Recent Economic Developments, Prospects, and Progress in Institution Building in the West Bank and Gaza Strip

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Preface

This paper was prepared by Milan Zavadjil, Nur Calika, Oussama Kanaan, and Dale Chua. It has benefited from suggestions from a large number of Fund colleagues. The paper was edited by Martha Bonilla of the External Relations Department. Any views expressed in this study are those of the authors and should not be attributed to the IMF, its Executive Directors, the Palestinian authorities, or the authorities of any member country.

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I. INTRODUCTION

The historic "Declaration of Principles on Interim Self-Governing Arrangements" between the Palestine Liberation Organization (PLO) and Israel outlined the gradual future handover of responsibility to the Palestinian Authority (PA) in the West Bank and Gaza Strip (WBGS). In keeping with this declaration, the PA assumed responsibility in the Gaza Strip and Jericho area in May 1994, and for five areas of activity in the West Bank (health, education, social welfare, tourism, and direct and VAT taxation) in December 1994. The remaining areas of responsibility in the West Bank were transferred gradually to the PA following the Interim Agreement of September 1995. The economic policy framework in the WBGS was largely defined in the Economic Protocol of April 1994, which addressed economic relations between Israel and the PA (see Box 1).

The PA has thus been confronted with the challenge of gradually assuming responsibility for most public sector functions in the WBGS. Economic management has also been complicated by frequent border closures that have disrupted the movement of goods and labor, and have thus inflicted severe damage on the economy. In these difficult circumstances, and in the absence of a domestic currency, the main macroeconomic challenge confronting the PA has been to establish a fiscal administration and ensure fiscal stability, as well as to cushion the impact of the border closures on the poorest segments of the population.

Although the economy of the WBGS is relatively free of major structural distortions, the PA will still need to take steps to create preconditions for attracting nondebt creating capital inflows and thus promoting private investment, in order to reduce the very high rate of unemployment. While security and political uncertainties are the main constraints to private sector investment currently, a transparent legal and regulatory framework will need to be established.

In keeping with the nonmember status of the WBGS in the IMF, the involvement of the IMF has been limited to the provision of technical assistance to the PA. Initially the emphasis was on assistance to establish the key economic and financial institutions, notably the Ministry of Finance and the Palestinian Monetary Authority (PMA). Since then, technical assistance has continued with the focus on improving revenue administration, expenditure management, and reforming the pension system; establishing and improving the bank supervision and check settlement systems; and creating a reliable system of macroeconomic statistics. In addition, the scope of Fund technical assistance widened in 1995–96 to include macroeconomic policy formulation. In this context, Fund staff has assisted the PA in preparing its annual budget, monitoring budgetary performance, reporting to donors, and mobilizing external financial resources.

The purpose of this paper is to review economic and institution-building developments in 1996, and to briefly assess the prospects for 1997. Chapter II provides a short overview. Subsequent chapters provide more details on fiscal (III), monetary (IV),

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and external (V) developments; the trade system (VI); and Fund technical assistance activity in the WBGS (VII). A review of macroeconomic statistics and of World Bank activity in the WGBS is provided in appendices. Earlier developments and the transfer of power from Israel to the PA were discussed extensively in the report entitled *West Bank and Gaza Strip—Recent Economic Developments and Prospects and Progress in Institution-Building—Background Paper Issued in Connection with the 1995 Article IV Consultation with Israel,* published in October 1995.

Box 1. The Protocol on Economic Relations

In April 1994, the Palestine Liberation Organization and the government of Israel agreed upon a "Protocol on Economic Relations," which had the following features:

Trade. Between Israel and the areas under the PA's authority, trade is to be free from restrictions, with the exception of quantitative restrictions on six agricultural products (poultry, eggs, potatoes, cucumbers, tomatoes, and melons). The restrictions are to be phased out gradually according to an agreed timetable. Israeli import policies will continue to apply to trade with third countries, with the provision that the PA will be allowed some flexibility in import policies with regard to specific categories of goods, in particular goods needed for its development program and certain specified goods from Arab and other countries.

Labor. Each side will attempt to maintain normal labor movements with the other, but will retain the right to determine the extent and conditions of labor movements into its own areas of jurisdiction.

Taxation. Each side will administer its own tax policies in its areas of authority, with the main proviso that the VAT rate in the areas under the PA's authority must not be more than 2 percentage points lower than the 17 percent currently in Israel. Taxes on international trade (including customs duties) will be shared between the two sides according to the "destination principle." Receipts from taxes and fees paid by Palestinians working in Israel and the Israeli settlements will in large part be transferred to the PA, according to an agreed upon formula.

Money. The Palestinian Monetary Authority will be established as the PA's official economic and financial advisor, the sole financial agent of the PA and public sector entities, the manager of the public sector's foreign exchange and gold reserves, and the agency responsible for licensing and supervising banks and foreign exchange dealers. The New Israeli Shekel (NIS) will continue to be one of the currencies circulating in the areas of the PA's authority, and will be accepted as means of payment for any transaction. The two sides will continue to discuss the possibility of introducing a Palestinian currency.

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II. Economic Developments and Policies in 1996 and Prospects for 1997

Economic developments in the WBGS in 1996 were dominated by political and security factors. The frequent border closures and increased political uncertainties resulted in a reduction in the number of Palestinians working in Israel, disruptions to trade and to the public investment program, and a general weakening of confidence. As a result, over the year as a whole, per capita income fell, unemployment rose to 34 percent, and only modest headway was made in developing the physical and institutional infrastructure (see Table 1). After the construction boom of 1994 and 1995, private investment also fell in 1996. By the second half of 1996, per capita income was about 20 percent lower and the unemployment rate 16 percentage points higher than in 1993, before the signing of the Oslo accords (Charts 1 and 2).[1] However, some progress was made in establishing and strengthening economic institutions and processes.

A. Situation at the Beginning of 1996

Economic developments in 1996 were disappointing, particularly in view of the more promising situation that prevailed at the end of 1995, following the signing of the Interim Agreement in September 1995 and the associated easing of political tensions and uncertainties. At the Ministerial Conference on Economic Assistance to the Palestinian People held in Paris on January 9, 1996, the PA expressed its resolve to pursue institution-building efforts and to continue the implementation of tight fiscal policies, with a view to achieving a balanced recurrent budget by 1997. Donors, in turn, were to shift away from emergency and recurrent budget financing and concentrate increasingly on providing financing and assistance aimed at an accelerated implementation of core public sector investment projects which were endorsed at the October 1995 Consultative Group (CG) meeting for the WBGS. This was seen as the best means to increase domestic employment, while laying the basis for reinvigorated private investment and trade.

B. The Border Closure and the Palestinian Authority's Response

As a consequence of three suicide attacks in Israel, a strict border closure was imposed on the WBGS on February 25, which virtually prohibited the movement of goods and labor to and from the WBGS. This led to the immediate unemployment of about 50,000 workers previously working in Israel (out of an estimated workforce of 530,000).
The blockade of merchandise trade exacerbated the fall in domestic incomes, in particular of those engaged in the production of exportables, notably in agriculture. Shortages in raw materials and other imported capital inputs disrupted the public investment program and investment activities in the private sector, especially in the construction sector, leading to a

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[1]As discussed in Appendix I, all macroeconomic data are subject to a high degree of uncertainty.

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Table 1. West Bank and Gaza Strip: Key Economic Indicators, 1993–97

(In millions of U.S. dollars, unless otherwise indicated)

	1993	1994	Est. 1995	Est. 1996	Proj. 1997
Real GDP (percent change)	–1.3	10.8	3.3	–1.6	5.4
Real GNP (percent change)	–10.1	3.9	–2.4	–2.9	8.1
Real GDP per capita (NIS, 1986 constant prices)	1,470	1,567	1,424	1,346	1,364
Real GNP per capita (NIS, 1986 constant prices)	1,766	1,764	1,538	1,435	1,492
Workers in Israel (in thousands) 1/	83.0	53.0	32.1	25.1	35.0
Workers in WBGS (in thousands) 1/	316.2	328.9	342.0	335.8	355.9
Unemployment rate (in percent)	18.0	24.7	29.0	34.2	31.5
Inflation rate (based on CPI)	11.0	14.0	10.8	7.9	8.1
Revenue	296	269	425	670	814
Current expenditure	273	298	492	782	866
Current deficit	23	–30	–67	–112	–52
Public investment	98	86	189	160	255
Foreign–financed employment programs	––	––	––	53	––
Overall deficit	–75	–115	–257	–325	–307
Exports of GNFS	245	312	473	413	470
Imports of GNFS	1,333	1,242	1,908	1,745	1,949
Remittances (receipts)	586	400	262	218	329
			(End of period)		
Net foreign assets	...	435	1,010	1,320	1,882
Domestic loans	...	97	270	398	...
Total deposits	...	523	1,142	1,695	...
Demand deposits	...	306	465	584	...
Time and savings deposits	...	217	678	1,111	...

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

1/ Annual averages.

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Box 2. The West Bank and Gaza Strip at a Glance

Area and population

The WBGS has a population of 2.55 million (Appendix Table 11). With about 38 percent of the population living in the Gaza Strip, its **distribution is highly uneven**; the West Bank has a population of 1.58 million and an area of 5,800 squared kilometers, whereas the Gaza Strip has a population of about 1 million and an area of 400 squared kilometers. It is a **very young** population, with about 50 percent below the age of 15. The population is **predominantly Palestinian** although Palestinians in the WBGS represent **less than one-half of the world's Palestinian population** (it is estimated that about 3.5 million Palestinians live in the diaspora).

Economic characteristics

The WBGS has a GDP of about US$3.2 billion (in 1996), and a somewhat higher GNP (because of the importance of remittances from workers in Israel) of US$3.4 billion; thus a GDP per capita income of US$1,255 and GNP per capita income of US$1,333. The WBGS' **economy is largely service-oriented**, with services and commerce representing about 58 percent of GDP, construction representing 21 percent, agriculture 14 percent, and industry 7 percent (in 1993). Since Israel's military occupation in 1967, the WBGS' **economy has been highly dependent on Israel's.** In 1993, there were 83,000 workers from the WBGS in Israel (about 21 percent of total WBGS employment), with remittances from those workers representing about 20 percent of GNP. Trade with Israel represented about 75 percent of exports of goods from and 87 percent of imports into WBGS. Given this dependence, the **recurrence of border closures** since 1995 has **stifled the economy**.

Social indicators

On the whole, **social indicators in the WBGS are close to the average for countries in the Middle East and North Africa region (MENA)**. Life expectancy at birth is 68 years, compared with MENA's average of 66 years. Illiteracy rate is 40 percent, compared with 39 percent for MENA. Infant mortality is 37 per 1,000, compared with MENA' average of 49 per 1,000. Gross primary enrollment (percent of school age population) is about 100 percent compared with the MENA average of 97 percent.

further sharp fall in domestic employment. Real GDP is estimated to have fallen by about 10 percent in the first quarter, and the unemployment rate to have risen to about 38 percent at the end of the first quarter from 29 percent in January.[2]

[2]Excludes underemployment.

