percent in the fourth quarter of 2012, from 30 percent in the same period the year before. Youth unemployment also increased from 47 percent in the fourth quarter of 2011 to 49 percent in the same period in 2012. Tight restrictions on mobility of labor into Israel, where before 2000 about one in eight Gazans found employment, remain an important impediment to lower unemployment.

Figure 1. Growth and Unemployment



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

3. **Inflation in WBG remains low at less than 2 percent.** In the West Bank, inflation was 2.7 percent at end-December 2012, although it reached 6 percent in September–October reflecting higher prices for food and petroleum products. Prices of petroleum products rose between 11 percent (for kerosene and diesel) and 15 percent (for regular gasoline) in September compared to the same period in 2011, before edging lower, reflecting price

[4] In 2012, Israel increased the number of work permits for Palestinians. The number of Palestinians from the West Bank working in Israel and settlements increased from 83,250 in 2011 to 86,700 in 2012.

developments in Israel from which the PA imports petroleum products. Annual inflation in Gaza was subdued at less than 1 percent in 2012, despite interruptions of supply of imported goods during the military confrontation in November.

4. **Commercial banks are profitable, well capitalized, and liquid, but the continued rise in lending to the PA poses a risk for the stability of the financial system.**

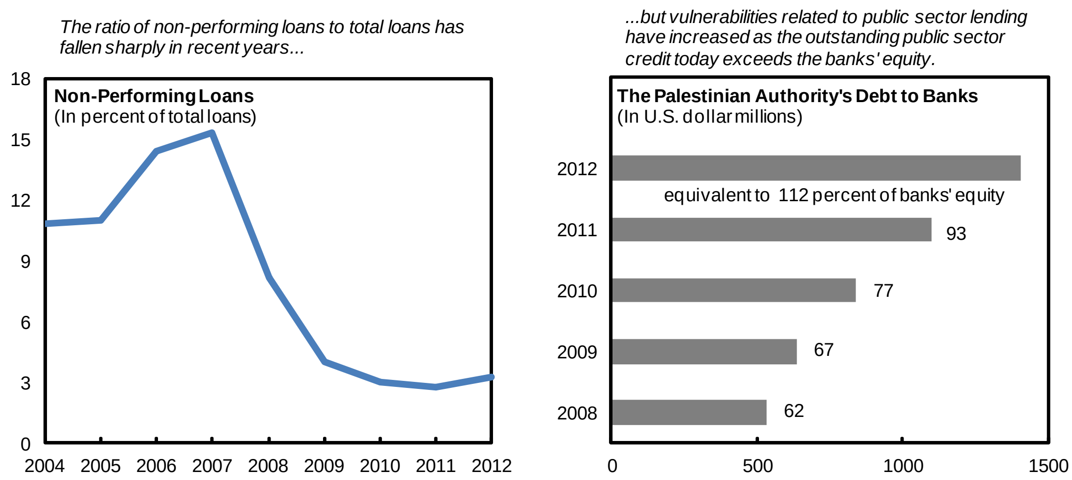
- Exposure to global markets continues to be limited, with conservative lending practices by banks and well-functioning banking supervision by the PMA.[5] Private sector credit growth in the West Bank declined from 17 percent in 2011 to 10 percent in 2012, reflecting worsened economic conditions, while in Gaza credit growth slowed marginally from 47 to 44 percent. The share of non-performing loans in total loans remains low, at 3.3 percent at end-December 2012 (Table 6). However, bank exposure to the PA has been increasing, and there is a risk that the PA will be unable to quickly reduce its arrears to private sector suppliers, which in turn could undermine the ability of these suppliers to settle their bank debts, leading to a rise in banks' non-performing loans.

- Private deposits in the West Bank grew by 8 percent in 2012, reflecting private income growth and continued expansion of bank branches. In Gaza, deposits increased by 1 percent in 2012, after having decreased in 2010–11 owing to large cash withdrawals to satisfy pent up demand after the relaxation of import restrictions.

- The PA's debt to commercial banks rose to $1.4 billion at end-2012, equivalent to 112 percent of banks' equity. One implication of the PA's liquidity difficulties has been temporary delinquencies by public sector employees on loan repayments, following delays in the payment of their wages. Loan repayments resumed with the resumption of wage payments. However, the risk of wage payment delays has contributed to a rise in demand by PA employees for bank loans. Bank credit to PA employees increased from $0.3 billion at end-2010 to $0.7 billion at end-2012.

[5] The Palestine Monetary Authority has maintained prudential regulation and supervision of commercial banks in Gaza after the PA lost control over government institutions in 2007.

Figure 2. The Banking Sector



Source: Palestine Monetary Authority.

5. **The authorities continue to take steps to strengthen financial system stability and infrastructure.**

- **Stress tests**. The PMA's stress tests suggest that the WBG's banking system is resilient, although the combination of high government indebtedness and deteriorating fiscal position poses a risk for some (systemic) banks (Box 1). The PMA's quarterly stress testing involves sensitivity tests and macro stress testing. The risks assessed include the direct and indirect exposure of the banking system to the government, and credit and concentration risks. The PMA also requires banks to conduct semi-annual stress tests with scenarios tailored to their specific conditions. The findings of these exercises have been applied to develop policies to strengthen the resilience of the banks to shocks, including a disaster recovery plan and recommendations to strengthen the capital base, diversification of credit and foreign investment portfolios, and for banks to conduct analysis and stress test shocks to strengthen their financial positions.

- **Deposit insurance**. A deposit insurance scheme to replace the implicit blanket guarantee and boost confidence in the banking system is awaiting presidential approval. The scheme, which is mostly financed by the commercial banks, is likely to be fully funded in seven to ten years.

- **PMA**. The authorities are working on a new central bank law that will strengthen the legal framework governing the PMA's operations.

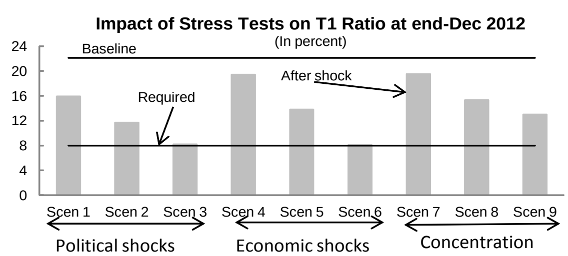
- **Payments system**. An important step has been taken towards establishing a modern payments system in the PA. A decree law passed in December 2012 granted the PMA the power to launch a national system for clearing and settling payments. The new system gives the central bank scope to introduce a centralized system for settlement of financial transactions and automated clearing, which should reduce settlement risk.

Box 1. Stress Tests of the Banking Sector

Since January 2011, the PMA has been conducting stress tests for the WBG's banking sector and individual banks. These quarterly stress tests consist of an assessment of the impact of credit, liquidity, market, and operation shocks on banks' financial position, capital adequacy, and liquidity. Given the high and increasing exposure of banks to the PA and its employees, the tests incorporate the effects of delayed repayments of loans by the government and delinquencies on PA employee loans.

The stress tests conducted in December 2012 did not deviate significantly from previous tests and indicate that the WBG's banking system is resilient to a broad range of shocks. The banking system is currently well capitalized, with the Tier 1 capital as a ratio of risk weighted assets at about 22 percent at end-December 2012. Of the nine scenarios, only two extreme scenarios highlight elevated risks. In Scenario 6 Tier 1 ratio fell close to the required minimum level of 8, but did not breach it. This scenario reflects an extreme "economic shock" assuming that 30 percent of private sector loans become delinquent, fair value of shares falls by 25 percent, and 20 percent of total deposits are withdrawn within one month. In Scenario 3 of extreme "political shock", the Tier 1 ratio comes also close to the minimum level. This scenario tests banking system exposure to the PA assuming a 40 percent delinquency rate on loans to the PA, 50 percent delinquency rate of loans to PA employees, a loss of 20 percent in the fair value of domestic investments, and a 20 percent withdrawal of deposits. The PMA is considering adding stress tests that capture the potential impact of the PA's large payment arrears to the private sector.

Shocks
- 20 to 40 percent of government loans suffer delayed payments
- 25 to 50 percent of PA employees loans become delinquent
- 10 to 30 percent of private sector loans (excluding PA employees loans) become delinquent
- 5 to 25 percent decline of fair value of investments
- 5 to 20 percent of deposits withdrawn within one month
- 1 to 5 largest borrowers become delinquent
- 1 to 5 largest depositors withdraw deposits



The stress-testing framework could be further improved. A recent IMF technical assistance mission that reviewed the PMA's stress testing framework recommends to (i) expand the range of risks routinely assessed to include interest rate, interbank contagion, cross border and foreign exchange risks, (ii) improve the calibration of risks to test larger shocks and tail risks, (iii) undertake a mapping of how risks transmit from the macro to the financial system, and (iv) broaden the techniques of analysis to include an Early Warning System.

