

ECONOMIC MONITORING NOTE

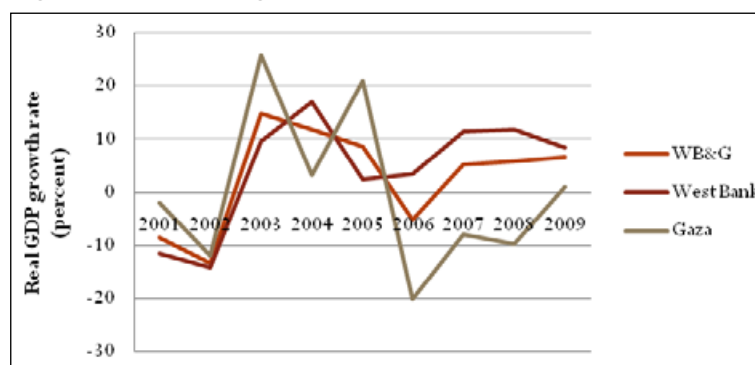
I. Overview

In 2009 WB&G experienced a third consecutive year of economic growth and rising per capita GDP. While this resurgence is a cause of optimism, the situation remains precarious. Growth in the West Bank can be partly attributed to the relatively stable security environment and improving business environment. But it appears to be mostly driven by large inflows of foreign assistance that may not be sustainable. The economy in Gaza remains devastated; however, a regular flow of goods coming through tunnels from Egypt and via other sources have allowed a few private sector activities to resume. Despite the growth, the recurrent deficit rose from roughly US\$1.3 billion in 2008 to US\$1.6 billion on a commitment basis in 2009, mostly as a result of emergency spending in Gaza in the aftermath of Israel's military operation (Operation Cast Lead, December 27, 2008 -- January 18, 2009). The PA has made substantial progress in implementing reforms in public financial management and fiscal strengthening. Nonetheless, there is a need for significant further steps to achieve fiscal sustainability. Furthermore, economic performance remains significantly obstructed by the continued restrictions on Palestinian activity in Area C and settlement growth¹.

II. Economic Developments

Growth in WB&G accelerated in 2009: initial estimates suggest real growth reached 6.8 percent, well above the 5.5 percent projected in the PA's 2009 budget. Most of the growth was in the West Bank, where the International Monetary Fund (IMF) and Palestinian Central Bureau of Statistics (PCBS) estimate real GDP growth was 8.5 percent. In addition, and despite the continued closure of Gaza, growth there was estimated to be positive at about 1 percent². For 2008, PCBS has recently issued revised estimates that put real growth at about 5.9 percent for WB&G, implying an increase in per capita GDP (see Figure 1). This means that the 2009 performance is the third consecutive year of per capita GDP growth and may signal that at least the West Bank economy is beginning to recover after years of decline.

Figure 1: Economic growth 2001-2009



Source: PCBS and World Bank staff calculations

The revival of growth in the West Bank is impressive but it is also precarious. It is being driven by a combination of large inflows of donor assistance, PA government reforms that have increased investor confidence, and the loosening of some Israeli security restrictions. However, the high level of external assistance over the past two to three years is probably the most important factor. In 2009, the PA received nearly US\$1.4 billion in budget support coming on top of US\$1.8 billion in 2008 and nearly US\$1 billion in 2007³. The large amounts of budget support have allowed the PA to maintain expansionary fiscal policies to support growth. In 2009, total PA commitments were equivalent to around 52 percent of GDP, with wage expenditures alone around 24 percent of GDP.

In contrast to the public sector, growth in important parts of the private sector has not been as robust. Between 1999 and 2009, manufacturing output was flat and its share in GDP fell from 12.5 to 11 percent. Output in agriculture fell by 47 percent during the same period, so that its share in GDP declined from 10.4 to 4.8 percent. The PA's reforms that have resulted in improved security and more efficient service delivery along with the Government of Israel's loosening of its security restrictions have significantly increased investor confidence: discussions with the private sector reveal the importance it places on sustaining this loosening through additional measures in 2010. However, there is yet no sign of a large-scale revival of private investment in the productive sectors of the economy. Since 2007, real output in the "manufacturing" and "hotels and restaurants" categories of GDP has increased by 7.3 and 8.5 percent respectively, well below the overall increase of GDP of 13 percent. The biggest jump in private sector activity has

1. See World Bank. 2007. Movement and Access Restrictions in the West Bank: Uncertainty and Inefficiency in the Palestinian Economy.