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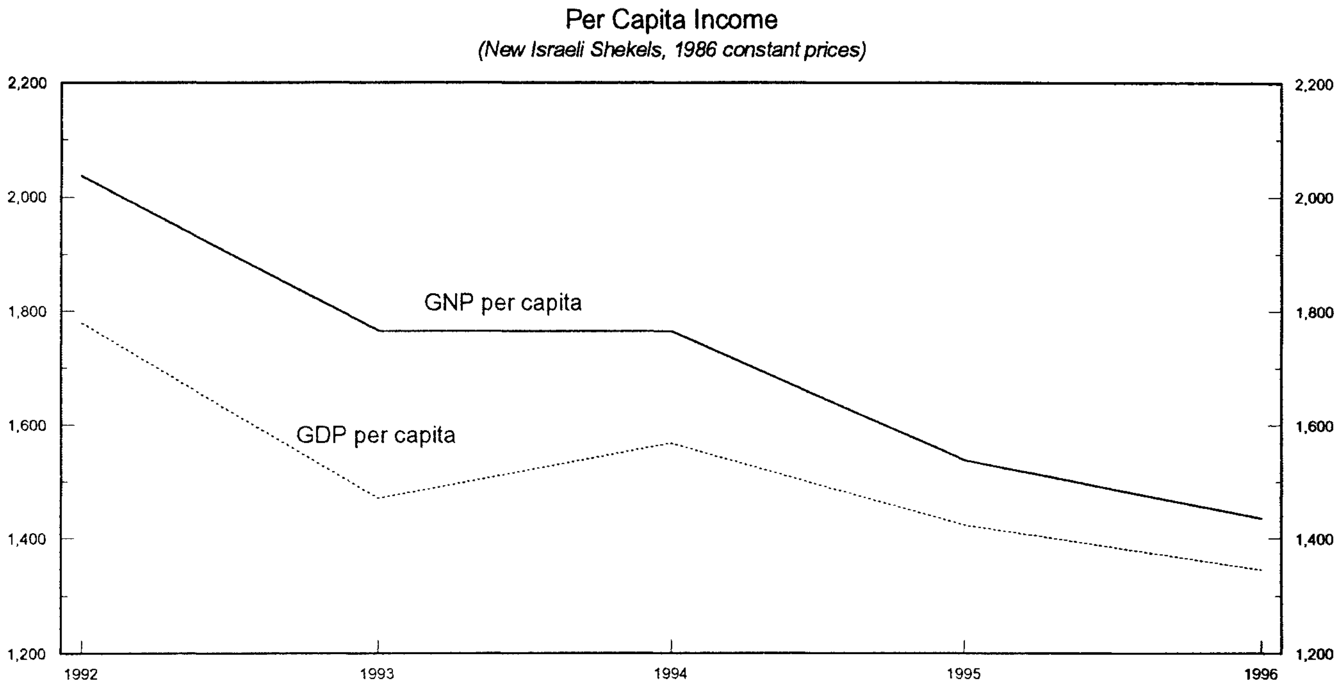
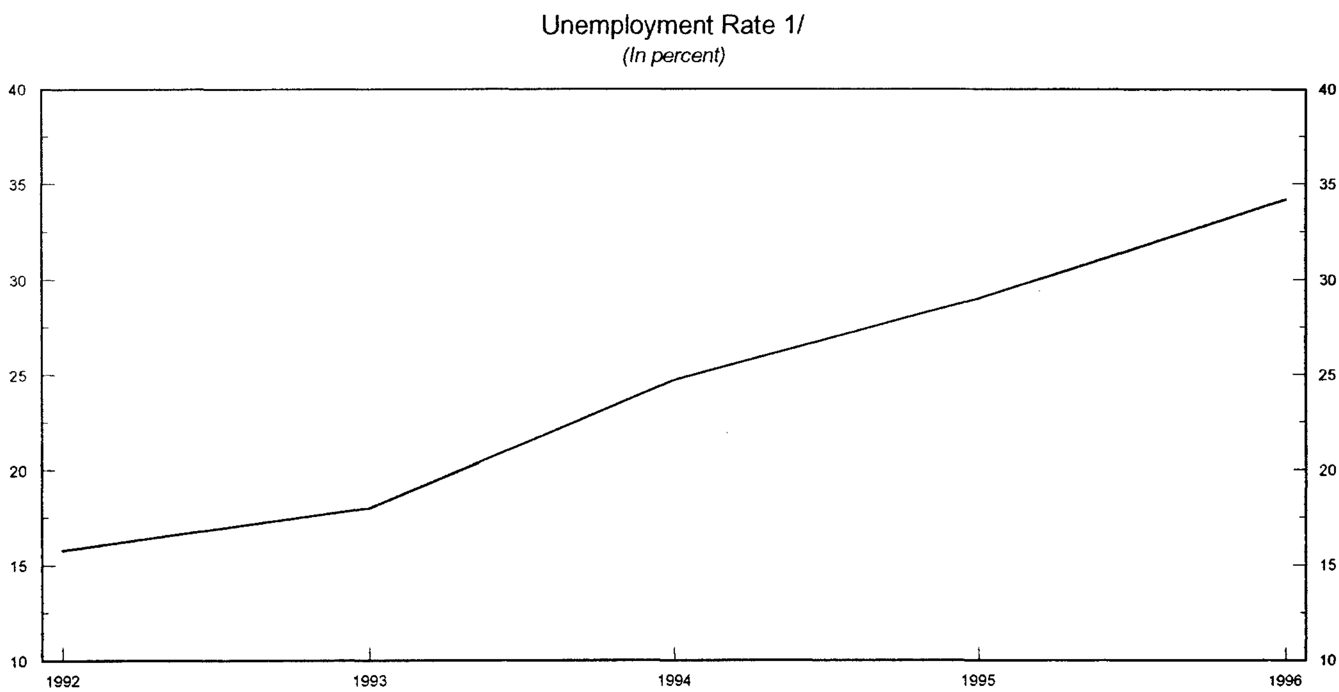
Chart 1
West Bank and Gaza Strip: Selected Economic Indicators, 1992-96





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

1/ Excludes underemployment.

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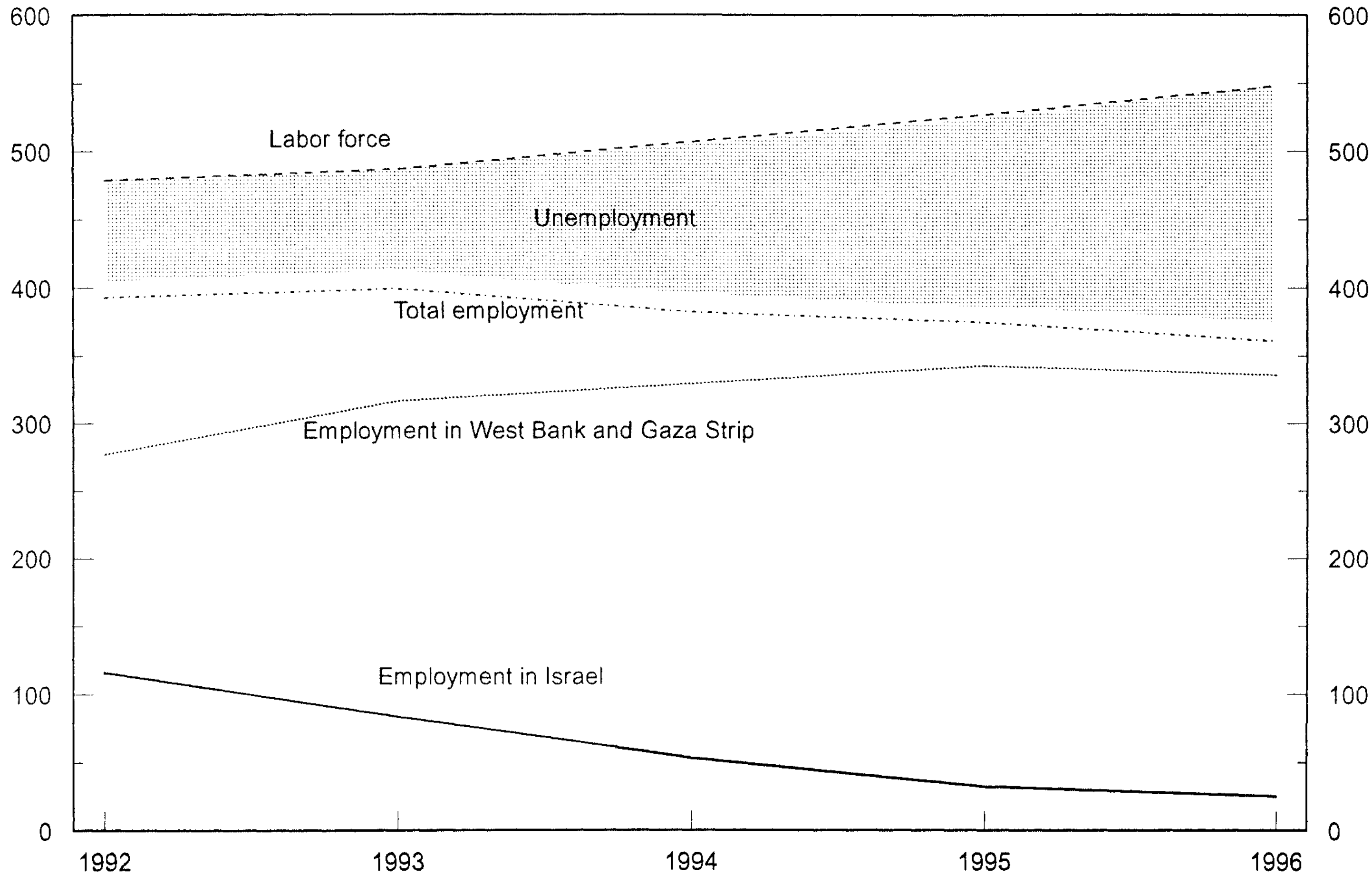
Chart 2

West Bank and Gaza Strip: Labor Market Indicators, 1992-96

(In thousands)



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

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Confronting a severe worsening in economic and financial conditions, the PA, with the help of donors, implemented a series of short-run measures designed to alleviate the adverse effects of the border restrictions on the more vulnerable segments of the population. These included:

- providing temporary employment through public works, the funding for which was covered domestically through a 5 percent solidarity charge on the wages of the employees of the PA, and from external funds channeled through the Holst Fund, the United Nations Development Program (UNDP), the United Nations Relief and Works Agency (UNRWA), and the Palestinian Economic Council for Development and Reconstruction (PECDAR).[3] The total number of workers employed in these programs has risen from about 10,000 workers in April to about 40,000 workers in subsequent months;

- providing social assistance to families deprived of their breadwinners' income as a consequence of the closure; and

- importing essential foodstuffs with the objective of preventing sharp increases in their prices and ensuring their availability to the population (largely at cost).

The Israeli authorities started to relax, in a gradual fashion, border restrictions starting in mid-April. The number of permits granted to Palestinian workers increased from about 15,000 in April to 36,000 in August and about 40,000 toward the end of the year. Restrictions on merchandise trade were also relaxed (more on imports than on exports), but the recovery of trade was inhibited by the rise in transportation costs as a result of more stringent security controls at the borders. Moreover, there were intermittent border closures in the second part of 1996 (notably, in late September and early October, and again in early November) so that the **average** number of workers employed in Israel is estimated at 25,100 in 1996, compared with 116,000 in 1992. With the gradual increase in Palestinian employment in Israel, and the implementation of the employment generation programs, real GDP recovered in the second half of the year. Nevertheless, it is estimated to decline by about 2 percent for the year as a whole, reflecting substantial declines in private and public investment (particularly construction) as a result of increased uncertainty, and in private consumption, which was only partially offset by the expansion of PA recurrent spending (Table 2, Appendix Tables 12 and 13, and Chart 3).[4] The induced slowdown in economic activity led to a contraction in imports of goods and nonfactor

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[3]The Johan Jorgen Holst Peace Fund is a World Bank administered fund used by donors to support the PA's recurrent budget and start-up and employment generation activities. PECDAR was established in 1994 to act as an implementing agency for investment projects.
[4]Real GNP is projected to decline by 3 percent, reflecting additionally the decline in workers' remittances.

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Table 2. West Bank and Gaza Strip: National Income Accounts, 1993–96

(In millions of NIS, 1986 constant prices)

	1993	1994	Est. 1995	Est. 1996
GDP 1/	3,340	3,701	3,495	3,438
Resource gap	-1,324	-1,124	-1,632	-1,497
Imports of goods and nonfactor services	1,620	1,497	2,165	1,958
Exports of goods and nonfactor services	296	373	533	461
Gross domestic expenditure	4,664	4,825	5,127	4,935
Consumption	3865	4054	4,410	4,228
Private	3,516	3,698	3,804	3,438
Government	349	356	606	790
Gross fixed investment	799	771	717	706
Private	638	663	452	393
Government	161	108	265	313
Net factor income	671	465	281	229
Remittances	671	465	281	229
Receipts	712	482	297	244
Payments	41	17	16	16
Net investment income	--	--	-1	--
Receipts	--	--	--	--
Payments	--	--	1	--
GNP	4,011	4,166	3,776	3,666

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

1/ Figures for exports and imports, and thus for GDP, in 1995 and 1996 are not comparable to those for earlier periods, because of a break in the series for exports and imports starting in 1995 (see Section V).