III. FISCAL POLICY IN 2012–13

A. Fiscal Developments in 2012

6. **In 2012, substantial aid shortfalls, along with worse-than-expected revenue and recurrent expenditure outturns, led to large arrears accumulation.**

- Total net revenues (after tax refunds) were about 6 percent lower than budgeted due to:

    - Slower than-expected implementation of tax administration reforms (Box 2). In September, the PA increased VAT from 14.5 to 15.5 percent in line with increased VAT rates in Israel, but this was rolled back to 15 percent on October 1.

    - Delays in the implementation of the Fayyad-Steinitz understanding reached in mid-2012 to enhance clearance revenue collection. Despite this delay, clearance revenues increased by 10 percent compared to 2011. This was partly due to progress in collecting VAT invoiced in Gaza, where in January 2012 the PA started collecting VAT invoices from goods imported through the main crossing between Gaza and Israel which contributed about NIS 100 million in revenues. The government of Israel advanced clearance revenue payments in July, September, and October. Following President Abbas' successful bid for non-member observer state status at the UN, Israel decided to use revenues due in December for the repayment of outstanding electricity debt to the Israeli Electricity Company and it held up clearance revenues in January and February 2013, which were later released.

    - Non-tax revenues were 1 percent below budgeted amounts as a result of lower intake from domestic fees and charges. Dividend payments from the Palestine Investment Fund were higher than budgeted.

- Recurrent expenditures were above budget targets, despite the wage bill being in line with the budget:

    - The wage bill increased by 6.8 percent compared to 2011 reflecting: (i) a uniform cost of living adjustment of 3 percent; (ii) an increase of 1.25 percent in base salary; and (iii) a net increase in staffing and budget to accommodate wage drift and promotions. To contain spending the authorities decided in August 2012 to freeze promotions and hiring, which limited the net increase in the number of public sector employees for the year to 1,165, compared to an average annual net increase of 3,372 in 2009–2011. Net hiring in 2012 consisted of a net increase in health (268 persons), education (732) and security (590) and a reduction (425) in other sectors.

- Non-wage recurrent spending was more than 16 percent above the budgeted amounts (Table A), on account of unbudgeted pension payments for security sector retirees, social assistance related to the hostilities in Gaza in November 2012, and medicine and other health spending. Minor capital expenditure was only about a third of the budgeted amount.

- Net lending expenditures (mostly payments by the treasury for utility bills owed by municipalities) exceeded the budgeted amounts by 168 percent.[6] This reflects non-payments by municipalities on account of: (i) municipalities that have not yet joined one of the commercial electricity distribution companies not raising electricity tariffs in line with higher Israeli tariffs, or municipalities raising tariffs with a delay; and (ii) the inability of the Ministry of Finance (MoF) to remit to some municipalities their share of tax revenues which prompted these municipalities to withhold some payments to the Israel Electricity Company. Nonetheless, progress was made in increasing the number of customers for the Northern Electricity Distribution Company (NEDCO), introducing financial performance targets for the electricity distribution companies, and installing additional pre-paid meters.

- Donor aid was lower than envisaged in the budget. The PA received $0.8 billion in budget support while $1 billion had been budgeted. Spending on development projects was $243 million (below the budgeted amounts), of which $156 million was received from donors, while the treasury contributed $54 million. As a result of the shortfall in development financing, $32 million in arrears was accumulated.

7. **The much higher than projected overall budget deficit of $1.7 billion (17.1 percent of GDP), combined with shortfalls in donor aid and the suspension of transfers of clearance revenues in December, has led to arrears build up and borrowing from domestic banks.** Donor aid for recurrent spending and development projects was roughly similar compared to 2011, but it fell short of what was needed to finance the deficit. While the transfer of NIS 900 million in clearance revenue advances by Israel during July–October (which was partially deducted from revenue transfers later) helped the PA make wage payments, the suspension of clearance revenue transfers in December, following the successful bid for non-member observer state status at the UN, aggravated the PA's liquidity crisis.[7] The financing difficulties resulted in the accumulation of NIS 2.2 billion ($570 million) in arrears, including wage arrears (Table B) and government debt

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[6] Reported net lending was NIS 1,072 million, of which NIS 468 million was deducted by Israel from clearance revenues due in December to settle outstanding debt to the Israel Electricity Company.

[7] Clearance revenues comprise two-thirds of the PA's total revenues and finance more than 40 percent of its spending. A prolonged suspension of clearance revenues will have a highly disruptive impact on financial and economic conditions in WBG. For more on the importance of clearance revenues and the potential impact of a prolonged suspension see 'Recent developments in clearance revenues', IMF, October 2011, available from www.imf.org/wbg.

owed to domestic banks increased to $1.4 billion at end-December 2012, from $1.1 billion at end-December 2011.

8. **The PA's considerable achievements in establishing a solid Public Financial Management (PFM) system are under threat of being eroded by the severe liquidity constraints.** The PFM reforms since mid-2007 have helped prioritize and raise the quality of public expenditures, and enhance transparency and accountability. In particular, expenditure management was to be enhanced from 2010 through the integration of the Commitment Control System (CCS) into the Financial Management Information System (FMIS). However, improving the CCS in the payment process to prevent arrears has remained an issue. The current fiscal crisis, which forces the PA to operate on a cash-rationing basis, has undermined further the functioning of established expenditure management processes. Difficulties in securing the revenue inflows anticipated in the budget—especially in the receipt of clearance revenues and donor commitments—have placed considerable pressure on budget management in recent months. A recent IMF technical assistance mission assisted the PA in updating its PFM reform strategy and identified measures that can help support the expenditure management system under these circumstances. A key step is to integrate the 'procurement module' into the FMIS, to ensure that line ministries do not issue purchase orders (incurring obligations) without commitments being created in the system. The linking of commitments with available cash with reservation of funds would help stem the accumulation of arrears. As part of its ongoing PFM reforms the MoF has, in 2012, completed the transitional steps of all fiscal data reporting and budget preparation to the GFSM 2001 standard. The new standard will be implemented during the 2013 budget approval and execution. The status and responsibilities of the Macro-Fiscal Unit (MFU) have also been clarified in 2012, and the MoF is preparing to expand the work of the MFU in 2013.

Table A. Non-Wage Expenditure, 2011–12

	Total	Operational Expenditure	Transfers	Minor Capital Expenditure
	(Commitment basis; in millions of NIS)			
2011				
Budget	5,043	1,864	3,089	90
Outturn	5,015	1,792	3,165	58
In percent of budget	99	96	102	64
2012				
Budget	4,901	1,959	2,864	78
Outturn	5,709	2,257	3,426	26
In percent of budget	116	115	120	33

Source: Ministry of Finance.

Table B. Composition of Net Arrears Accumulation, 2009–12

	2009	2010	2011	2012
	(In millions of NIS)			
Contributions to the pension fund:				
of which : employee's share 1/	171	185	374	544
government's share	355	172	573	608
Wage arrears 1/	---	---	---	272
Nonwage expenditures 2/	460	92	353	439
Net lending	77	-103	---	---
Development projects 3/	118	88	270	124
Tax refund	-140	-39	368	239
Total	1,040	394	1,939	2,226

Source: Ministry of Finance.

1/ Item classified under wage expenditures.
2/ Including to private sector suppliers.
3/ Item classified under development projects.