2. PCBS has not yet published GDP estimates for West Bank and Gaza separately. These figures are based on IMF estimates.

3. These figures do not take into account hundreds of millions more in aid that have flowed into the economy through the United Nations and from bilateral assistance programs.

been in the construction and real estate service sectors, which have gone up by nearly 28 percent. In the face of the PA's projected fiscal retrenchment, it is imperative that private investment take off – and that will require improved access to markets in Israel, East Jerusalem, as well as to Area C.

Despite the ongoing blockade, the IMF estimates that real GDP growth in Gaza was 1 percent in 2009, implying a continued decline in per capita GDP. Since the vast majority of the Gaza private sector remains moribund, the economy is sustained by government spending and humanitarian assistance. It is unclear how much spending the Hamas authorities undertake, but they have a large security force and a substantial civil service. The PA regularly pays its more than 63,000 employees in Gaza and maintains its large system of social transfers to needy households in Gaza. In addition to this regular spending, the PA has also undertaken substantial emergency spending in Gaza to offset some of the effects of the recent fighting. In 2009, the PA indicates that emergency spending in Gaza reached US\$300 million and has detailed US\$142 million in spending to help families who lost their homes, make emergency repairs to utilities, and for other emergency requirements. In addition, the international community continues to provide humanitarian aid for Gaza, led by the United Nations Relief and Works Agency (UNRWA) providing services for the more than 950,000 registered refugees.

Rather than reflecting a recovery of the Gaza economy, the reported 1 percent real GDP growth results from the development of coping mechanisms that have allowed some economic activity to resume on a very limited scale. The sustained flow of goods arriving through tunnels from Egypt, including fuel, spare parts, and limited inputs, has allowed some production and private sector activities to resume – albeit in the context of an unregulated informal economy. Monitoring by the Palestine Trade Center (PalTrade) and local business organizations finds that employment in the industrial sector has increased from about 2,000 during 2008 to nearly 5,000 at the end of 2009 (see Table 1), well short of the 35,000 employed in June 2007 before the total closure⁴. In many cases, enterprises have transformed themselves to offer different services, such as a construction firm opening a restaurant or changing markets from export to domestic. However, most remain simply closed.

Table 1: Gaza -- Status of key industrial sectors during three periods

Sector	Indicator	Before closure (14 June 2007)	During the Closure 2008	Currently Dec 09–Jan 10	Notes
Industry	No. of working establishments	3,900	117	1170 See notes	10% of establishments are working with 20%-50% capacity; 20% operating with around 10% capacity; 70% of industrial establishments are closed
	No. of workers	35,000	2000	5,000	
Construction	No. of working establishments	125	8	50	(Current scope includes small maintenance works)
	No. of workers	50,000	100	1,500	

Source: Palestinian Federation of Industries and Palestinian Contractors' Union, as reported in PalTrade

Unemployment rates in the WB&G reflect the growth. In the West Bank unemployment in the fourth quarter of 2009 fell to 18 percent from 20 percent in the same quarter of 2008. At the same time the labor force participation rate rose from 43 to 44 percent. Unemployment also dropped in Gaza, falling from 45 percent in the fourth quarter of 2008 to 39 percent in the last quarter of 2009. However, part of this can be explained by the fact that the labor force participation rate also dropped from 39 to 37 percent. Unemployment in Gaza has also been ameliorated by job creation schemes funded by donors. A recent survey conducted jointly by the Food and Agricultural Organization and World Food Program found that 61 percent of the Gaza and 25 percent of the West Bank population is food insecure.