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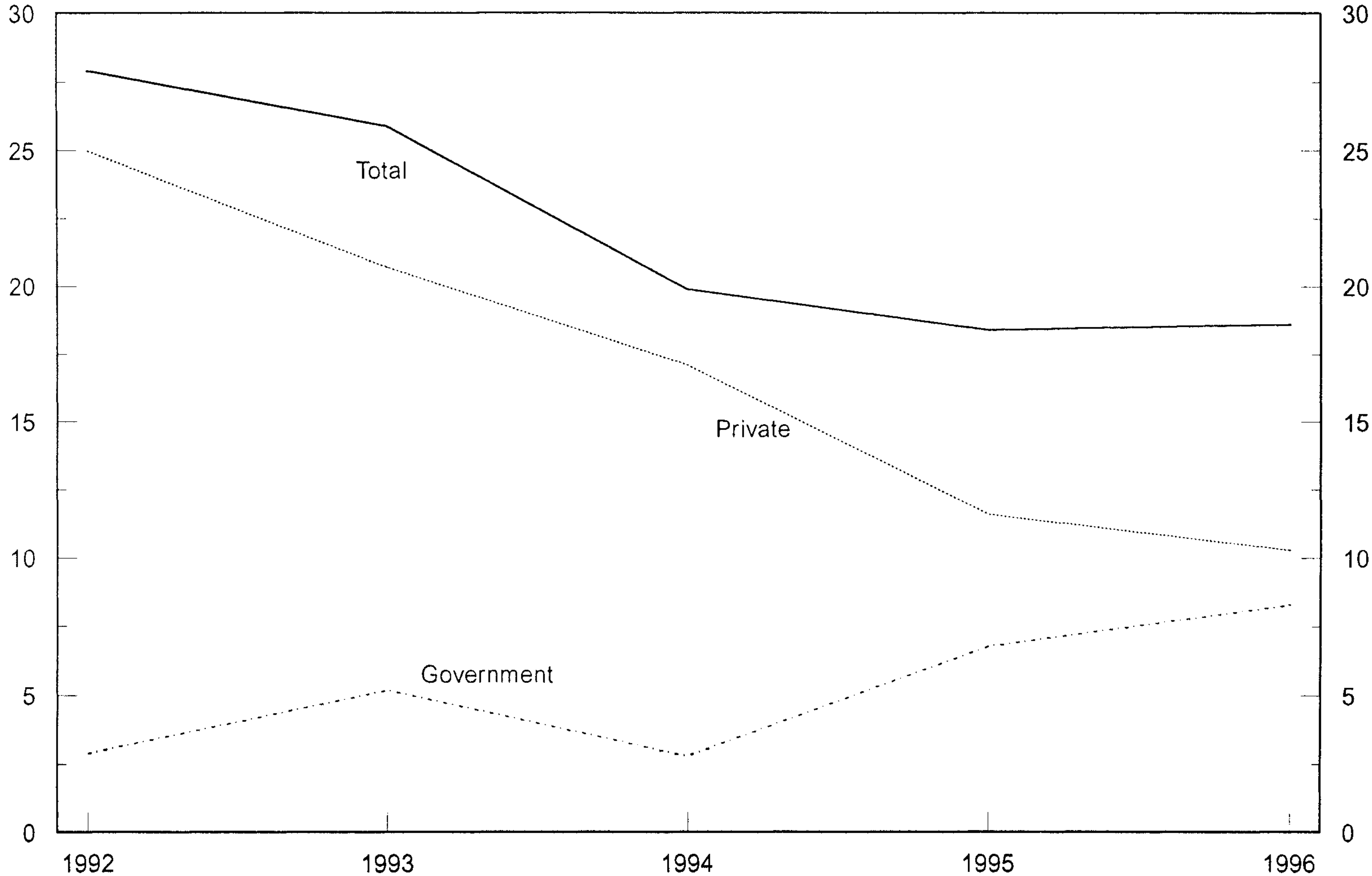
Chart 3

West Bank and Gaza Strip: Gross Fixed Investment, 1992-96

(As a percent of GDP)



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

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services in 1996 by 9 percent. Nevertheless, a large trade deficit remained and together with the estimated rise in net foreign assets of US$310 million was financed, as in previous years, by unrequited transfers and capital inflows.

Despite the pressures on expenditures and revenues emanating from the border closures, the PA managed to limit the increase in the recurrent deficit (see Section III below). Reflecting perseverance in improving revenue administration, PA revenues, at US$670 million, exceeded the draft budget target by 21 percent (Table 3). Nonwage expenditures exceeded the target by over one-half because of spending related to (i) the border closure; (ii) unbudgeted expenditures due to institution building; and (iii) at least an additional unbudgeted US$32 million spent from accounts not under the control of the Ministry of Finance. In addition, overall wage and salary payments exceeded 1996 draft budget target modestly, reflecting in large part higher than anticipated police recruitment. In all, the recurrent budgetary deficit is estimated at US$112 million, about US$37 million higher than targeted under the draft budget. Public investment did not provide the envisaged boost to the economy in 1996; PA capital outlays are estimated at US$160 million, well below the level in 1995 and the amount envisaged at the time of the Paris Conference.

Despite the unsettled political and security conditions, banking system deposits and net foreign assets increased sharply in 1996. This reflected the increasing role of the banking system as the keeper of the WBGS's residents' financial savings, which was not accompanied by a proportional expansion of domestic bank lending. Rapid deposit growth was maintained throughout 1996, due to the growing number of banks and bank branches throughout the WBGS and the continuing shift in portfolio preferences from cash to deposits, evident since the PA assumed responsibility for the banking system. In all, deposits are estimated to have increased by US$550 million during 1996. However, domestic credit is estimated to have increased by less than one-fourth of that amount, largely as a result of the high risks of bank lending in the WBGS and the depressed demand for capital by local investors in the prevailing uncertain political and economic environment.

While changes in the CPI in the WBGS are usually governed by the rate of inflation prevailing in Israel, two additional effects, acting in opposite directions, came into play in 1996 as a result of the intensified border closure. Tight restrictions on imports put upward pressure on prices in the period immediately following the closures (particularly in Gaza), but the decline of remittances and other sources of income (including those derived from export activities) exerted a strong downward pressure on prices, leading to a steady fall in the monthly rate of increase in the CPI. Monthly increases in the CPI, which averaged over 1.5 percent per month in the first quarter, fell to negative levels toward the end of the year, well below the levels recorded by the CPI in Israel (Table 4). The inflation rate for the year as a whole is estimated at about 8 percent, compared with 11.5 percent in Israel.

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Table 3. West Bank and Gaza Strip: Summary Table of the Fiscal Operations of the Palestinian Authority, 1995–97

(In millions of U.S. dollars)

	1995 Draft Budget	1995 Est.	1996 Draft Budget	1996 Proj.	1997 Draft Budget
Revenue 1/	216.0	424.9	554.3	670.1	814.2
Domestic revenue	114.5	158.5	207.4	247.2	301.1
Tax revenue	84.7	108.2	136.6	169.4	205.1
Nontax revenue	29.9	50.3	70.9	77.8	96.0
Revenue clearances	101.4	266.4	346.8	422.9	513.1
Current expenditure	443.7	492.0	629.3	782.2	866.0
Wage bill civil service	187.9	193.8	249.7	247.6	296.0
Wage bill police force	96.6	110.5	147.3	153.7	199.0
Nonwage budgetary expenditure 2/	159.1	187.7	232.3	348.9	371.0
Other expenditure 3/	--	--	--	32.0	--
Current balance excluding foreign–financed employment programs	−227.7	−67.1	−75.0	−112.1	−51.8
Foreign–financed employment programs	--	--	--	53.1	--
Current balance including foreign–financed employment programs	−227.7	−67.1	−75.0	−165.2	−51.8
Capital expenditure	143.4	190.0	272.8	160.0	...
Of which: PMA capital	10.0	--	--	--	--
Overall balance	−371.1	−257.1	−347.8	−325.2	...
Financing	225.4	...	272.8	...	...
Domestic financing	--	...	--	...	...
Foreign financing	225.4	325.0	272.8	266.8	...
Recurrent budget financing	92.0	135.0	--	53.7	...
Employment generation programs	--	--	--	53.1	...
Capital expenditure	133.4	190.0	272.8	160.0	...
Financing gap	145.7	--	75.0	...	51.8 4/
Memorandum items:					
Revenue 5/	6.7	13.2	17.2	20.7	23.0
Current balance 5/ 6/	−7.1	−2.1	−2.3	−3.5	−1.5
Overall balance 5/	−11.5	−8.0	−10.8	−10.1	...

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

1/ Estimates of revenue include collections transferred to bank accounts outside the control of the Ministry of Finance (see footnotes 1 and 3, Table 5).

2/ Including expenditures on emergency programs associated with the border closures and additional unbudgeted expenditures that were not included in the 1996 draft budget (see footnotes 1, 2, and 3, Table 6).

3/ From accounts not directly under the control of the Ministry of Finance (see footnote 4, Table 6).

4/ Projected recurrent budget financing gap for 1997.

5/ In percent of GDP.

6/ Excluding foreign–financed employment programs.

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Table 4. West Bank and Gaza Strip: Inflation Rates (Based on Cost of Living Index), 1993–96 1/

	1993	1994	Est. 1995	Est. 1996 QI	Est. 1996 QII	Est. 1996 QIII	Est. 1996 QIV	Est. 1996
West Bank and Gaza	11.0	14.0	10.8	5.1	1.0	2.4	–0.6	7.9
Israel	11.1	12.3	8.1	2.8	4.1	1.1	...	11.5
Jordan	4.8	3.6	4.5	3.3	–4.1	3.9	...	6.5

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

1/ All figures are on an annual basis, except for figures shown for quarters, which show the rates of increase over the previous quarter.

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Box 3. Impact of Employment of Palestinian Workers in Israel on Budgetary Revenues

The employment of Palestinian workers in Israel has an important direct and indirect impact on budgetary revenue for the PA. This mobile work force affects the PA budgetary revenue in two ways.

First, a rise in Palestinian workers employed in Israel would lead to an increase in revenue clearances from customs duties and VAT and domestic revenue. As Palestinian workers in Israel remit or bring back their earnings, consumption in the WBGS is boosted once the higher disposable income is spent. Income which is spent on third-party imports would generate custom duties and other indirect taxes, including VAT through the clearance system (see Box 4). Goods purchased directly from Israel will generate only VAT revenue (again through the clearance system). Alternatively, if the income is spent on goods and services produced domestically in the WBGS, the tax base will also be enhanced. In the first instance, indirect taxes will be generated. This is followed by a second order impact as domestic sellers pay income taxes, as well as increase their own spending on other goods and services which, in turn, would create a further multiplier effect.

Second, more Palestinian workers employed in Israel would lead to an increase in revenue clearances in income tax and health fees for the PA, as Israel transfers virtually all income tax and health fees which are withheld on Palestinian workers. In 1995, this amounted to approximately US$16 million.

With an average daily wage of US$30, and workers assumed to work 26 days per month, 10,000 additional workers employed in Israel would generate US$94 million per year. Assuming an average propensity to import and consume of 0.6 and 0.9 respectively, it is estimated that a further US$19 million in taxes could be raised for every additional 10,000 Palestinian workers in Israel.

C. The Palestinian Authority's Policy Stance in 1997 and its Medium-Term Strategy

The medium-term economic strategy of the PA is geared toward addressing the unemployment problem. About one-third of the labor force is currently unemployed and this could increase unless strong economic growth is achieved—as the labor force and population are projected to continue growing by 4 percent a year. A substantial increase in investment to GDP ratios from the current 18–19 percent, as well as efficient use of resources, will be therefore required to reduce unemployment. While in the short run, better implementation of the public investment program could provide a boost to investment, in the medium term, the PA will need to rely on increased private investment.

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Box 4. Revenue Clearance System

Under the Protocol on Economic Relations signed by the PA and Government of Israel on April 29, 1994, the two sides have established a revenue clearance system to apportion an agreed pool of selected tax revenues which have arisen as a result of the de facto customs union. On indirect taxes such as customs duties and VAT on Israeli-Palestinian transactions, tax revenues accrue either to the Palestinian or the Israeli side according to the "destination principle" and the transfer of revenues is made periodically after a reconciliation of accounts. In the case of petroleum excises collected by the Israeli authorities, all revenues are transferred automatically to the PA. On direct taxes, such as income taxes and health fees paid by Palestinian workers in Israel and in the Israeli settlements, 75–100 percent of revenues collected at source are transferred. As the collecting agent, Israel levies a 3 percent service fee on all gross clearance revenue.

Transfers from the clearance system have formed a significant and stable source of revenue for the PA. In both 1995 and 1996, 63 percent of PA revenues originated from the clearance system. VAT clearance revenue, which routinely amounted to nearly one-third of total revenue, was by far the most importance source of clearance revenue.

On indirect taxes, the revenue clearance is based on actual payments or bookkeeping transactions. For customs duty, VAT, and purchase taxes on third-party goods that are imported by Palestinian entities and destined directly for WBGS, a coding system used in import declarations has ensured that the correct fiscal revenues are properly transferred to the PA. As the initial problems associated with taxpayer education have largely been resolved, the system is now working relatively smoothly.

For VAT on Palestinian-Israeli transactions, the invoicing mechanism that supports the functioning of the VAT was a natural candidate for revenue clearance. Because the VAT is a multi-stage tax, to avoid tax cascading, each side has agreed to recognize all invoice-supported VAT payments that have been made to the other side. This arrangement permits each tax authority to recover from its counterpart the amount that is allowed to be deductible from the VAT liabilities by firms in its own jurisdiction. This feature provides an incentive for both sides to widen the coverage of their respective VAT because doing so will automatically increase the amount each can recuperate from the other side. This system, which requires considerable coordination, has functioned well following the introduction of a unified invoice system in January 1995.