Table C. Fiscal Indicators, 2011–13

	2011	2012		2013	2011	2012		2013
		Budget	Act.	Proj. 1/		Budget	Act.	Proj. 1/
	(In millions of NIS, unless otherwise indicated)				(In millions of U.S. dollars, unless otherwise indicated)			
Total net revenues	7,321	8,493	7,989	8,733	2,046	2,235	2,072	2,325
Gross domestic revenues	2,642	3,087	2,806	3,010	738	812	728	801
Tax revenues	1,727	2,124	1,852	1,992	483	559	480	530
Nontax revenues	915	963	954	1,018	256	254	248	271
Gross clearance revenues	5,095	5,859	5,617	6,179	1,424	1,542	1,457	1,645
Tax refunds	416	454	434	456	116	119	113	121
Total recurrent expenditures (commitment basis):	11,897	12,114	13,593	13,656	3,325	3,188	3,525	3,636
Wage expenditures	6,381	6,813	6,812	7,090	1,783	1,793	1,767	1,888
Non-wage expenditures	5,015	4,901	5,709	6,066	1,402	1,290	1,481	1,615
Net lending	501	400	1,072	500	140	105	278	133
Total recurrent expenditures (cash basis)	10,597	12,114	11,730	13,928	2,962	3,188	3,042	3,708
of which: non-wage expenditures (cash basis)	4,089	6,813	4,663	6,066	1,143	1,793	1,209	1,615
Recurrent balance (commitment basis)	-4,576	-3,621	-5,604	-4,923	-1,279	-953	-1,453	-1,311
Recurrent balance (cash basis)	-2,803	-3,621	-3,082	-5,195	-783	-953	-799	-1,383
Development projects (commitment basis)	1,325	1,330	937	1,295	370	350	243	345
Development projects (cash basis)	1,054	1,330	813	1,295	295	350	211	345
Overall balance (cash basis, including development expenditures)	-3,858	-4,951	-3,894	-6,490	-1,078	-1,303	-1,010	-1,728
Financing	3,858	4,951	3,894	6,490	1,078	1,303	1,010	1,728
External support for recurrent and development expenditures	3,364	4,951	3,587	4,883	940	1,303	930	1,300
External support for recurrent expenditures disbursed or indicated	2,759	3,811	2,986	3,756	771	1,003	774	1,000
External support for development expenditures	605	1,140	601	1,127	169	300	156	300
Domestic financing	490	0	490	---	137	0	127	---
Residual/Financing gap	4	---	-182	1,607	1	---	-47	428
Memorandum items:								
GDP	34,977	37,129	38,343	41,677	9,775	9,771	9,944	11,097
Domestic tax revenue (percent of GDP)	4.9	5.7	4.8	4.8	4.9	5.7	4.8	4.8
Clearance revenue (percent of GDP)	14.6	15.8	14.6	14.8	14.6	15.8	14.6	14.8
Wage expenditures (commitment basis, percent of GDP)	18.2	18.3	17.8	17.0	18.2	18.3	17.8	17.0
Net lending (including subsidies; percent of GDP)	1.4	1.1	2.8	1.2	1.4	1.1	2.8	1.2
Recurrent balance (commitment basis, percent of GDP)	-13.1	-9.8	-14.6	-11.8	-13.1	-9.8	-14.6	-11.8
Recurrent balance (cash basis, percent of GDP)	-8.0	-9.8	-8.0	-12.5	-8.0	-9.8	-8.0	-12.5
Net expenditure arrears accumulation	1,300	---	1,863	-272	363	---	483	-72
of which: non-wage arrears	926	---	1,046	---	259	---	271	---
Net expenditure arrears accumulation (percent of GDP)	3.7	---	4.9	-1	3.7	---	4.9	-1
Debt service, interest	237	161	232	226	66	42	60	60
Domestic	226	143	215	209	63	38	56	56
External	11	18	17	17	3	5	4	4
Debt service, principal	-531	691	1,719	1,675	-148	182	446	446
Domestic	-560	600	1,670	1,627	-157	158	433	433
External	29	91	49	48	8	24	13	13

Sources: Ministry of Finance and IMF staff projections.

1/ Projections are based on authorities' draft budget as of end-February.

B. Fiscal Policy in 2013

9. **The authorities are planning to reduce the overall fiscal deficit by 2¼ percent of GDP.** The draft 2013 budget, which is expected to be finalized by end-March, is based on conservative revenue assumptions, a reduction in the growth of the wage bill, prioritization of non-wage spending, and a stepped up pace of revenue administration reforms. The main elements of the budget are:

- A recurrent deficit of $1.3 billion (on a commitment basis; 11¾ percent of GDP). Donor budget support in 2013 is expected to reach $1 billion, leaving a financing gap of at least $0.4 billion, which includes payment of 2012 wage arrears.

- Gross domestic revenues are conservatively projected to increase by 7 percent. Clearance revenues on a commitment basis are projected to increase by 10 percent, in line with average annual growth in 2010-12, and assuming that the recent modest pick-up in clearance revenues collected in Gaza will last. The authorities believe there are no outstanding clearance revenue advances received in 2012, but the Government of Israel claims there is an outstanding amount of NIS 560 million as of end-February 2013. It has not indicated if and when it expects repayment. Additional revenues can be expected if progress is made on implementing the agreement with Israel to improve and streamline the collection of clearance revenues to reduce leakage. Domestic tax revenues are projected to increase by 7.6 percent through implementation of the IMF technical assistance recommendations to improve tax administration, especially enhancing compliance and widening the tax base (Box 2). VAT rates were increased in 2012 and are expected to remain unchanged in 2013. The treasury is also expected to receive dividends from the Palestine Investment Fund and income from telecom and other license fees.

- Recurrent expenditure and net lending are budgeted to increase by 1 percent. The increase in the wage bill will be limited to 4.1 percent (compared to an annual growth of 6.8 percent in 2012) which assumes: (i) a uniform cost of living allowance of 3 percent for base wages; (ii) a wage increase of 1.25 percent; and (iii) budget for promotions.

- A 6.3 percent increase in nonwage expenditures is driven mainly by an 11 percent increase in transfers. Development spending is budgeted at NIS 1.3 billion, with the understanding that projects will only be implemented when there are matching funds from donors.

- Net lending is budgeted to decline by 53 percent.[8] The following measures are aimed at curbing the recent rise in electricity related net lending: (i) transferring more households to the commercial electricity distribution companies; (ii) measures to ensure that municipalities collect and transfer electricity payments for households that cannot yet be transferred to commercial distribution companies; and (iii) measures by the distribution companies to increase collection rates.

- The budget assumes zero net bank borrowing, but allows bridge loans. Arrears on public sector wages from December 2012 were paid in February 2013. The financing constraints will only allow the payment of private sector arrears when additional donor funding becomes available, beyond what is needed to finance the recurrent deficit.

10. **There are a number of downside risks to the budget**. First, external development support could be less than the assumed $300 million, especially given project aid levels in 2011–12. Second, the Government of Israel may require repayment of clearance revenue advances made in 2012 and electricity debts that it claims are still outstanding. Third, donor support for the budget might again fall short of expected amounts. The first two risks could increase the financing gap by $0.3 billion, which would raise the total financing gap to $0.7 billion. Any shortfalls in budget support would further add to this gap. A sharp increase in international fuel prices would also add to the fiscal gap if payment discipline for electricity is not improved.

11. **Staff made a number of recommendations to cover the 2013 baseline financing gap** (Table D).

- Additional restraint on the wage bill, including a wage freeze in nominal terms and a freeze on promotions. This measure would save NIS 280 million relative to the draft budget.

- Cap the rise in transfers to 5 percent, rather than the budgeted 11 percent. This would save NIS 210 million relative to the draft budget. The recommended increase would allow continuing expansion of the coverage of the cash transfer program for poor and vulnerable households.

- Rationalize selected allowances, especially those going to high income earners. This measure could save NIS 100 million.

- Increase selected fees—such as registration, transportation, and court fees—and the purchase tax on vehicles.

[8] This assumes all arrears to the Israeli Electricity Company have been cleared in 2012.

- Rationalization of the medical referral process by introducing clear and stringent criteria as recommended by the World Bank.
- Mobilize additional budget support from donors, including from Arab countries.

Table D. Proposed Measures to Cover the 2013 Financing Gap

	Budget savings, in millions of NIS
Financing gap	1607
Measures:	590
Freeze on promotions and wages	280
Transfers increase by 5, rather than 11 percent	210
Allowances rationalized	100
Remaining financing gap 1/	1017

1/ To be covered by additional donor aid, or expenditure and revenue measures.

12. **Moreover, staff urged the authorities to devise a contingency plan that would guard against fiscal risks**. Contingency measures are needed in case the fiscal risks outlined above materialize. Possible options include: (i) a full review of allowances with a view to realize 10 percent savings (total allowances exceeded NIS 2 billion in 2012); (ii) applying the net hiring freeze to the West Bank while continuing the practice of no hiring in Gaza where attrition reduces the number of PA workers; (iii) identify ongoing development projects that have fallen short of donor financing and explore options to secure financing from other donors or reconsider the projects; and (iv) review the development spending to identify spending that should be classified as recurrent and bring that spending under the appropriate budget ceilings.

Box 2. Measures to Increase Budgetary Revenues

I. Increasing clearance revenue

The PA is keen to increase the amount and predictability of clearance revenues. The clearance revenues represent about two-thirds of the PA's revenues which are collected by Israel in the form of indirect taxes on imported goods. These revenues are agreed upon by the PA and Israel in monthly clearance sessions and then transferred by Israel after deduction of fees for goods and services charged to the PA. Because these transfers are the PA's dominant source of revenues any effective strategy to bring the PA's finances on a sustainable path should include a set of measures to reduce leakages of clearance revenues, secure the timeliness of transfers, and increase the transparency and predictability of deductions. This underscores the importance of implementing the understanding in July 2012 between Minister Steinitz and Prime Minister Fayyad, which included: (i) data-sharing to better appraise and trace the extent and sources of tax leakages; (ii) enhancing control and tracing by both sides of merchandise destined to the WBG to enforce compliance of taxpayers with unified invoice requirements; (iii) establishing bonded warehouses for WBG imports entering through Israeli ports; and (iv) reviewing current revenue-sharing practices to ensure that they are in line with the Paris Protocol, including the equal sharing of exit fees levied by Israel on Palestinian passengers crossing the Allenby Bridge.