4. Employment in 2007 was already depressed since even then it was costly and difficult to import and export.

III. The PA Fiscal Position

Despite the revival of growth and its extensive reform program, the PA's recurrent deficit increased in 2009, mostly as a result of emergency spending in Gaza in the aftermath of Israel's military operation. The recurrent budget deficit on a commitment basis was nearly US\$1.6 billion, up from US\$1.3 billion in 2008 and almost US\$143 million more than projected in the revised 2009 budget. Most of the deficit growth can be attributed to the emergency situation in Gaza, which forced the PA to add US\$300 million to the budget mid-year. In addition, about US\$141 million in arrears were brought forward from 2008 and reported as 2009 commitments. Thus, commitments actually incurred in 2009 were below the revised budget. Nonetheless, wage expenditures exceeded the budget by about 2 percent, mostly due to compensation provided to public employees for the interest paid on loans they incurred in 2006 when the PA was unable to pay salaries.

The original 2009 budget called for donor support of US\$1.15 billion to fund the recurrent deficit and another US\$503 million for the development budget. It was hoped that there would be an improvement in the quality of the budget compared to previous years by beginning to shift donor funding from recurrent costs to development expenditures. In September 2009 the projected support necessary for the recurrent and development budgets was raised to US\$1.45 and US\$1.1 billion respectively to respond to the needs in Gaza. However, at the end of the year the recurrent deficit was nearly US\$1.6 billion and including development spending made the overall deficit more than US\$1.77 billion. Only about US\$1.36 billion in budget support and another US\$390 million in development financing materialized. Consequently, the PA was forced to turn to borrowing from local banks and accumulating arrears of US\$221 million. Thus, because of the emergency in Gaza, there was no significant shift of external resources from recurrent to development expenditures in 2009.

The recently released 2010 budget commits the PA to resuming the path to less dependence on donor support for recurrent expenditures. The budget projects a recurrent budget deficit of US\$1.2 billion and US\$670 million in development expenditures. However, these projections are based on strong assumptions and will require discipline on the PA's part. The projections assume real GDP growth of 7 percent and that the PA will be able to increase domestic revenues by almost 21 percent through improved tax collection. They also assume that the PA will maintain the same level of non-wage expenditures that it did in 2009. Finally, the PA's decision to give a general 4 percent wage increase to public sector employees has increased the budget expenditures. However, the share of the wage bill in GDP is expected to decline from 24 percent in 2009 to 22 percent in 2010.

IV. Public Finance Management

Related to the reforms that strengthen the PA's fiscal position are reforms that increase the efficiency and transparency of Government expenditure, i.e. reforms in public financial management (PFM) and procurement. The PA has a strong track record of strengthening its PFM system in order to ensure that government resources are managed in a transparent and accountable manner. The initial focus of the current government was on ensuring that cash controls were operating effectively, while more recently attention has been given to improving the budget preparation procedures, and the accounting and reporting of government expenditures.

In preparing the 2010 budget a number of advances were made. For the first time the PA received expenditure requests from budget units through a shared database. It also took another step on the path towards a program based budget by updating the accounting system so that it can capture expenditure information at the level of programs. For the 2011 budget the Ministry of Finance (MoF) intends to introduce a new budget classification based on international standards.

In recent months improvements have also been made in the way the budget is executed, which has strengthened the MoF's control of expenditures. In particular the computerized accounting system now connects the MoF with all line ministries and governorate offices and a commitment control system has been introduced to provide MoF with more control over expenditures in 2010. Another significant step is the completion by the MoF in December 2009 of the 2008 financial statements and submission to the State Audit and Administrative Control Bureau (SAACB). This is the first time that the PA has produced closed financial statements based on international standards. Developments have also occurred in the tax administration system, which have improved the effectiveness of enforcement activity since mid-2009 and in conjunction with the stronger economy there has been a noticeable increase in the taxes being collected.

5. The PA recognized that public sector wages were higher than in the private sector and unsustainable. To deal with this challenge the PRDP committed the PA to having no general wage increase and allowing inflation to slowly lower real wages. However, due to unexpectedly high inflation of nearly 10 percent in 2008, the PA provided a 6 percent wage increase in 2009. Inflation in 2009 was only about 2.75 percent. The 4 percent general wage increase provides a real wage increase for most PA employees.