On direct taxes, the Protocol specifies that 75 percent of income taxes paid by Palestinian workers who are employed in Israel be transferred to the PA. This revenue-sharing formulae recognizes the principle that income tax should in part be used to finance the infrastructure which makes production possible and in part be used to finance the social services consumed by the workers. As most Palestinian workers employed in Israel commute to work daily and are therefore more likely to consume their social services in WBGS, the income tax deducted at source from wages of Palestinian workers in Israel is thus shared between the two authorities. In addition, the Protocol further specifies that 100 percent of all health fees paid by Palestinian workers in Israel and in the Israeli settlements be transferred to the PA in recognition of the service criterion.

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To increase investment and savings, the PA is implementing structural measures in the fiscal, financial, external, and regulatory areas, although success will depend also on the political and security situations. In the macroeconomic area, the goal is to maintain domestic financial stability and promote private sector activity and confidence by the pursuit of a tight fiscal policy and the continuation of institution-building efforts, including by increasing the transparency and accountability of fiscal operations. The PA intends to reduce substantially the recurrent deficit in 1997 and achieve small but rising surpluses thereafter, so as to allow for a domestic budgetary contribution to public investment and for an increasing focus of donor assistance on building infrastructure and on other investment projects.

Assuming modest improvements in security and political conditions, the outlook for 1997 is for a moderate recovery in exports and private investment, and an increase in the number of Palestinian workers in Israel to 35,000 (see Table 1). Under such conditions, real GDP is projected to rise by 5–6 percent, and the unemployment rate is projected to fall slightly to 31.5 percent. The PA draft budget aims at reducing the recurrent deficit from an estimated US$112 million in 1996 (3.5 percent of GDP) to US$52 million in 1997 (1.5 percent of GDP), while taking steps to ensure a substantial rise in foreign-financed capital expenditures. The main factor contributing to the reduced recurrent deficit in 1997 is the projected 21 percent increase in revenues, which reflects the expansion of the revenue base in late 1996, the rebound in economic activity and, to a lesser extent, a modest further improvement in tax administration. In addition, recurrent expenditures will be restrained through avoiding a general wage increase, and strict limits on nonwage expenditures. However, new PA employment is expected to rise by 9 percent due to the recruitment of 3,000 new policemen, as well as 3,700 teachers and health personnel.

To achieve the above budget target, improvements are being undertaken in expenditure management and revenue collection. In particular, all revenues, expenditures, and external financing are to be centralized under the control of the Ministry of Finance by March 1, 1997, with the aim of increasing efficiency in the use of budgetary resources. This will also enhance prospects for donor support to cover the recurrent budget deficit. Efforts continue to be made to strengthen the Budget, Treasury, and Audit Departments at the Ministry of Finance. In the area of revenue administration, with the basic revenue structure in place, the focus is on improvements in enforcement, particularly in the income tax area, and the recruitment of qualified staff. The establishment and operationalization of large taxpayer units should also help tax collection, including the VAT.

From 1967 until a few years ago, the expansion of income in the WBGS was driven by employment in Israel and the Gulf states. Since 1992, however, such employment has been in decline, with little prospect for an immediate recovery. Employment for the rapidly growing labor force will therefore need to be generated through the growth of exports of

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goods and services, which will require an environment conducive to private sector investment and growth. The general policy of the PA in this area is to continue to avoid interventions in the product market and the distortion of price incentives. In the same spirit, the PA is making efforts to remove some of the domestic impediments to private investment, in particular, by improving the regulatory environment. This would involve, with assistance of the World Bank, the review, consolidation, and improvement of a wide set of laws that currently regulate private sector activity (including the Investment Law).

The PA has undertaken to dismantle import monopolies (notably on petroleum products, cement, tobacco, and some electronic products) by end-1998, which currently represent the major structural distortion in the economy, as well as steps to improve their operations until that time. The PA is also aiming at further encouraging private sector investment through the strengthening of financial intermediation. Toward this end, efforts to strengthen the capabilities of the Palestinian Monetary Authority are currently underway, especially in the area of bank supervision and regulation, with a view to ensuring a sound financial system with well-regulated banking operations.

The PA is continuing its efforts to mobilize external resources from donors, in particular in the context of the Ad Hoc Liaison Committee (AHLC) and the Consultative Group (CG), with a view to ensuring the availability of funds to cover the recurrent budget gap in 1997, and to eliciting support for and the prompt disbursement of funds for key public investment projects. At the CG meeting convened by the World Bank on November 19–20, 1996, donors pledged some US$880 million to support the public investment program. However, considerable follow-up work is required to ensure that these pledges are translated into commitments and disbursements for specific investment projects in the public investment program. Donors have also endorsed the 1997 draft budget target, and it is expected that commitments to cover the 1997 recurrent budget financing gap will be made at the next AHLC meeting.

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III. Institution Building and Developments in the Fiscal Area

A. Institution Building

Following the "Agreement on the Gaza Strip and Jericho Area"[5] of April 29, 1994, the PA had systematically begun to assume control of the basic public sector tasks that were performed by the Israeli Civil Administration during 1967–94. To meet these responsibilities, the PA needed to establish a system of institutions, and to raise the necessary resources to finance them. The strategy adopted in the institution-building process was as follows: when necessary, institutions were created to meet challenges that arose from the new arrangements but, whenever possible, existing institutions which could be expected to continue to function relatively efficiently in the new regime were maintained. In this way, limited resources would be applied to the most urgent needs.

The PA has assumed, on the revenue side, full responsibilities in the WBGS for the income tax and the VAT (on domestic transactions), and nontax revenues. In addition, as a partner in the de facto customs union with Israel, it participates in a revenue clearance system that administers customs duties, the VAT on Israeli-Palestinian transactions, petroleum excises, and income tax and health fees paid by Palestinian workers in Israel and in the Israeli settlements (see Box 4 for discussion of the revenue clearance system).

To minimize the risk of revenue loss associated with the transfer of powers, the PA has maintained, with minor exceptions relating to income tax rates, all earlier tax policies while focusing its main efforts on establishing a modern tax administration. Progress in improving the latter has been encouraging. By mid-1995, concrete steps were already being adopted to reverse the initial decline in revenue collection associated with the disruption in the tax administration immediately following the transfer of powers. By early 1996, 8 VAT and 8 income taxes offices had commenced full operations and the dissemination of taxpayer information, especially in the West Bank, had begun to improve considerably.

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[5]This was the first of several agreements that map out the systematic transfer of powers in the WBGS from the government of Israel to the PA, as noted above. This agreement transferred all agreed self-governing responsibilities and authorities in the Gaza Strip and Jericho areas. In December 1994, the Agreement on Preparatory Transfer of Powers and Responsibilities handed over to the PA five spheres of activity in the West Bank (health, education, social welfare, tourism, and direct taxation and VAT on domestic production). In addition, the Protocol on Further Transfer of Powers and Responsibilities handed over, as of September 1995, an additional eight spheres of activities in the West Bank to the PA. Lastly, under the Israeli-Palestinian Interim Agreement on the West Bank and Gaza, which supersedes all earlier agreements, all remaining spheres of activity, with minor exceptions (water and sewage), were to be transferred during the 18 months following the elections of the Palestinian Council in early 1996.

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More recently, the training of tax officers and the recruitment of staff have gathered pace while the documentation and computerization of a unified invoice system for the VAT, which was introduced in January 1995, were enhanced.

Other key steps to strengthen tax administration are also planned for the near future. Specific measures are the operationalization of large taxpayer units and the implementation of an issue-oriented audit strategy to maximize revenue productivity. Courts for resolving tax disputes are also in the process of being established.

Mirroring developments in the assumption of control of fiscal revenues, the PA has also gradually taken over responsibilities for public expenditures since April 1994. The most important functions of the PA are currently related to health, education, and security, which account for about 80 percent of recurrent expenditures.

Progress in institution building in expenditure management, after a slow start, also accelerated recently. Among the positive developments was the promulgation of a modern Organic Budget Law in 1996, which lays the foundation for rational expenditure management. In addition, a budget circular that provided guidelines for budgetary preparation was issued to line ministries, while Budget, Treasury, and Audit Departments were established, with several senior officials appointed by mid-1996. Finally, physical facilities such as offices and office equipments have improved markedly. However, recruitment in general has been hampered by the difficulties of bringing qualified Palestinians to work in the Gaza Strip, where much of the PA administration is located.

The PA has also undertaken to bring all revenues and expenditures, including revenues from PA commercial activities (particularly import monopolies), under the control of the Ministry of Finance by March 1, 1997. This is a crucial decision, as up to one-fourth of domestic revenues are currently being diverted to accounts outside of the Ministry of Finance, which has been putting pressure on the liquidity position of the Ministry of Finance; this lack of control by the Ministry of Finance (and the resulting incomplete data) has also impeded fiscal analysis.

Other steps envisaged for strengthening expenditure management in the near future are (a) the recruitment of additional staff in various departments where a clear organizational structure has been adopted, (b) the approval of financial regulations, including the Palestinian Monetary Authority Act and the Audit Law, (c) the placement of financial comptrollers in the line ministries under the control of the Ministry of Finance, and (d) the strengthening of recruitment procedures.

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As the PA has not yet decided on its overall trade policy option,[6] no significant customs administration capacity has so far been established, although the nucleus of the PA customs organization has been put in place. Nevertheless, measures which have recently been adopted to strengthen customs administration include a plan for the expansion of storage facilities at border crossing points to accommodate the expected growth in trade.

B. Fiscal Structure and Recent Fiscal Developments

Under very difficult conditions, the PA succeeded in 1996 to hold down the budget deficit to a moderate level. Confronted with continued high start-up costs in establishing a fiscal administration and the frequent border closures that affected revenue performance while imposing substantial additional government expenditures to alleviate the attendant economic hardship, the increase in the recurrent budget deficit in 1996 was kept to some 1 percent of GDP. Specifically, it reached 3.5 percent of GDP or US$112 million (Chart 4).[7] The PA achieved this mainly by protecting revenue through further improving tax administration (as noted above) and by prioritizing expenditures. These measures should also lay the grounds for reducing the recurrent deficit to 1.5 percent of GDP in 1997, as envisaged under the draft budget, and for eliminating the recurrent deficit in 1998.

Recurrent expenditures in 1996 were 24 percent (US$153 million) higher than envisaged under the budget, in part reflecting emergency expenditures to deal with the border closure. Of this amount, US$116 million was offset by better than expected revenue performance. The remainder was financed by a combination of modestly higher than envisaged external assistance and withdrawals from government deposits that were built up in 1995 when external financing exceeded the recurrent deficit. This enabled the PA to maintain its operations without incurring substantial arrears, although its bank position deteriorated significantly, reaching an overdraft of US$35 million at end-September 1996.[8]

As in the preceding year, **revenues** performed very strongly in 1996 due to the greater than expected improvement in tax administration outlined above, and particularly the superior performance of the unified invoice system. As a result, total revenue exceeded the budget target by about 21 percent to reach 20.7 percent of GDP. Since improvements in tax administration are still under way, in 1997, total revenue is projected to rise to about 23 percent of GDP or US$814 million (Table 5). Revenue collection from the clearance

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[6]See Section VI.
[7]In 1995, the recurrent deficit was US$67 million. Both 1995 and 1996 recurrent expenditures and deficits may be understated as they may include only partial expenditure information from accounts not under the control of the Ministry of Finance.
[8]The overdraft may have been collateralized by PA deposits not under the control of the Ministry of Finance.