II. Increasing domestic tax revenue

The PA is also keen to increase domestic revenue by broadening the domestic tax base and improving administration of revenue collection. In 2012, the PA raised the top income tax rate from 15 percent to 20 percent and worked to reform the tax assessment processes, increase the rigor and frequency of audits, and better enforce penalties. It agreed with about a dozen companies on a voluntary two-year suspension of income tax exemptions. These measures helped increase income tax revenue to the equivalent of 1.7 percent of GDP from 1.4 percent of GDP in 2011. The VAT rate was increased from 14.5 percent to 15 percent on October 1st following a change in the VAT rate in Israel, but the change came too late to have a positive impact on 2012 VAT collection.

In 2012, the PA also laid the groundwork for more comprehensive revenue administration reforms, which culminated, in February 2013, in the adoption of a Revenue Action Plan (RAP). The plan is to be implemented under the supervision of a newly established Director of Revenues, and with technical assistance from DFID, USAID, and the IMF. The ambitious plan aims to expand the tax base and improve compliance by establishing a fully integrated revenue administration of income tax, VAT, customs, and other direct and indirect taxes. The RAP has nine priorities: (i) train staff; (ii) update laws and regulations; (iii) adopt a new computerized taxpayer system; (iv) implement a taxpayer awareness program; (v) adopt integrated revenue administration and a matching functional organization; (vi) reform the large taxpayer unit (LTU); (vii) initiate taxpayer identification and registration units; (viii) improve taxpayer services; and (ix) initiate a taxpayer investigations program.

Reform of the LTU should be the top priority. Despite low tax-payer compliance the LTU collects about two-thirds of income tax revenues and VAT on domestic goods. A new director of the LTU has been appointed. Other measures that should improve revenue collection are in the pipeline, including hiring more staff, better enforcement of punitive measures for non-filers, and the use of improved tax-forms. Coverage by the LTU has been expanded to include taxpayers with more than NIS10 million in annual revenues, increasing the number of taxpayers under the LTU's purview by 40 percent.

IV. Medium-Term Outlook and Structural Reforms

13. **The baseline macroeconomic outlook has deteriorated further since the last staff report in September 2012**. Real GDP growth in West Bank and Gaza is projected at 5 percent in 2013 and averaging 4 percent per year over 2013–2016, far below recent growth rates, with growth in both the West Bank and Gaza on a declining trend.[9] For illustrative purposes, this projection assumes a continued deadlocked peace process, falling donor aid as a percent of GDP, and no progress in phasing out the restrictions on movement and access.[10] The persistence of Israeli restrictions on exports from Gaza and import controls on private investment inputs continues to undermine medium-term growth prospects there. Inflation is projected to be benign, at a small margin above Israeli inflation.[11] In view of the marked decline in growth rates in WBG, little progress is expected in reducing the unemployment rate from high levels. Indeed, the projected GDP growth rates are well below what is needed to absorb labor market entrants, let alone significantly reduce unemployment (Box 3).

14. **The fiscal position is expected to remain under severe pressure**. Financing constraints are projected to lead to expenditure compression over the medium term, both in the wage bill and nonwage expenditures (60 percent of which is social transfers).[12] The revenue-to-GDP ratio would rise only modestly, reflecting mostly administrative measures. As a result, the fiscal deficit will decline gradually, a contraction that, while helping the economy move towards fiscal sustainability over time, represents a further drag on the economy, at least as long as the private sector does not pick up the slack.

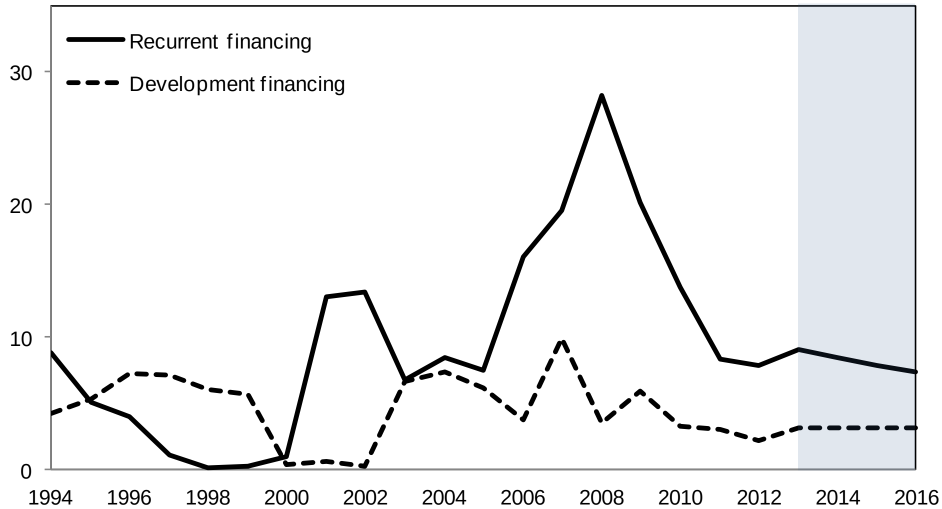
[9] Although average growth of 4 percent (2013–16) may appear relatively high compared to other countries in the region, a staff study found that there has been a large gap between the economy's potential and actual growth rates. If WBG since 1994 had had the same trend output growth as during 1968–87 (when borders with Israel were more open), real GDP per capita in 2010 would have been 88 percent higher (see Staff Report for the Meeting of the Ad Hoc Liaison Committee, September 2011, available from www.imf.org/wbg).

[10] There are currently no indications that such restrictions will be phased out. The Government of Israel cites security concerns that restrict its ability to ease or lift restrictions in the West Bank and Gaza.

[11] WBG's CPI has a higher weight for food than the Israeli index, and with food prices rising rapidly in recent years, WBG's inflation has been at a steady margin above Israel's inflation rate.

[12] The PA is assumed not to resort to bank borrowing in the medium term as that source of financing has already reached banks' limits.

Figure 3. Composition of Donor Aid
(In percent of GDP)



Source: Ministry of Finance.

15. **The risks to this already somber outlook are tilted considerably to the downside** (Table E). Should fiscal risks to the budget in 2013 materialize along the lines described in paragraph 10 resulting in a financing gap of $0.9 billion (assuming $200 million shortfall in budget support), fiscal adjustment to close the gap would need to be 5 percent of GDP higher than assumed in the draft budget. This is bound to result in wage arrears, leading to a further loss in confidence, public unrest, and strikes, which in turn will hurt the delivery of essential government services. Under this scenario, liquidity in the banking sector and availability of private credit will be affected by worsened public finances, as a result of banking system exposure to the PA and its employees. Over 2013–16, assuming significantly lower donor support and even slower progress on structural reforms than in the baseline scenario, unemployment would increase to 27 percent by 2016. Given the large margins of uncertainty, it is possible that the downturn under this scenario could be even deeper and more protracted.

Table E. Comparison of Baseline and Downside Scenarios, 2012–16

	Est.	Baseline Scenario				Downside Scenario			
	2012	2013	2014	2015	2016	2013	2014	2015	2016
Real GDP (percent change)	6.0	5.0	4.4	3.6	3.1	-0.6	3.7	3.1	2.7
	(In percent of GDP, unless otherwise stated)								
Gross capital formation, *of which:*	16.8	16.7	16.1	15.8	14.8	15.3	12.7	10.6	8.6
Public	2.4	3.1	3.1	3.1	3.1	1.5	1.4	1.4	1.4
Public finances 1/									
Revenues	20.8	21.0	21.1	21.5	21.7	19.3	19.3	19.3	19.4
Recurrent expenditures and net lending	35.5	32.8	31.0	29.9	29.1	37.0	34.4	32.9	31.8
Arrears accumulation	4.9	-0.7	-1.5	-0.8	-0.7	9.8	7.7	6.8	6.1
Recurrent balance (commitment, before external support)	-14.6	-11.8	-9.9	-8.5	-7.4	-17.7	-15.0	-13.6	-12.4
Recurrent balance, cash (before external support)	-8.0	-12.5	-11.4	-9.3	-8.1	-7.9	-7.3	-6.8	-6.3
Development expenditures	2.4	3.1	3.1	3.1	3.1	1.5	1.4	1.4	1.4
(In millions of U.S. dollars)	243	345	370	398	425	150	158	165	174
Overall balance (before external support)	-17.1	-14.9	-13.0	-11.6	-10.5	-19.1	-16.5	-15.0	-13.8
Total external support, including for development expenditures	9.4	11.7	11.5	10.9	10.4	9.3	8.8	8.2	7.7
(In millions of U.S. dollars)	930	1,300	1,370	1,398	1,425	950	958	965	974
External support for recurrent expenditure (in millions of U.S. dollars)	774	1,000	1,000	1,000	1,000	800	800	800	800
External sector									
Current account balance (excluding official transfers)	-33.3	-29.7	-27.4	-24.5	-22.4	-25.9	-22.2	-18.4	-15.7
Current account balance (including official transfers)	-23.9	-18.0	-15.9	-13.6	-11.9	-16.6	-13.5	-10.2	-8.0
Exports of goods and nonfactor services	15.8	15.9	16.5	17.1	17.5	17.4	17.9	18.5	18.9
Import of goods and nonfactor services	61.0	57.1	55.6	52.6	50.3	59.2	56.7	52.5	49.5
Memorandum items:									
Per capita nominal GDP (U.S. dollars)	2,316	2,510	2,616	2,734	2,839	2,306	2,405	2,523	2,622
Unemployment rate (average in percent of labor force)	23	22	21	21	21	24	25	26	27

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

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

16. **While important structural reforms were implemented under the Palestinian Reform and Development Plan (PRDP, 2008–10), progress has been slow in recent years.** Under the PRDP the PA improved the targeting of social assistance which allowed coverage to expand despite limited budgetary means. It also reduced electricity subsidies from 11 percent of GDP in 2007 to 1½ percent of GDP in 2011 while shielding low-income households with a targeted tariff structure.[13] Recently, however, progress in implementing much needed structural reforms has been slow. Civil service reform and pension reform, both required to reduce the PA's recurrent deficit to a sustainable level, have not moved forward in a meaningful way and as a result donor engagement in both areas has weakened. A major achievement was the passage of the new procurement law, which came into effect in 2012. Several laws that would strengthen the regulatory environment for the private sector have been approved by the Cabinet but have been awaiting Presidential approval since 2011.