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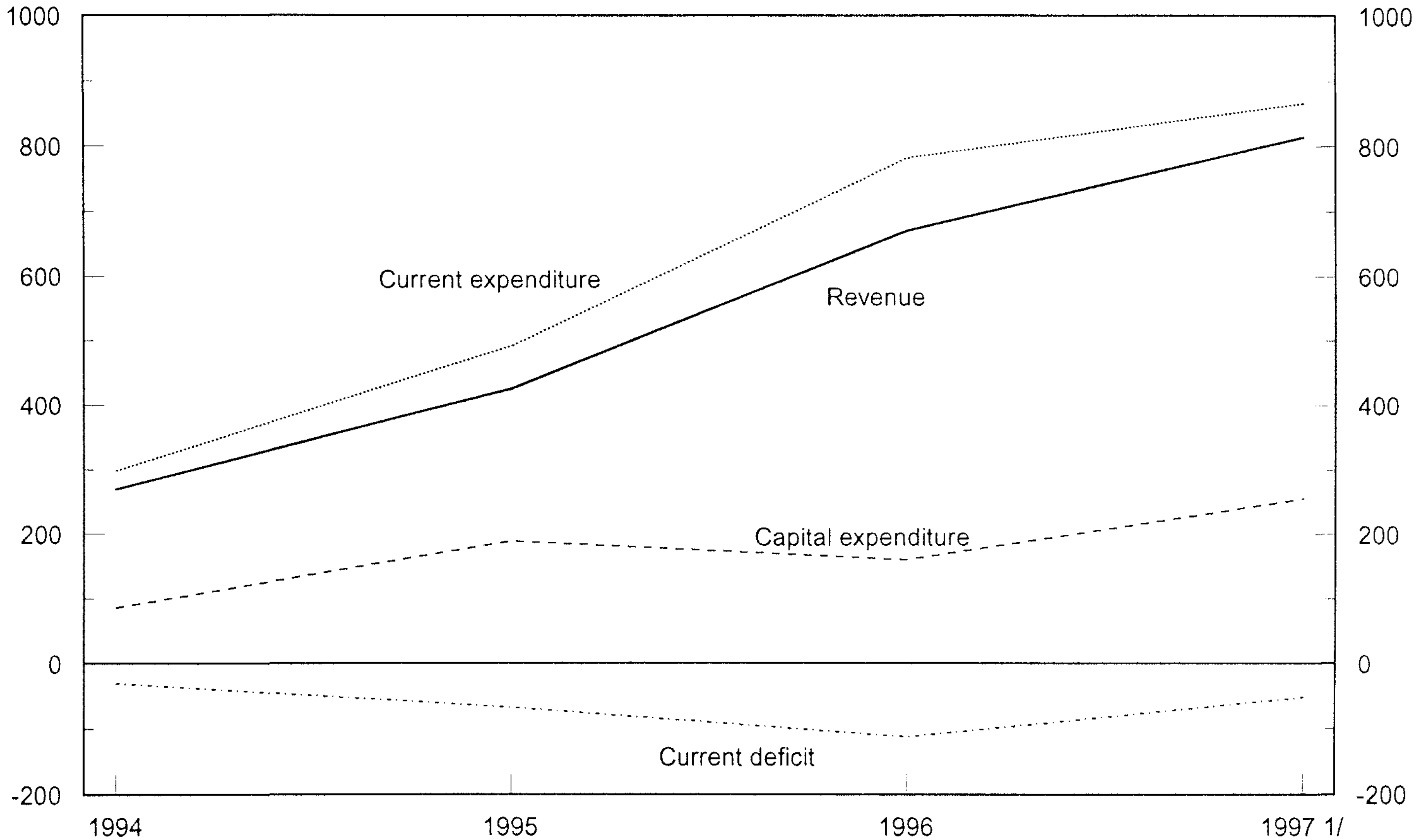
Chart 4

West Bank and Gaza Strip: Fiscal Indicators, 1994-97

(In millions of U.S. dollars)



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

1/ According to 1997 budget.

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Table 5. West Bank and Gaza Strip: Revenue of the Palestinian Authority, 1995–97

(In millions of U.S. dollars)

	1995 Draft Budget	1995 Est.	1996 Draft Budget	1996 Proj.	1997 Draft Budget
Revenue	216.0	424.9	554.3	670.1	814.2
Domestic tax revenue	84.7	108.2	136.6	169.4	205.1
Income tax	26.2	44.4	31.9	45.7	55.8
VAT	55.0	55.8	66.8	59.9	70.5
Customs duties	2.7	7.3	8.2	26.3	37.5
Property tax	0.7	0.7	0.6	0.8	1.0
Excises 1/	--	--	29.1	36.7	40.3
Other	0.1	--	--	--	--
Revenue clearances	101.4	266.4	346.8	422.9	513.1
Customs duties 2/	16.3	18.9	30.6	86.0	109.3
VAT 2/	54.1	191.9	210.4	221.8	267.9
Petroleum excise 3/	25.5	33.5	82.2	100.8	116.5
Income tax	1.4	5.0	5.8	2.2	4.8
Health fees	3.6	10.1	11.6	5.4	7.1
Other	0.5	7.0	6.2	6.7	7.5
Nontax revenue	29.9	50.3	70.9	77.8	96.0
Transportation fees	7.8	11.1	26.4	14.3	22.5
Health insurance	9.5	12.7	11.3	14.0	17.3
Health fees	6.7	11.9	9.2	10.3	12.2
Other nontax revenue	5.9	14.6	24.0	39.2	44.0

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

1/ In 1996, domestic collections of tobacco and alcohol excises were transferred to a bank account outside the control of the Ministry of Finance. In 1995, these collections were not included in the budget.

2/ Estimates of clearance revenue from customs duties and VAT are based on data provided by the Israeli authorities. Estimates are gross of deductions made to settle utility and medical product arrears accumulated by the Palestinian Authority against Israeli suppliers.

3/ In 1995 and 1996, petroleum excise clearance revenues were transferred to a bank account outside the control of the Ministry of Finance.

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Box 5. Social Safety Net

In the WBGS, social assistance to help the poor is provided by the PA, as well as UNRWA, NGOs, and foreign donors. Two types of programs are available. First, a well-targeted, direct assistance program in the form of food vouchers or small cash transfers is in place to help vulnerable groups. It is estimated that about 170,000–180,000 people in poor households annually benefit from this program, which is co-financed by the PA, UNRWA, and NGOs. Second, public works programs, which have been intensified in recent years in response to the border closures, provide employment opportunities for unemployed workers. It is estimated that some 40,000 temporary jobs were created under this scheme in 1995 and 1996. The public works programs are predominately financed by UNRWA and other donors.

system has been strong and tax evasion appears to be limited in this area. In contrast to revenue clearances, revenue collections from domestic sources (tax and nontax) were below potential, mainly due to the lack of enforcement (notably penalties and tax courts) in the income tax area. Thus, notwithstanding recent improvements in tax administration, there is still scope for strengthening domestic revenue performance.

The gradual assumption of functions by the PA, coupled with the desire to strengthen security, and services in education and health, has resulted in a strong increase in the **recurrent expenditure** to GDP ratio to 24.1 percent in 1996, from about 10 percent of GDP in 1994. As the PA hardly intervenes in the economy and has virtually no debt, expenditures on subsidy or interest payments are negligible. Wages, however, represent a sizable portion of recurrent expenditures—51 percent in 1996—which is unusually high by international standards. The rest is made up largely of expenditures on materials and supplies which increased sharply in 1996 owing to continuing administrative start-up costs and emergency expenditures to offset the prolonged border closure, as outlined above (Table 6).

The rise in the wage bill in 1996 mostly reflects the growth of PA employment and only to a very minimal extent that of higher wages—the last general wage increase of 10–15 percent was granted in January 1995. In fact, PA remuneration continues to be lower than in the private sector—though less so than in some neighboring countries—which has hampered recruitment in some areas. In contrast, the size of government employment has continued to increase rapidly. Civilian employment rose from 34,800 in December 1995 to 39,000 in September 1996 while police employment increased from 24,000 to 33,000 in the same period. The rapid growth in PA employment since 1994 reflects several factors including the assumption of employees of the former Israeli civilian administration, the determination of the PA to provide better services to the population, difficult security conditions, and, to a lesser extent, the efforts of the PA to reduce unemployment. Police wages, at 4.8 percent of GDP in 1996, are a particularly heavy burden for the PA.

Capital expenditures, estimated at US$160 million in 1996, were somewhat less than in the previous year. While this represents a significant share of GDP (4.9 percent), it is considerably less than pledged by donors and envisaged as necessary to revive the

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Table 6. West Bank and Gaza Strip: Expenditure and Financing Operations of the Palestinian Authority, 1995–97

(In millions of U.S. dollars)

	1995 Draft Budget	1995 Est.	1996 Draft Budget	1996 Proj.	**1997 Draft Budget**
Total expenditure	587.1	682.0	902.1	995.3	...
Current expenditure	443.7	492.0	629.3	782.2	**866.0**
Wages and salaries	284.5	304.3	397.0	401.3	**495.0**
Civil service	187.9	193.8	249.7	247.6	**296.0**
Police force	96.6	110.5	147.3	153.7	**199.0**
Interest payments	--	--	2.2	3.1	**0.3**
Transfer to other governments	16.6	16.9	16.3	22.0	**25.0**
Closure emergency programs 1/	--	--	--	23.0	--
Other unbudgeted programs 2/	--	--	--	36.6	--
Other budgetary expenditure 3/	142.6	170.8	213.8	264.2	**345.7**
Other expenditure 4/	--	--	--	32.0	--
Current balance excluding foreign–financed employment programs	–227.7	–67.1	–75.0	–112.1	**–51.8**
Foreign–financed employment programs	--	--	--	53.1	--
Current balance including foreign–financed employment programs	–227.7	–67.1	–75.0	–165.2	**–51.8**
Capital expenditure	143.4	190.0	272.8	160.0	...
Of which: PMA capital	10.0	--	--	--	--
Overall balance	–371.1	–257.1	–347.8	–325.2	...
Total financing	225.4	...	272.8	...	...
Domestic financing	--	...	--	...	...
Foreign financing	225.4	325.0	272.8	266.8	...
Recurrent budget financing	92.0	135.0	--	53.7	...
Holst fund	67.1	114.3	--	29.7	...
EU	24.9	20.7	--	19.0	...
Israeli clearance advance	--	--	--	5.0	...
Employment generation programs	--	--	--	53.1	...
Holst fund	--	--	--	28.8	...
UNDP/UNRWA/PECDAR	--	--	--	24.3	...
Capital expenditure	133.4	190.0	272.8	160.0	...
Grants	133.4	144.8	208.0	...	...
Loans	--	45.2	64.8	...	...
Financing gap	145.7	...	75.0	...	**51.8**
Memorandum item:					
Settlement of arrears	7.7	17.3	14.5	...	--

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

1/ Costs of emergency programs related to the border closure including increased social assistance payments, the net cost of importing and distributing basic foodstuffs to alleviate market pressures, and budget transfers to the PA's own–financed employment–generation programs.

2/ Other unbudgeted programs include the operating costs of the Palestinian National and Legislative Councils, the operating cost of the new Gaza airport, and additional recurrent cost related to new administrative structures and functions.

3/ Other budgetary expenditure estimates include deductions from clearance revenues made to settle utility and medical products arrears accumulated by the Palestinian Authority against Israeli suppliers.

4/ These are closure–related expenditures from accounts not directly controlled by the Ministry of Finance.

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neglected physical and social infrastructure. The weak implementation performance, though worsened by teething problems on the part of the PA administration and donors, was largely a result of difficulties in the movement of goods and persons caused by the border closures. However, based on the conclusions of the Consultative Group meeting of November 19–20, 1996, efforts to accelerate the implementation of the public investment program, including through closer monitoring by the AHLC, are expected to be made in 1997.

While the PA has begun to adopt measures to trim the budget deficit, there remain **structural issues** that should be tackled if fiscal sustainability is to be achieved in the future.

- Currently, there is no single, comprehensive social insurance scheme in the WBGS. While the autonomous Gaza Pension Fund has accumulated a substantial financial reserve, there is no segregated pension fund in the West Bank. There, modest employee contributions are merged with other PA revenues and the responsibility for covering any operating deficits rests with the PA. In addition, the PA is also in the process of creating a pension fund for the police. Unless an appropriate, consolidated pension scheme is developed, and the growth of PA employment is curbed, the net fiscal outlays for pensions are expected to rise sharply in the near future, thereby exerting mounting pressure on the fiscal position. The IMF is assisting the PA to address this issue.

- Health, education, and some other services to refugees from Israel are currently provided by UNRWA. It seems likely that the provision of these services will gradually be assumed by the PA, which could put further pressure on its fiscal position.

IV. Developments in Money and Banking

A. The Banking System

The banking system has expanded sharply in the WBGS in parallel with the gradual expansion of the PA's responsibility for this area. Earlier, during the Intifada in the late 1980s and early 1990s, banking activity in the WBGS had been limited. There were only two Israeli banks (operating almost exclusively in Israeli settlements), one Jordanian bank (the Cairo-Amman Bank) and one local bank (Bank of Palestine), operating alongside a relatively efficient system of moneychangers. These banks offered a limited range of services and had very low levels of domestic lending. Banking sector activity started to increase vigorously in late-1993, with the opening of new Jordanian bank offices throughout the WBGS. Between December 1993 and February 1996, the number of non-Israeli banks increased from 4 to 15, while the number of bank offices increased from 13 to 58. The expansion in 1995 and 1996 was achieved to an important extent through the increase in the number of branches of the

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three largest banks (the Arab Bank, the Cairo-Amman Bank, and the Jordan Bank). These banks accounted for 80 percent of deposits in early 1996, while the largest locally incorporated bank, the Bank of Palestine, accounted for another 10 percent.

As the Jordanian dinar, Israeli shekel, and the U.S. dollar are the currencies used in the WBGS, the scope for monetary policy is very limited. The supervision of banks is therefore currently the primary function of the PMA. Supervision is performed largely off-site, through the examination of the balance sheets of banks, which since January 1996 have been submitted to the PMA on a monthly basis. While the supervision capability of the PMA has been improving gradually, there is still ample scope for further strengthening it, especially through the recruitment of qualified staff and systematic on-site supervision.