[13] See for a detailed discussion of structural reforms Box 3 in the IMF's report for the meeting of the Ad Hoc Liaison Committee in New York, September 23, 2012.

Box 3. The Growth-Unemployment Nexus

Since the establishment of the PA in 1994 private sector employment growth in WBG has been insufficient to absorb the rapid rise in the labor force. The number of West Bank workers in Israel and settlements has increased slightly in recent years, but insufficient to compensate for loss of employment in Israel for about 60 thousand workers from Gaza after the closure in 2000–01. High average annual public employment growth of 5 percent (PA and local governments) since 1997 has helped absorb new labor force entrants, but private sector job creation has been insufficient to prevent a rise in unemployment from 12 percent in 1999 to 23 percent in 2012.

Composition of Labor Force Growth, 1997–2012

	1997–2007	2008–12
Labor Force	4.3	4.6
Unemployment	0.8	1.2
Israel and Settlements	-0.1	0.4
West Bank and Gaza	3.6	3.0
Public Sector	0.9	0.8
Private Sector	2.7	2.2

Sources: Palestine Central Bureau of Statistics; and IMF staff calculations.

A growth rate of 4½ percent is needed to absorb new labor market entrants while much higher growth rates are needed to reduce unemployment significantly.[1] In 2013–16 an estimated 160 thousand young Palestinians will enter the labor market. Labor force participation among elderly workers is low, so only a limited number of existing jobs will become available as workers retire. Assuming the estimated elasticity holds in the medium term, an average growth of 4½ percent is required to absorb the projected expansion of the labor force. Growth is forecasted to be 4 percent in 2013–16, which would be insufficient to absorb all new labor force entrants and would lead to a small increase in the number of unemployed workers, but also to a modest decline in the unemployment rate from 23 percent to about 21 percent in the medium term on account of the expanding labor force. A reduction of the unemployment rate by half, however, would require average real growth rates of 7½ percent in 2013–16. It is estimated that a lower average growth rate of about 2 percent would result in an unemployment rate of about 27 percent in the medium term.

Scenarios for Growth in Total Factor Productivity and Real GDP, 2013–20

Real Wage Growth	TFP	Real GDP	Unemployment Rate in 2020
	(Average annual percent)		
Low (0 percent)	1	6	7
Medium (1.5 percent)	3	7	7
High (3 percent)	4	9	7

Source: IMF staff calculations.
Note: Scenarios assume no change from 2012 levels in employment (in Israel and the settlements and the public sector), labor force participation, and population growth.

Allowing reasonable real wage growth would require even higher real growth rates to absorb new entrants and bring unemployment down. We perform a simulation of required GDP and productivity growth depending on three scenarios for assumed rates of real wage growth: low (constant real wage), medium (1.5 percent growth), and high (3 percent growth).[2] The results show that in order to reduce unemployment to 7 percent in 2020 at a constant real wage the economy needs to grow at 6 percent with productivity growth of 1 percent. A more realistic scenario with a growing real wage requires higher productivity and GDP growth rates. With wages increasing at 1.5 percent per year, a target unemployment rate of 7 percent by 2020 will require real GDP to grow by 7 percent per year, and productivity to grow by 3 percent per year. Real GDP growth in WBG has averaged 4.8 percent per year since 1994.

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[1] Simulations based on an estimated one-year ahead elasticity of employment with respect to output of 0.98. This elasticity is a combination of contemporaneous employment elasticity with respect to output and employment persistence. The simulations assumes no structural changes in the economy, such as a sharp deterioration of the fiscal situation, a substantial change in the movement and access regime, or a deteriorating security situation.

[2] The simulations were performed with a (log-linearized) Cobb-Douglass production function $Y = A_t K_t^{\alpha} L_t^{1-\alpha}$, where Y is real output, K is the stock of capital, L is labor, A is technology and $\alpha = 0.35$.

V. Staff Appraisal

17. **Since the last staff report for the AHLC in September, the WBG's economy has deteriorated markedly and the public finances are on an unsustainable track**. Economic growth has weakened, the unemployment rate has increased, and the fiscal position has deteriorated to the point where core government functions have been affected, with ongoing cash rationing eroding public financial management institutions. Unsustainably high fiscal deficits combined with aid shortfalls are resulting in a large buildup of arrears and increased bank borrowing in the context of a slowing economy. Worryingly, with donor aid receding, the government's ability to finance large deficits is becoming more and more circumscribed. Thus, arrears, many with private suppliers, are causing them to become progressively more reluctant to provide the PA with goods and services while also causing distortions in the private sector. Arrears in the form of delayed or partial payment of wages risk social unrest and strikes, while additional recourse to the banks would further increase banking sector vulnerabilities.

18. **It is important for the PA, the Government of Israel, and the international community to take the necessary joint steps.** A coordinated approach is ideal, but the three parties should not use inaction by others as a reason not to do their part. The PA needs to exercise fiscal restraint and revive the structural reform agenda. In particular, the PA should prevent the further buildup of damaging arrears, avoid pressure on banks to increase their already high exposure to the PA, stop the erosion of fiscal institutions, and safeguard transfers for poor and vulnerable households and other key government spending which will undoubtedly come under pressure if spending levels are not brought in line with projected donor aid. While fiscal adjustment is necessary, an overly severe public sector retrenchment at a time when the private sector is weak would have adverse consequences for growth. It is therefore important that donors give the PA breathing space for an orderly and sustainable fiscal adjustment through additional aid and, more broadly, that the international community provide a framework for economic cooperation between Palestinians and Israelis. For its part, the Government of Israel needs to ensure timely transfer of clearance revenue. It could also help by working with the PA to improve its collections in line with the Fayyad-Steinitz understanding reached in mid-2012. It would also be crucial to remove Israeli restrictions on movement and access to allow the private sector's footprint in the WBG economy to grow and hence reduce aid dependency.

19. **The WBG's economic outlook continues to deteriorate, and risks to mount**. While regional economic and political uncertainties are contributing factors, many of the core obstacles to robust growth and reduced unemployment remain in place: a lack of broad based easing of Israeli restrictions on the WBG, shortfalls in aid (partly a reflection of fiscal difficulties in the donor countries), and private sector reticence to invest, given uncertainties. The risks to this already somber outlook are tilted to the downside.

20. **WBG's fiscal situation is particularly precarious and requires measures over and above those in the draft budget**. In 2012, large financing gaps were covered through an accumulation of arrears and recourse to bank financing. For 2013, staff's fiscal projections imply that the budget as currently drafted incorporates a financing gap of $0.4 billion, after taking into account expected donor budget support of $1 billion and payment of 2012 wage arrears. With additional donor support uncertain, to avoid a further buildup of arrears and pressure on the banks to increase their already high exposure to the PA, staff recommends that the authorities implement additional fiscal measures to cover the gap. The measures could include: maximum restraint on the wage bill through a wage and promotion freeze, limiting the increase in transfers to 5 percent, rationalizing allowances, and aligning government fees with actual costs of providing the service. Any remaining gaps would need to be covered by additional donor financing or additional expenditure or revenue measures. Indeed, it is critical that these measures are accompanied by increased donor aid to minimize the adverse impact on growth. To guard against fiscal risks that could push the financing gap to $0.7 billion, the authorities should additionally devise a contingency plan which could target a further rationalization of allowances, a tightening of hiring in the West Bank, measures to seek donor support or termination, if needed, of underfunded projects, and bringing recurrent spending that is part of project budgets under the appropriate budget ceilings.

21. **Beyond the urgently needed additional fiscal measures, it is important to broaden the effort to attain fiscal sustainability and to strengthen fiscal institutions**:

- Worryingly, some of the previous progress in the area of public financial management is at risk of being undone by the liquidity crisis, reflecting in turn uncertainty with respect to the receipts of revenues, including clearance revenues and aid disbursements. The PA needs to do its utmost to contain and manage this risk.

- The establishment of the Large Taxpayer Unit (LTU) and Macro-Fiscal Unit (MFU) is welcome, but personnel issues should be resolved without further delay. The LTU will also need to show it has teeth by vigorously enforcing the rules and imposing fees on late- or non-filers. For the MFU, progress should be made toward refining the fiscal forecasting models and assumptions that are needed to formulate a coherent and reliable medium-term fiscal framework.

22. **Although the banking system is highly capitalized, liquid, and has low nonperforming loans, financial stability risks have increased**. Stress tests indicate that banks in the WBG are resilient. However, the increasing exposure to the government at a time when its fiscal position is weakening, as well as rising credit to government employees (in part to compensate for unpaid wages), represent risks that have the potential to propagate through the system. The worsening macroeconomic environment in the region poses additional risks.

23. **Beyond the immediate challenges of dealing with the liquidity crisis, the three parties have to take actions to ensure a sustainable increase in growth.** Recent growth in WBG has been driven by the public sector and financed by external assistance. With aid expected to decline, this is not a sustainable growth model, as also suggested by staff's medium-term projections. In order to allow a larger role for the private sector, it would be essential to roll back and eventually eliminate the restrictions imposed on the WBG by Israel, which are a key impediment to growth and investment. The legal and regulatory environment needs to be upgraded to attract foreign investment. In this regard, the new procurement law is a welcome step. And the public sector needs to become more efficient in delivering its services. This requires a coherent system for the PA to manage its workforce, informed by a comprehensive civil service reform, which has the potential to deliver large fiscal savings over time. Finally, the PA's pension system is in dire need of reform, which should include, starting this year, the indexing of pensions to CPI inflation, raising the retirement age, and eliminating lump sum payments at retirement.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2010–16

(Population: 4.2 million; 2011 est.)
(Per capita GDP: $2,345; 2011)
(Poverty rate: 18 percent in the West Bank and 39 percent in Gaza Strip; 2011 est.)

			Est.	Projections			
	2010	2011	2012	2013	2014	2015	2016
Output and prices	(Annual percentage change)						
Real GDP (2004 market prices)	9.3	12.2	6.0	5.0	4.4	3.6	3.1
West Bank	8.4	10.4	5.0	4.6	4.2	3.5	3.0
Gaza	11.9	17.6	9.0	6.0	4.9	3.8	3.4
CPI inflation rate (end-of-period)	2.8	2.7	1.7	2.8	2.8	2.8	2.8
CPI inflation rate (period average)	3.7	2.9	2.8	2.8	2.8	2.8	2.8
Investment and saving	(In percent of GDP)						
Gross capital formation, *of which:*	18.5	17.3	16.8	16.7	16.1	15.8	14.8
Public	2.7	1.7	2.4	3.1	3.1	3.1	3.1
Private	15.8	15.5	14.3	13.6	13.0	12.7	11.7
Gross national savings, *of which:*	7.9	-6.4	-7.2	-1.2	0.2	2.2	2.9
Public	3.3	1.7	0.9	-0.7	0.1	1.7	2.3
Private	4.6	-8.0	-8.0	-0.5	0.1	0.5	0.6
Saving-investment balance	-10.6	-23.6	-23.9	-18.0	-15.9	-13.6	-11.9
Public finances 1/	(In percent of GDP)						
Revenues	22.6	20.9	20.8	21.0	21.1	21.5	21.7
Recurrent expenditures and net lending	36.8	34.0	35.5	32.8	31.0	29.9	29.1
Wage expenditures	19.3	18.2	17.8	17.0	16.1	15.8	15.6
Nonwage expenditures	14.7	14.3	14.9	14.6	13.9	13.3	12.8
Net lending	2.8	1.4	2.8	1.2	1.0	0.8	0.8
Recurrent balance (commitment, before external support)	-14.3	-13.1	-14.6	-11.8	-9.9	-8.5	-7.4
Recurrent balance, cash (before external support)	-13.4	-8.0	-8.0	-12.5	-11.4	-9.3	-8.1
Development expenditures	3.6	3.8	2.4	3.1	3.1	3.1	3.1
(In millions of U.S. dollars)	298	370	243	345	370	398	425
Overall balance (before external support)	-17.8	-16.9	-17.1	-14.9	-13.0	-11.6	-10.5
Total external support, including for development expenditures	15.3	10.1	9.4	11.7	11.5	10.9	10.4
(In millions of U.S. dollars)	1,275	984	930	1,300	1,370	1,398	1,425
External support for recurrent expenditure (in millions of U.S. dollars)	1,146	815	774	1,000	1,000	1,000	1,000
Financing gap (in millions of U.S. dollars)	...	...	...	428	362	185	113
Monetary sector 2/	(Annual percentage change)						
Credit to the private sector	31.1	23.8	14.2	13.2	12.6	11.8	11.3
Private sector deposits	9.9	4.1	6.9	6.8	6.6	6.4	6.2
External sector	(In percent of GDP)						
Current account balance (excluding official transfers)	-25.9	-33.7	-33.3	-29.7	-27.4	-24.5	-22.4
Current account balance (including official transfers)	-10.6	-23.6	-23.9	-18.0	-15.9	-13.6	-11.9
Exports of goods and nonfactor services	13.8	15.4	15.8	15.9	16.5	17.1	17.5
Import of goods and nonfactor services	55.5	59.1	61.0	57.1	55.6	52.6	50.3
Net factor income	7.2	7.3	6.9	6.7	6.5	6.4	6.3
Net current transfers	23.9	12.7	14.3	16.5	16.7	15.5	14.5
Private transfers	8.6	2.7	4.9	4.7	5.2	4.6	4.1
Official transfers	15.3	10.1	9.4	11.7	11.5	10.9	10.4
Memorandum items:							
Nominal GDP (in millions of U.S. dollars)	8,344	9,775	9,944	11,097	11,904	12,801	13,676
Per capita nominal GDP (U.S. dollars)	2,061	2,345	2,316	2,510	2,616	2,734	2,839
Unemployment rate (average in percent of labor force)	24	21	23	22	21	21	21
Al Quds stock market index (annual percentage change)	-0.7	-2.6	0.1	…	…	…	…

Sources: Palestinian authorities and IMF staff estimates and projections.

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

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2010–16

	2010	2011	2012	Projections			
				2013 1/	2014	2015	2016
	(In millions of U.S. dollars, unless otherwise stated)						
Total net revenues	1,883	2,046	2,072	2,325	2,510	2,747	2,971
Gross domestic revenues	701	738	728	801	874	992	1,100
Tax revenues	431	483	480	530	574	612	650
Nontax revenues (accrued)	270	256	248	271	300	380	450
Nontax revenues (cash)	270	219	232	271	300	380	450
Clearance revenues (accrued)	1,258	1,424	1,457	1,645	1,766	1,893	2,015
Clearance revenues (cash)	1,241	1,490	1,581	1,645	1,766	1,893	2,015
Clearance revenues (net arrears)	16	-66	-124	---	---	---	---
Less tax refunds	76	116	113	121	130	138	145
Total recurrent expenditures and net lending (commitment)	3,073	3,325	3,525	3,636	3,692	3,832	3,984
Wage expenditures (commitment)	1,612	1,783	1,767	1,888	1,921	2,025	2,131
Wage expenditures (cash)	1,562	1,679	1,555	1,960	1,921	2,025	2,131
Wage expenditures (net arrears)	50	105	212	-72	---	---	---
Nonwage expenditures (commitment)	1,226	1,402	1,481	1,615	1,652	1,700	1,746
Nonwage expenditures (cash)	1,155	1,143	1,209	1,615	1,832	1,800	1,846
Nonwage expenditures (net arrears)	71	259	271	---	-180	-100	-100
Net lending (commitment)	236	140	278	133	120	107	107
Net lending (cash)	263	140	278	133	120	107	107
Net lending (net arrears)	-28	---	---	---	---	---	---
Recurrent balance (commitment, before external support)	-1,191	-1,279	-1,453	-1,311	-1,182	-1,085	-1,013
subtract: nontax revenue arrears	---	36	15	---	---	---	---
add: expenditure arrears (net)	93	363	483	-72	-180	-100	-100
subtract: net clearance due (+) or repaid (-)	16	-66	-124	---	---	---	---
add: arrears on tax refunds due (+) or repaid (-)	-2	103	62	---	---	---	---
Recurrent balance (cash, before external support)	-1,117	-783	-799	-1,383	-1,362	-1,185	-1,113
Development expenditures (commitment)	298	370	243	345	370	398	425
Development expenditures (cash)	275	295	211	345	370	398	425
Development expenditures (arrears)	23	76	32	---	---	---	---
Overall balance (cash, including development expenditures)	-1,392	-1,078	-1,010	-1,728	-1,732	-1,583	-1,538
Total financing	1,392	1,078	1,010	1,728	1,732	1,583	1,538
Net domestic bank financing	97	93	127	---	---	---	---
Other domestic financing	---	---	---	---	---	---	---
External financing for recurrent expenditures	1,146	815	774	1,000	1,000	1,000	1,000
External financing for development expenditures	129	169	156	300	370	398	425
Net external debt	---	---	---	---	---	---	---
Residual/Financing gap	20	1	-47	428	362	185	113
Memorandum items:	(In percent of GDP; unless otherwise stated)						
Revenues	22.6	20.9	20.8	21.0	21.1	21.5	21.7
Recurrent expenditures and net lending	36.8	34.0	35.5	32.8	31.0	29.9	29.1
Wage expenditures	19.3	18.2	17.8	17.0	16.1	15.8	15.6
Nonwage expenditures	14.7	14.3	14.9	14.6	13.9	13.3	12.8
Net lending	2.8	1.4	2.8	1.2	1.0	0.8	0.8
Recurrent balance (commitment) before external support:	-14.3	-13.1	-14.6	-11.8	-9.9	-8.5	-7.4
Recurrent balance (cash) before external support	-13.4	-8.0	-8.0	-12.5	-11.4	-9.3	-8.1
External support (recurrent)	13.7	8.3	7.8	9.0	8.4	7.8	7.3
in millions of U.S. dollars	1,146	815	774	1,000	1,000	1,000	1,000
Development expenditures (cash)	3.3	3.0	2.1	3.1	3.1	3.1	3.1
Overall balance (cash)	-16.7	-11.0	-10.2	-15.6	-14.6	-12.4	-11.2
Total external support (in millions of U.S. dollars)	1,275	984	930	1,300	1,370	1,398	1,425
Nominal exchange rate (average; NIS per US dollar)	3.7	3.6	3.9	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	8,344	9,775	9,944	11,097	11,904	12,801	13,676