Reflecting the rapidly evolving political situation, responsibility for overseeing the operations of banks in the WBGS has shifted in the past decade. Before 1993, the Bank of Israel (BOI) supervised all banks, with the supervision of the Cairo-Amman Bank done jointly with the Central Bank of Jordan (CBJ). Between end-1993 and December 1995, banks in Gaza and Jericho came under the jurisdiction of the PMA, while those in the rest of the West Bank remained under the jurisdiction of the BOI. Since December 1995, the PMA has been responsible for the supervision, regulation, licensing and the setting of reserve requirements for all banks in the WBGS. While the PMA law has not yet been approved, the Governor of the PMA exercises supervisory functions under existing laws in his separate capacity as supervisor of banks. The CBJ and the BOI maintain home supervisory responsibilities over branches of Jordanian and Israeli banks, respectively.

The PMA licenses banks, and sets minimum capital requirements and reserve requirements.[9] The PMA in large part redeposits bank reserves with banks in the WBGS (with the exception of U.S. dollar reserves), thus having little effect on aggregate bank liquidity in the WBGS. Reserve ratios for JDs and NIS deposits are set at the same rate as in neighboring countries in order not to stimulate capital flow between the WBGS and those countries. PMA policies on capital adequacy, the liquidity ratio, and large exposure for a single customer and currency risk are expected to be approved in the coming months. While the PMA has already relicensed all banks in Gaza and Jericho, it is currently in the process of relicensing banks in the rest of the West Bank. A clearance and settlement system for checks and transfers denominated in JDs and U.S. dollars has been established.

Despite the strong and rapid expansion of the commercial banking sector described above, the level of development of the financial sector as a whole remains below that in other countries in the region. The range of financial institutions is still limited to

[9]The PMA has imposed a ratio of required reserves to deposits of 14 percent for deposits in Jordanian dinars (JDs), and 8 percent for those in New Israeli Shekels (NIS), while the ratio for the U.S. dollar is 10 percent. The required reserves are transferred by the banks on a monthly basis. Only the required reserves in U.S. dollars are remunerated.

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commercial banks and a few insurance companies; there are no significant markets for long-term debt, equity capital or government securities; there are few instruments and options for risk management; and the range of collateral available to banks to securitize loans is limited.

B. Monetary Developments in 1995 and 1996

Monetary developments have been characterized by the continuing redistribution of the public's assets from cash in hand to deposits and by stagnant bank lending due to political and institutional constraints. The consequent increase in net foreign assets—mainly claims by branches in the WBGS against their parent banks in Jordan—has resulted in a political dissatisfaction in the role that banks have been performing in the WBGS.

Deposits grew at an average rate of 7–8 percent per month in 1994–95 owing mainly to the transformation by the public of currency holdings into bank deposits, resulting from increased confidence following the PA's assumption of power, coupled with the widening of the geographical area covered by banks (Table 7 and Chart 5). However, the rate of deposit growth dropped sharply from an average of about 7 percent in December 1994 to December 1995 to 1 percent in February 1996 owing to the impact of the border closures, possibly reflecting an increase in the precautionary demand for cash by the public (i.e., to minimize the risk of illiquidity) in conditions where such disturbances are seen as likely to restrict the movement of depositors, as well as of bank employees and other resources needed to conduct normal operations. The rate of growth has gradually recovered to an average of about 3 percent per month since April 1996, reflecting the easing of the closures.

The composition of deposits between demand deposits and time and savings deposits has shifted markedly since end-1994, with the proportion of time and savings deposits in total deposits rising steadily from 41 percent at end-1994 to 69 percent at end-October 1996. This has reflected the increasing attractiveness of placing savings in banks as a result of the increased competition between banks, in line with the expansion of the banking system, as well as the general shift in the holdings of savings from cash to deposits.

In addition to the shift toward time and savings deposits, there has been a shift in demand toward deposits held in U.S. dollars and other hard currencies, and away from Jordanian dinars, with the proportion of deposits in U.S. dollars increasing from 30 percent at end-September 1995 to 34 percent at end-January 1996 and 42 percent at end-October[10] (Table 8). This trend reflects regional uncertainties, as well as institutional factors such as the fact that the PMA only renumerates U.S. dollar reserves and the removal of the restrictions imposed by the BOI on deposits held in U.S. dollars and other hard currencies following the transfer of jurisdiction from the BOI to the PMA toward the end of 1995.

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[10]During the same period, JD deposits declined from 46 percent of total bank deposits to 39 percent, and NIS deposits declined from 23 percent of bank deposits to 18 percent.

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Table 7. West Bank and Gaza Strip: Consolidated Accounts of the Deposit Money Banks, 1994–96 1/

(In millions of U.S. dollars, unless otherwise indicated)

	1994	1995	1996				
	Dec.	June	January	March	June	August	October
Assets	604.5	1,005.3	1,714.9	1,739.6	2,058.4	2,013.0	2,058.7
Reserves (with the PMA)	...	...	120.4	130.0	156.4	163.1	195.2
Foreign assets	...	...	1,112.0	1,038.6	1,190.0	1,287.4	1,285.9
Domestic loans and other claims	96.6	178.9	273.7	316.9	343.6	367.5	395.4
Claims on government 2/	...	...	3.1	--	--	--	--
Claims on nonfinancial public enterprises	...	...	19.9	7.8	3.1	7.5	46.4
Claims on private sector	...	...	250.7	309.1	340.5	360.0	349.0
Unclassified assets	...	...	208.8	254.1	-156.4	195.0	182.1
Fixed assets	...	...	35.4	30.2	39.0	42.2	43.6
Intrabank claims	...	...	81.6	8.8	215.8	28.7	27.7
Interbank claims	...	...	48.4	62.2	106.6	112.5	98.8
Accrued interest receivable	...	...	2.0	4.0	5.6	9.5	6.1
Other assets	...	...	41.4	148.9	1.5	2.1	6.0
Liabilities	604.5	1,005.3	1,714.9	1,739.6	2,058.4	2,013.0	2058.7
Total deposits	522.8	803.6	1,211.0	1,264.3	1,522.9	1,569.2	1563.7
Demand deposits	306.1	375.6	492.7	463.3	555.0	540.4	486.9
Time and savings deposits	216.7	428.0	718.3	801.0	967.9	1,028.8	1,076.7
Foreign liabilities	...	...	99.6	71.6	68.2	67.3	35.2
Government deposits 2/	...	...	37.9	56.0	9.6	29.6	65.7
PMA deposits	...	...	28.0	14.8	101.8	107.9	92.4
Capital accounts	...	...	87.1	99.7	108.5	101.6	137.3
Unclassified liabilities	...	...	251.3	233.2	247.4	137.4	164.5
Intrabank liabilities	...	...	84.1	10.6	165.9	19.1	17.9
Interbank liabilities	...	...	93.9	37.6	46.0	54.3	117.8
Accrued interest payable	...	...	3.8	5.0	5.1	6.5	7.8
Other liabilities	...	...	69.5	180.0	30.4	57.5	21.0
Memorandum items:							
Net foreign assets	434.7	668.2	1,012.4	967.0	1,121.8	1,220.1	1,250.7
Demand deposits as a percentage of total deposits	58.6	46.7	40.7	36.6	36.4	34.4	31.1
Rate of growth of deposits (monthly)	...	...	...	2.9	7.1	5.9	-0.4
Domestic loans as a percentage of total assets	16.0	17.8	16.0	18.2	16.7	18.3	19.2

Sources: For 1996, figures are from the PMA. For 1994 and 1995, figures were compiled by the Palestinian Economic Policy Research Institute (MAS).

1/ Data for end–December 1995 are not available

2/ Data from the Bank of Palestine may be incomplete.

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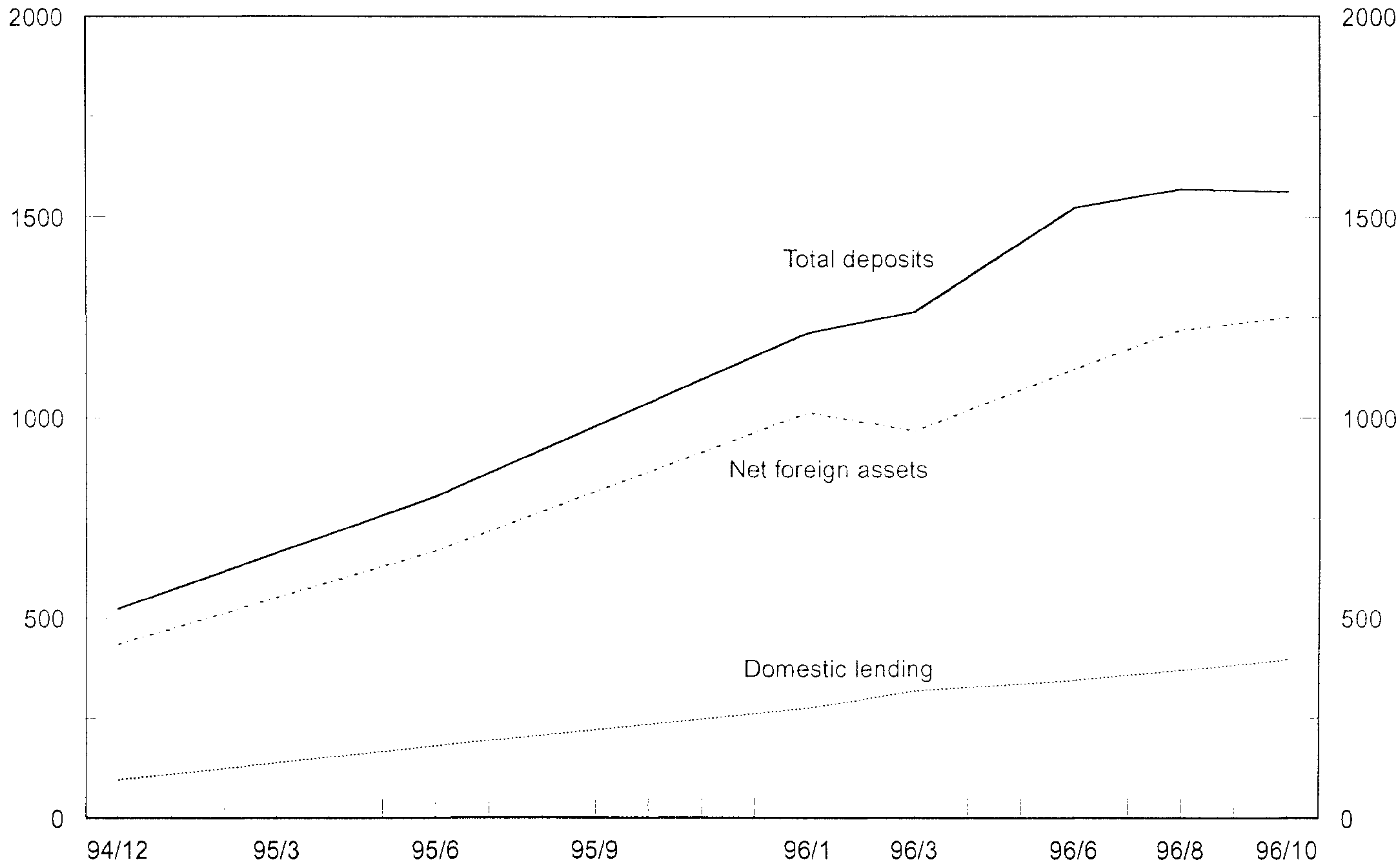
Chart 5

West Bank and Gaza Strip: Monetary Indicators, December 1994-October 1996

(In millions of U.S. dollars)



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

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Table 8. West Bank and Gaza Strip: Composition of Deposits by Currency, 1995–96

	1995	1996				
	September	January	March	June	August	October
			(In percent of total deposits)			
Total deposits	100.0	100.0	100.0	100.0	100.0	100.0
In NIS	22.8	19.9	18.7	19.8	19.5	18.0
In JDs	46.2	44.5	44.8	40.8	38.9	39.1
In U.S. dollars	30.4	34.3	35.4	37.3	40.3	41.8
In other currency	0.7	1.3	1.1	2.0	1.4	1.2
			(In millions of U.S. dollars)			
Total deposits	1,012.5	1,211.0	1,264.4	1,522.7	1,569.2	1,564.3
In NIS	230.9	241.3	236.7	301.9	305.4	281.7
In JDs	467.3	539.0	566.0	621.9	610.2	611.0
In U.S. dollars	307.4	415.0	447.9	568.2	632.1	653.2
In other currency	7.0	15.7	13.8	30.7	21.5	18.3

Source: Palestinian Monetary Authority.