Sources: Ministry of Finance and IMF staff projections.

1/ Projections are based on authorities' draft budget as of end-February.

Table 3. West Bank and Gaza: Central Government Fiscal Operations, 2010–16

	2010	2011	2012	Projections			
				2013 1/	2014	2015	2016
	(In millions of shekels, unless otherwise stated)						
Total net revenues	7,028	7,321	7,989	8,733	9,447	10,297	11,112
Gross domestic revenues	2,617	2,642	2,806	3,010	3,289	3,717	4,116
Tax revenues	1,608	1,727	1,852	1,992	2,160	2,293	2,433
Nontax revenues (accrued)	1,009	915	954	1,018	1,129	1,424	1,683
Nontax revenues (cash)	1,009	785	895	1,018	1,129	1,424	1,683
Clearance revenues (accrued)	4,695	5,095	5,617	6,179	6,648	7,096	7,537
Clearance revenues (cash)	4,634	5,330	6,096	6,179	6,648	7,096	7,537
Clearance revenues (net arrears)	61	-235	-479	---	---	---	---
Less tax refunds	285	416	434	456	490	516	541
Total recurrent expenditures and net lending (commitment)	11,473	11,897	13,593	13,656	13,897	14,364	14,903
Wage expenditures (commitment)	6,017	6,381	6,812	7,090	7,229	7,591	7,970
Wage expenditures (cash)	5,832	6,007	5,996	7,362	7,229	7,591	7,970
Wage expenditures (net arrears)	185	374	816	-272	---	---	---
Nonwage expenditures (commitment)	4,575	5,015	5,709	6,066	6,218	6,373	6,532
Nonwage expenditures (cash)	4,312	4,089	4,663	6,066	6,895	6,748	6,906
Nonwage expenditures (net arrears)	263	926	1,046	---	-677	-375	-374
Net lending (commitment)	880	501	1,072	500	450	400	400
Net lending (cash)	983	501	1,072	500	450	400	400
Net lending (net arrears)	-103	---	---	---	---	---	---
Recurrent balance (commitment, before external support)	-4,445	-4,576	-5,604	-4,923	-4,450	-4,067	-3,790
subtract: nontax revenue arrears	0	130	59	---	---	---	---
add: expenditure arrears (net)	345	1,300	1,863	-272	-677	-375	-374
subtract: net clearance due (+) or repaid (-)	61	-235	-479	---	---	---	---
add: arrears on tax refunds due (+) or repaid (-)	-9	368	239	---	---	---	---
Recurrent balance (cash, before external support)	-4,170	-2,803	-3,082	-5,195	-5,128	-4,442	-4,164
Development expenditures (commitment)	1,114	1,325	937	1,295	1,392	1,491	1,590
Development expenditures (cash)	1,026	1,054	813	1,295	1,392	1,491	1,590
Development expenditures (arrears)	88	270	124	---	---	---	---
Overall balance (cash, including development expenditures)	-5,196	-3,858	-3,894	-6,490	-6,520	-5,933	-5,754
Total financing	5,196	3,858	3,894	6,490	6,520	5,933	5,754
Net domestic bank financing	363	334	490	---	---	---	---
Other domestic financing	---	---	---	---	---	---	---
External financing for recurrent expenditures	4,276	2,915	2,986	3,756	3,764	3,748	3,741
External financing for development expenditures	482	605	601	1,127	1,392	1,491	1,590
Net external debt	---	---	---	---	---	---	---
Residual/Financing gap	74	4	-182	1,607	1,364	693	424
Memorandum items:	(In percent of GDP; unless otherwise stated)						
Revenues	22.6	20.9	20.8	21.0	21.1	21.5	21.7
Recurrent expenditures and net lending	36.8	34.0	35.5	32.8	31.0	29.9	29.1
Wage expenditures	19.3	18.2	17.8	17.0	16.1	15.8	15.6
Nonwage expenditures	14.7	14.3	14.9	14.6	13.9	13.3	12.8
Net lending	2.8	1.4	2.8	1.2	1.0	0.8	0.8
Recurrent balance (commitment) before external support:	-14.3	-13.1	-14.6	-11.8	-9.9	-8.5	-7.4
Recurrent balance (cash) before external support	-13.4	-8.0	-8.0	-12.5	-11.4	-9.3	-8.1
External financing for recurrent expenditures	13.7	8.3	7.8	9.0	8.4	7.8	7.3
In millions of U.S. dollars	1,146	815	774	1,000	1,000	1,000	1,000
Development expenditures (cash)	3.3	3.0	2.1	3.1	3.1	3.1	3.1
Overall balance (cash)	-16.7	-11.0	-10.2	-15.6	-14.6	-12.4	-11.2
Total external support (in millions of shekels)	4,758	3,520	3,587	4,883	5,156	5,239	5,330
Nominal exchange rate (NIS per US dollar)	3.73	3.58	3.86	...	...	...	...
Nominal GDP (in millions of shekels)	31,148	34,977	38,343	41,677	44,802	47,982	51,157

Sources: Ministry of Finance and IMF staff projections.
1/ Projections are based on authorities' draft budget as of end-February.

Table 4. West Bank and Gaza: Central Government Fiscal Operations, 2010–16

(GFSM 2001; in millions of U.S. dollars)

	2010	2011	2012	Projections			
				2013 1/	2014	2015	2016
Revenue	3,157	3,030	3,002	3,625	3,880	4,145	4,396
Taxes	1,612	1,790	1,824	2,054	2,210	2,367	2,521
Domestic taxes	431	483	480	530	574	612	650
Clearance taxes	1,258	1,424	1,457	1,645	1,766	1,893	2,015
Tax refund	-76	-116	-113	-121	-130	-138	-145
Grants	1,275	984	930	1,300	1,370	1,398	1,425
External budget support	1,146	815	774	1,000	1,000	1,000	1,000
External development support	129	169	156	300	370	398	425
Other revenue	270	256	248	271	300	380	450
o/w Dividends	40	45	31	34	38	48	57
Expenditures	3,372	3,695	3,768	3,981	4,062	4,230	4,409
Expense	3,073	3,325	3,525	3,636	3,692	3,832	3,984
Compensation of employees 2/	1,612	1,783	1,767	1,888	1,921	2,025	2,131
Use of goods and services	493	501	585	626	637	671	706
Grants 3/	236	140	278	133	120	107	107
Other expense 4/	733	901	895	990	1,015	1,029	1,040
Net acquisition of nonfinancial assets	298	370	243	345	370	398	425
Gross Operating Balance	84	-295	-523	-11	188	313	412
Net lending / borrowing (overall balance)	-214	-665	-766	-356	-182	-85	-13
Net financial transactions	-214	-665	-766	-356	-182	-85	-13
Net acquisition of financial assets	---	---	---	---	---	---	---
Domestic							
Currency and deposits	---	---	---	---	---	---	---
Net incurrence of liabilities	195	664	813	-72	-180	-100	-100
Domestic	195	664	813	-72	-180	-100	-100
Loans	97	93	127	---	---	---	---
Net domestic bank financing	97	93	127	---	---	---	---
Other accounts payable	97	571	686	-72	-180	-100	-100
Arrears (recurrent)	90	430	530	-72	-180	-100	-100
Arrears (capital)	23	76	32	---	---	---	---
Arrears (clearance)	16	-66	-124	---	---	---	---
Foreign	---	---	---	---	---	---	---
Loans	---	---	---	---	---	---	---
Statistical Discrepancy	*20*	*1*	*-47*	---	---	---	---
Memorandum items:							
Gross operating balance excl. grants (commitment)	-1,191	-1,279	-1,453	-1,311	-1,182	-1,085	-1,013
Gross operating balance excl. grants (cash)	-1,117	-783	-799	-1,383	-1,362	-1,185	-1,113
Overall balance (NLB) excl. grants (commitment)	-1,489	-1,649	-1,696	-1,656	-1,552	-1,483	-1,438
Overall balance (NLB) excl. grants (cash)	-1,392	-1,078	-1,010	-1,728	-1,732	-1,583	-1,538
Revenue as (percent of GDP)	37.8	31.0	30.2	32.7	32.6	32.4	32.1
Expenditure as (percent of GDP)	40.4	37.8	37.9	35.9	34.1	33.0	32.2
Expense as (percent of GDP)	36.8	34.0	35.5	32.8	31.0	29.9	29.1
Wage expenditure as (percent of GDP)	19.3	18.2	17.8	17.0	16.1	15.8	15.6
Nonwage expenditures as (percent of GDP)	5.9	5.1	5.9	5.6	5.3	5.2	5.2
GOB (commitment) excluding grants as (percent of GDP)	-14.3	-13.1	-14.6	-11.8	-9.9	-8.5	-7.4
GOB (cash) excluding grants as (percent of GDP)	-13.4	-8.0	-8.0	-12.5	-11.4	-9.3	-8.1
External support (recurrent)	13.7	8.3	7.8	9.0	8.4	7.8	7.3
in millions of U.S. dollars	1,146	815	774	1,000	1,000	1,000	1,000
NLB (commitment) excluding grants as (percent of GDP)	-17.8	-16.9	-17.1	-14.9	-13.0	-11.6	-10.5
NLB (cash) excluding grants as (percent of GDP)	-16.7	-11.0	-10.2	-15.6	-14.6	-12.4	-11.2
Total external support (in millions of shekels)	1,275	984	930	1,300	1,370	1,398	1,425
Nominal GDP (in millions of shekels)	8,344	9,775	9,944	11,097	11,904	12,801	13,676
Exchange Rate	3.7	3.6	3.9	...	...	...	...

Sources: Ministry of Finance and IMF staff projections.

1/ Projections are based on authorities' draft budget as of end-February.
2/ Wage expenditures.
3/ Grants to local governments related to purchase of water and electricity.
4/ Includes transfers (social benefits) and minor capital.

Table 5. West Bank and Gaza: Central Government Fiscal Operations, 2010–16

(GFSM 2001; in millions of shekels)

	2010	2011	2012	Projections			
				2013 1/	2014	2015	2016
Revenue	11,786	10,841	11,576	13,616	14,603	15,536	16,443
Taxes	6,019	6,406	7,035	7,715	8,318	8,873	9,429
Domestic taxes	1,608	1,727	1,852	1,992	2,160	2,293	2,433
Clearance taxes	4,695	5,095	5,617	6,179	6,648	7,096	7,537
Tax refund	-285	-416	-434	-456	-490	-516	-541
Grants	4,758	3,520	3,587	4,883	5,156	5,239	5,330
External budget support	4,276	2,915	2,986	3,756	3,764	3,748	3,741
External development support	482	605	601	1,127	1,392	1,491	1,590
Other revenue	1,009	915	954	1,018	1,129	1,424	1,683
o/w Dividends	149	160	120	128	142	179	211
Expenditures	12,586	13,222	14,530	14,951	15,289	15,855	16,492
Expense	11,473	11,897	13,593	13,656	13,897	14,364	14,903
Compensation of employees 2/	6,017	6,381	6,812	7,090	7,229	7,591	7,970
Use of goods and services	1,840	1,792	2,257	2,350	2,396	2,515	2,641
Grants 3/	880	501	1,072	500	450	400	400
Other expense 4/	2,735	3,223	3,452	3,716	3,822	3,858	3,891
Net acquisition of nonfinancial assets	1,114	1,325	937	1,295	1,392	1,491	1,590
Gross Operating Balance	313	-1,056	-2,017	-40	706	1,172	1,540
Net lending / borrowing (overall balance)	-800	-2,381	-2,954	-1,335	-686	-319	-50
Net financial transactions	-800	-2,381	-2,954	-1,335	-686	-319	-50
Net acquisition of financial assets	---	---	---	---	---	---	---
Domestic							
Currency and deposits	---	---	---	---	---	---	---
Net incurrence of liabilities	726	2,377	3,136	-272	-677	-375	-374
Domestic	726	2,377	3,136	-272	-677	-375	-374
Loans	363	334	490	---	---	---	---
Net domestic bank financing	363	334	490	---	---	---	---
Other accounts payable	363	2,043	2,646	-272	-677	-375	-374
Arrears (recurrent)	336	1,538	2,043	-272	-677	-375	-374
Arrears (capital)	88	270	124	---	---	---	---
Arrears (clearance)	61	-235	-479	---	---	---	---
Foreign	---	---	---	---	---	---	---
Loans	---	---	---	---	---	---	---
Statistical Discrepancy	*74*	*4*	*-182*	---	---	---	---
Memorandum items:							
Gross operating balance excl. grants (commitment)	-4,445	-4,576	-5,604	-4,923	-4,450	-4,067	-3,790
Gross operating balance excl. grants (cash)	-4,170	-2,803	-3,082	-5,195	-5,128	-4,442	-4,164
Overall balance (NLB) excl. grants (commitment)	-5,559	-5,901	-6,541	-6,218	-5,842	-5,558	-5,380
Overall balance (NLB) excl. grants (cash)	-5,196	-3,858	-3,894	-6,490	-6,520	-5,933	-5,754
Revenue (percent of GDP)	37.8	31.0	30.2	32.7	32.6	32.4	32.1
Expenditure (percent of GDP)	40.4	37.8	37.9	35.9	34.1	33.0	32.2
Expense (percent of GDP)	36.8	34.0	35.5	32.8	31.0	29.9	29.1
Wage expenditure (percent of GDP)	19.3	18.2	17.8	17.0	16.1	15.8	15.6
Nonwage expenditures (percent of GDP)	5.9	5.1	5.9	5.6	5.3	5.2	5.2
GOB (commitment) excluding grants (percent of GDP)	-14.3	-13.1	-14.6	-11.8	-9.9	-8.5	-7.4
GOB (cash) excluding grants (percent of GDP)	-13.4	-8.0	-8.0	-12.5	-11.4	-9.3	-8.1
External support (recurrent)	13.7	8.3	7.8	9.0	8.4	7.8	7.3
in millions of NIS	4,276	2,915	2,986	3,756	3,764	3,748	3,741
NLB (commitment) excluding grants (percent of GDP)	-17.8	-16.9	-17.1	-14.9	-13.0	-11.6	-10.5
NLB (cash) excluding grants (percent of GDP)	-16.7	-11.0	-10.2	-15.6	-14.6	-12.4	-11.2
Total external support (in millions of shekels)	4,758	3,520	3,587	4,883	5,156	5,239	5,330
Nominal GDP (in millions of shekels)	31,148	34,977	38,343	41,677	44,802	47,982	51,157
Exchange Rate	3.7	3.6	3.9	...	...	...	...

Sources: Ministry of Finance and IMF staff projections.

1/ Projections are based on authorities' draft budget as of end-February.

2/ Wage expenditures.

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

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

Table 6. West Bank and Gaza: Financial Soundness Indicators, 2010–12

(In percent)

	Dec-10	Dec-11	Dec-12
Capital adequacy (for all Banks)			
Tier I capital to risk-weighted assets	23.3	22.9	22.1
Regulatory Capital to Risk Weighted Assets	21.4	21.1	20.4
Capital adequacy (for local Banks)			
Tier I capital to risk-weighted assets	26.5	24.5	22.6
Regulatory Capital to Risk Weighted Assets	21.6	20.3	18.7
Asset quality 1/			
Nonperforming loans (percent of total loans)	3.1	2.7	3.3
Nonperforming loans net of provisions to capital	2.9	3.8	5.7
Coverage ratio (provisions as percent of nonperforming loans	70.4	60.9	56.0
Earnings and profitability			
Return on assets (ROA)	2.1	1.9	1.8
Return on equity (ROE)	21.1	17.0	16.3
Interest income to gross income	59.4	71.7	72.4
Non-interest expenses to gross income	55.0	57.2	55.4
Personal Cost to non-interest expenses	30.4	31.7	29.9
Liquidity			
Liquid assets to total assets	40.9	36.8	38.4
Liquid assets to demand and savings deposits	78.4	74.4	71.7
Liquid assets to total deposits	49.1	46.9	45.8

Source: PMA.

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

2/ Return on equity (ROE): income before extraordinary items and taxes to average tier 1 capital.