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Domestic private lending has continued, since end-1994, to represent only a small part of total assets, with the loan-asset ratio stagnating in the 16–19 percent range.[11] This low ratio is a reflection of the depressed local demand for capital by investors and the high risks of lending in the WBGS associated largely with the absence of a stable economic environment and political setting, as well as some institutional weaknesses. The latter include the absence of developed credit information and asset registration systems, which confines the collateral base for securitizing loans to land and personal guarantors, as well as the absence of a strong and stable legal framework. The authorities are working with the World Bank to develop a legal framework that would facilitate the pledging of assets as collateral.

Reflecting the constraints to domestic lending outlined above, banks have kept their assets largely outside the WBGS (primarily in Jordan), with the share of foreign assets in total assets remaining broadly in the 60–65 percent range. Holdings of foreign assets fell as a result of the closure in February-March but resumed their steady rise thereafter.

V. External Developments

Because of the severe limitations of the available data that are discussed in Appendix I, only the broadest conclusions can be made about the structure and the recent evolution of the WBGS balance of payments. In 1995–96, the balance of payments was characterized by the following.

(i) Large trade deficits, averaging US$1.2 billion (or 38 percent of GDP) annually, were recorded, incurred largely in trade with Israel as a result of the existing trade arrangements (see below)(Table 9). Exports, estimated at under US$0.4 billion in 1996, were mainly related to subcontracting in labor-intensive sectors such as shoes and clothing, and a few agricultural goods;

(ii) Labor income from the employment of Palestinians in Israel, averaging almost 8 percent of GDP annually (compared with an annual average of 29 percent of GDP in 1992–93), partly financed the trade deficits;

(iii) Substantial donor assistance, accounting for average annual inflows of 17 percent of GDP, also financed a substantial part of the trade deficits (see Box 6); and

(iv) The goods and services deficit, as well as a build-up of net foreign assets equivalent to 14 percent of GDP annually in 1995–96, was financed mainly by private capital inflows and/or unrequited transfers (an average of 33 percent of GDP annually).

[11]Complete data on lending to and borrowing from the government are not available.

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Table 9. West Bank and Gaza Strip: Balance of Payments, 1992–97

(In millions of U.S. dollars)

	1992	1993	1994	Est. 1995	Est. 1996	Proj. 1997
Current account	–149	–240	–152	–574	–708	–746
Current account, excluding grants	–373	–522	–530	–1,171	–1,112	–1,079
Goods and services	–384	–536	–545	–1,187	–1,129	–1,096
Exports of goods and services	1,295	831	712	735	631	799
Imports of goods and services	1,679	1,367	1,256	1,923	1,760	1896
Trade balance	–933	–902	–798	–1,287	–1,179	–1,252
Exports, f.o.b.	299	236	227	373	316	366
Of which: Israel	249	178	204	345	278	--
Imports, c.i.f.	1,232	1,138	1,024	1,660	1,495	1618
Public sector	--	--	85	241	187	252
Private sector	1,232	1,138	939	1,419	1308	1366
Of which: Israel	1,106	990	920	1,521	1,350	--
Services (net)	549	366	253	100	50	156
Remittances (net)	898	552	386	248	204	321
Receipts	930	586	400	262	218	329
Payments	32	34	14	14	14	8
Public investment income (net)	--	--	--	--	–1	–3
Receipts	--	--	--	--	--	--
Payments	--	--	--	--	1	3
Nonfactor services (net)	–349	–186	–133	–148	–153	–163
Receipts	66	9	85	100	97	104
Payments	415	195	218	248	250	267
Unrequited transfers	235	296	393	613	421	351
Public	224	282	378	597	404	333
UNRWA	163	169	111	103	100	70
Israel	61	113	43	22	--	--
EAP grants	--	--	224	471	304	263
Private	11	14	15	17	17	18
Capital account	149	240	152	1,149	1,018	1308
Public sector	...	...	16	15	57	95
Loans	...	...	16	15	82	102
Amortization	...	...	--	--	25	8
Other (incl. net errors and omissions)	149	240	136	1134	961	1213
Overall balance	...	...	...	575	310	562
Financing (commercial banks (net))	...	...	...	–575	–310	–562
Memorandum items:						
GDP in U.S. dollars	2,686	2,557	3,077	3,222	3,234	3,546
External outstanding debt	--	--	16	31	88	182
As percent of GDP	--	--	1	1	3	5

Sources: Israeli Central Bureau of Statistics; Ministry of Planning and International Cooperation; Palestinian Monetary Authority; and IMF staff estimates.

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This amount includes a portfolio shift out of currency and into bank deposits on the part of the population as well as other capital and transfer inflows from Palestinians working in the diaspora, but nevertheless cannot be fully explained.[12]

After the steady decline in both commodity exports and imports in 1993–94, both are estimated to have increased in 1995.[13] The trade deficit in 1995 was almost US$1.3 billion. At the same time, the surplus in the services account narrowed sharply, reflecting primarily the decline in workers' remittances. The number of Palestinian workers in Israel is estimated to have declined by about 39 percent to a little over 32,000 workers. As a result, the deficit in the goods and services account peaked at 37 percent of GDP. This deficit was financed by the sharp increase in unexplained private capital inflows and/or unrequited transfers as well as public external assistance.

The border closures and the weakening of economic activity in 1996 resulted in the narrowing of the deficit in the goods and services account of the WBGS. In particular, exports declined by about 15 percent and imports by about 10 percent. Given, however, the very low base of exports compared with imports, the deficit in the trade balance declined in 1996 to less than US$1.2 billion, or about 37 percent of GDP, from 40 percent of GDP in 1995. On the other hand, the surplus in the services account, reflecting the impact of border closures on worker remittances, fell by almost two percentage points of GDP. However, the recurrent deficit was financed by private capital inflows and/or private unrequited transfers that are expected to remain high, although about US$170 million less than in 1995.

VI. Trade Policy

The economic agreements between Israel and the PLO in 1993–95, culminating in the Interim Agreement, largely regularized the existing trade regime of the WBGS. The WBGS is, de facto, in a customs union with Israel, with the above-mentioned Agreement delineating the parameters within which the WBGS may conduct its trade relations with the outside world. Even if the PA were to exercise fully the flexibility that it is allowed in the Interim Agreement for some of its traded goods, the trade regime would still remain basically a customs union, mainly because of the low Israeli tariffs which to some extent set the upper limit to the WBGS' tariffs.

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[12]In the first round, a shift from cash to deposits (a transaction between residents) would manifest itself as positive net errors and omissions with a corresponding entry increase in commercial banks' NFA position. It would finance a current account deficit only when the banks, in the second round, sell this foreign exchange to importers.

[13]There was a significant increase in trade activity in 1995. The recorded absolute increases shown in Table 9 are exaggerated, however, due to the change in the method of estimating exports and imports. See Appendix I for further details.

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Box 6. Development Assistance

Donors consider the achievement of economic and social progress in the WBGS as an essential element of the peace process. They have therefore supported the upgrading of public infrastructure, the enhancement of the human resource base, the relief of social hardship, and paving the way for sustained private sector-led growth in the medium term in support of this agenda. Since the signing of the Declaration of Principles in September 1993, donors have pledged for the period 1994–98 a total of almost US$3.0 billion in assistance to the WBGS. These funds are in addition to any assistance that donors have traditionally allocated to the WBGS through NGOs, the UN system, and other channels. Of these pledges, about 78 percent (US$2.3 billion) has been committed to particular activities in the areas of investment, technical assistance, and transitional support (which includes start-up and recurrent expenditures as well as employment generation activities), with the bulk in the form of grants (see Table 10 and Figure 1). Of this amount, the largest part has been committed for investment projects. By November 1996, 34 donors had disbursed US$1.3 billion to implementing agencies and field offices, with the top five donors—the United States, Japan, the European Union (EU), Norway, and Saudi Arabia—accounting for 58 percent of the total outstanding disbursements. Disbursements for investment projects were 45 percent of such commitments, while disbursements relating to transitional activities were 85 percent of commitments. It must be noted, moreover, that actual disbursements on the ground level were significantly less (especially for investment projects) than these amounts which reflect donor disbursements to implementing agencies.

The relatively slow pace of foreign-financed project implementation is attributed to the following key factors: (i) donors' procedures, which have not adapted to the unique circumstances of the WBGS, particularly relating to flexibility in reallocating funds and coordinating with other donors; (ii) official Palestinian institutions concerned with coordinating and facilitating the flow of donor assistance, which have only recently enhanced their effectiveness; and (iii) shortages in material and impediments to the movement of local and international personnel involved in project implementation caused by the border closures. While in 1994–95, factors (i) and (ii) were the most important constraints to project implementation, in 1996, factor (iii) gained importance.

At the Ministerial Conference on Economic Assistance to the Palestinian People on January 9, 1996, about US$840 million was pledged to WBGS, with the bulk of the pledges for the public investment program over the period 1996–98, including a core investment program of US$550 million that had been endorsed by donors at the October 1995 Consultative Group (CG) meeting for the WBGS. The 1996 core investment program encompassed top priority investment projects in physical and social infrastructure, projects in support of private sector development, and projects in support of institutional development. As the subsequent November 1996 CG meeting for the WBGS, donors' pledges exceeded the US$845 million requested by the Palestinians for their 1997 investment program. The latter included new priority projects as well as projects from the 1996 core investment program that remained unfunded or under funded. The general focus of the 1997 public investment program remained the same as in 1996—namely, projects geared for the development of infrastructure, social sectors, private sector, and public sector institutions.

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Table 10. West Bank and Gaza Strip: Development Assistance, 1994–96

(In millions of U.S. dollars)

	1994			1995			1996			**1994–1996**		
	Pledges	Commitments	Disbursements	Pledges	Commitments	Disbursements	Pledges	Commitments	Disbursements	Pledges	**Commitments**	**Disbursements**
Total	819	786	480	744	608	454	927	932	414	2,490	**2,326**	**1,348**
Investment		447	211		365	237		609	190		**1,421**	**639**
Technical assistance		91	71		51	46		137	59		**279**	**177**
Transitional support		248	197		192	171		185	165		**626**	**533**

Source: Matrix of Donors' Assistance, November 1996.

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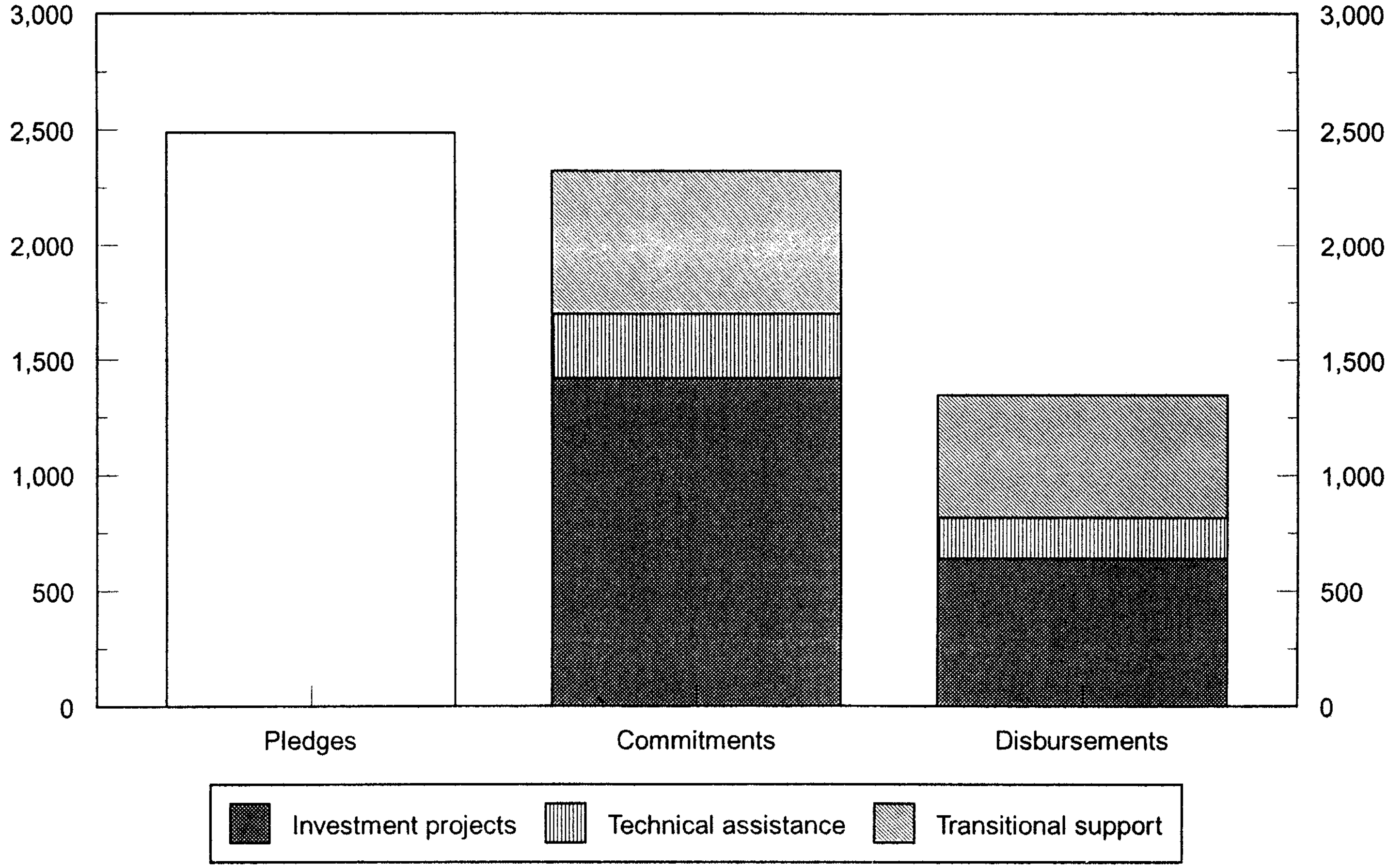
Figure 1

West Bank and Gaza Strip: Development Assistance, 1994-96

(In millions of U.S. dollars)



Source: Secretariat of the Ad Hoc Liason Committee's "Matrix of Donors' Assistance to the West Bank and Gaza," dated November 1996.

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The Interim Agreement with Israel sets the parameters for the trade system that will be in effect in the WBGS until agreement on the permanent status of the WBGS is reached at the latest by May 1999. Under its terms, the PA has free access to external markets without restrictions, on the basis of certificates of origin issued by itself. Moreover, the existing agreements allow the WBGS and Israel to form, with respect to certain traded goods, a free trade area, in which the WBGS' freedom to set customs duties and other trade measures with third countries is clearly delineated.[14] Thus the PA is allowed to determine its own import and customs policy and procedures for certain categories of imports. These include import policies (such as rates for customs duties, purchase tax, levies, excises, etc., and licensing requirements) for certain locally produced goods (List A1 items) from Jordan, Egypt, and other Arab trading partners and for certain basic foodstuffs (List A2 items) from other countries; the quantities of such imports, however, have to be in accordance with the market need as agreed by Israeli and Palestinian authorities.[15] In addition, the PA may set its own customs and other duties on imports (List B items) for its development program. List B imports include specified tools and equipment for the purposes of earth works, stone works, wood works, construction, textile industry, commercial refrigeration, and farming, as well as certain electrical equipment, conveyance equipment, and pharmaceutical products. The PA is also given authority to determine its own rates of customs and purchase tax on imports of motor vehicles and petroleum products. For all other goods, the Israeli import duty rates have to be the minimum basis for the PA and the Israeli import system (such as licensing and standard requirements) has to be utilized. So far, the PA has not implemented any of these prerogatives relating to setting customs and other rates in the Interim Agreement and, in fact, has implemented, with the exception of passenger imports and Jordanian-origin imports, the Israeli trade regime.[16]

Consequently, the trade regime of the WBGS is at present essentially the same as that of Israel. The latter has more than 85 different ad valorem, specific, combined and alternative tariff rates, with import duties ranging from zero percent to 100 percent, with

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[14]The exception to a de facto customs union or a de facto free trade area is the provision in the Interim Agreement which allows temporary quotas on six agricultural commodities that are to be traded between WBGS and Israel; these quotas are to be gradually removed by 1998. The quotaed items are poultry, eggs, potatoes, cucumbers, and tomatoes, which are exported from WBGS, and, melon, which is exported from Israel.

[15]Since the signing of the Interim Agreement, the quantities of items in Lists A1 and A2 have been increased significantly through agreements with Israel.

[16]The exception relating to passenger imports (i.e., imports brought into WBGS by individual travelers) is a tariff structure that was introduced at the beginning of 1995 for 76 categories of passenger imports. These imports are subject to ad valorem tariff rates ranging from 17 percent to 327 percent and some of these imports (38 categories) are subject to an additional specific rate. Regarding imports from Jordan, tariffs have been set at zero under the trade agreement with Jordan.

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an average of about 8 percent.[17] Duty-free treatment is afforded to about 40 percent of tariff positions. In general Israeli tariff rates on processed items are higher (average of about 10 percent) than those levied on semi-processed items (7 percent average), which in turn are higher than those levied on raw materials (about 2 percent). Israel is unilaterally committed to reducing its tariffs on imports from countries with which it does not have free trade agreements.[18] Import licensing and quotas exist for a limited number of products. No duties, taxes or charges are imposed on exports. However, as in other economies, exports may be restricted for a number of reasons, such as for control of quality and standard of goods, compliance with international agreements, and the conservation of local resources. Most products do not require export licenses, although for some commodities (such as food products and fresh agricultural products) export licensing is retained for sanitary and quality control.

As indicated above, Israel has free trade agreements with the United States, the EU, and EFTA. At the end of 1995, the United States finalized an agreement to extend free trade status to the WBGS and efforts are under way to conclude a Euro-Mediterranean Association Agreement with the WBGS.

In conclusion, the envisaged trade regime for the WBGS under the Interim Agreement on the one hand allows the exports of the WBGS free access to the large Israeli market, allows the WBGS to derive the benefits of a relatively liberal trade regime (compared with the trade regimes of neighboring countries) and, to some extent, allows the WBGS to benefit from the existing free trade arrangements of Israel. On the other hand, it forces the WBGS to adopt a trade regime that might not be best suited for its economic circumstances (resource endowments) and development strategy, and may be binding the WBGS to the pace of trade liberalization under way in Israel.

VII. IMF Technical Assistance

The IMF has an exceptionally large program of technical assistance to the PA which involves several IMF departments.

Technical assistance from the **Fiscal Affairs Department** (FAD) to the PA, including the provision for long-term experts, is geared to help the PA in establishing a modern revenue administration and an efficient public expenditure management system.

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[17]Excludes preferential tariff rates under free-trade arrangements.

[18]Most Israeli products from the United States, the EU, and the European Free Trade Area (EFTA) benefit from preferential duty-free status.

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FAD missions have advised the PA on a wide range of issues, including the organization and setting up of tax departments and the coordination of tax issues with the Israeli authorities. In this connection, a resident advisor on tax administration was assigned to the Ministry of Finance since August 1995 and another expert was appointed in January 1997 to assist in computerizing the revenue administration.

On public expenditure management, FAD has recommended steps to improve budget execution and expenditure management, enhance expenditure control and audit, and strengthen cash management. FAD has, recently, also assisted in the implementation of a government financial management information system (GFMIS). In this regard, an expert has been assigned to the Ministry of Finance since June 1996. Furthermore, a budget advisor commenced work in early November. A mission to review the pension system and make recommendations for reform took place in November.

Building on the technical assistance work of FAD, and in response to donors' requests, the **Middle Eastern Department** (MED) has been assisting the PA with reporting on revenue and expenditure developments and progress in institution building in the fiscal area, in the context of the Ad-Hoc Liaison Committee and the Consultative Group meetings, and with budget formulation in the context of a medium-term macroeconomic framework.

The **Monetary and Exchange Affairs Department** (MAE) has been assisting the PMA on (i) organization and management issues associated with the establishment of the PMA; (ii) bank licensing and supervision; (iii) the clearing and payments system; (iv) foreign exchange management; and (v) the drafting of appropriate banking legislation. The MAE is currently providing technical assistance through periodic missions and through two resident experts in the areas of bank supervision and information technology.

The **Legal Department** (LEG), in coordination with MAE, has assisted the PA in the preparation of a draft law for the PMA, which defines its basic purposes and goals, and in the preparation of the draft banking law. The **Statistics Department** (STA) has been assisting the PA in the area of monetary statistics, and will be providing assistance in the areas of balance of payments statistics and national income accounts. The **IMF Institute** (INS) has been offering training courses to Palestinian officials, both at headquarters and in the field.

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Economic Statistics in the West Bank and Gaza Strip

The PA has been building—with the assistance of donors—an infrastructure to provide prompt and reliable economic statistics. As outlined by the Master Plan for Palestine Official Statistics of the Palestine Bureau of Statistics (PBS), many institutions have had to be established from scratch, and initial surveys have had to be conducted to provide a secure base of source data for some sectors. Below is a status report on progress in developing macroeconomic statistics and how the major aggregates are currently derived.

Production, Prices, and Employment

In late 1994, responsibility for the collection of data on national income accounts and on the Consumer Price Index (CPI) was transferred from the Israeli Central Bureau of Statistics (ICBS) to the Palestinian Central Bureau of Statistics (PCBS) and the Ministry of Planning's Department of Central Statistics (DCS). Although work on producing comprehensive national income accounts is proceeding at the PCBS, data are not available for 1995 and 1996. The estimates presented earlier in this report therefore rely on sectoral employment data to estimate real GDP growth for those two years (see Appendix Table 14). In the absence of large increases in the aggregate capital stock since 1993, and assuming a standard constant returns to scale production function, the rate of growth of output in 1995 and 1996 was approximated by the product of the rate of growth of labor in particular sectors in those years and the elasticity of output with respect to labor in 1993–94.

As regards expenditures, public investment and consumption, and imports and exports of goods and nonfactor services were obtained from the budget and balance of payments estimates, respectively, as discussed below. Changes in private investment are estimated on the basis of changes in private imports of construction materials and capital goods. With GDP on the production side estimated using the method described above, private consumption was then obtained as a residual.

As regards the CPI, the PCBS has been collecting CPI data for the WBGS since November 1995. For the period January-November 1995, CPI data are available only for the Gaza Strip (from the DCS). For 1995, the CPI data for the WBGS were estimated on the basis of the CPI data for the Gaza Strip, with changes in the CPI in the West Bank taken as approximately equal to those in the Gaza Strip.

Fiscal Data

The Ministry of Finance regularly provides, with a lag of 6–8 weeks, fiscal data on the PA's monthly budgetary operations to the staff. The overall coverage is uneven. On the revenue side, the coverage is good with fairly comprehensive monthly domestic revenue data conveyed in a timely manner. These are supplemented by the monthly revenue clearance data,

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provided by the Israeli authorities, also on a timely basis. On the expenditure side, however, only a skeletal breakdown of monthly expenditures is available and data on expenditures from accounts not under the control of the Ministry of Finance are not available. Capital expenditures are also not provided and are estimated on the basis of reports of donors. In addition, no information on budgetary domestic financing is usually provided.

Banking Statistics

Since early 1994 and prior to January 1996, selected balance sheet items were collected by the Palestine Economic Policy Research Institute. Starting in January 1996, the PMA has been receiving on a monthly basis the balance sheets of the non-Israeli commercial banks in the WBGS, which are then consolidated by PMA and IMF staff. Monetary data are generally satisfactory, though one significant shortcoming is the incompleteness of the data covering claims on government and government deposits of the Bank of Palestine. The balance sheet of the PMA has also become available recently.

Balance of Payments

As presently compiled, the balance of payments estimates for the WBGS are based on limited data and are heavily dependent on past data relations and/or assumptions. Moreover, information on balance of payments developments appears to be deteriorating steadily because the Israeli authorities, who used to assemble complete balance of payments estimates for WBGS, are at present confining gathering data on the WBGS only to very aggregate data needed for the Israeli balance of payments,[19] while the PA is presently collecting only trade data for the Gaza Strip. Under these circumstances, considerable care is required in making balance of payments assessments for the WBGS, which is underlined by some recent changes in estimating some aggregates, as noted below. Individual balance of payments categories are estimated as follows:

(i) **Exports.** For the Gaza Strip, the DCS of the Ministry of Planning and International Cooperation (MOPIC) assembles export and import data on a quarterly basis (exports to Israel, the West Bank, and other countries are published separately). For the West Bank, there are no Palestinian sources of data, so that the ICBS aggregated data on Israeli imports from the WBGS has to be the basis of the estimates.[20] In late 1996, the ICBS revised upward its series on imports from the WBGS on the basis of VAT claims on

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[19]The ICBS compiled full balance of payments estimates for the Gaza Area and Judea and Samaria (West Bank) until 1987. (For further details, see the ICBS publication, *National Accounts of Judea, Samaria and the Gaza Area, 1968–1993.*) After 1987, the coverage of balance of payments for WBGS steadily deteriorated. In the early 1990s, coverage was confined to current account transactions.

[20]Recently, ICBS has been providing the data only in aggregate form, without a breakdown of trade into West Bank and the Gaza Strip.

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the WBGS.[21] Using information on the West Bank's exports to Israel and the ICBS' past data on West Bank's trade with the rest of the world, estimates of total exports of the West Bank are derived.[22]

(ii) **Imports.** For the Gaza Strip, as indicated above, the Palestinian DCS is compiling quarterly data.[23] The situation for imports of West Bank is the same as described above for exports, including the utilization by ICBS of the WBGS' VAT claims on Israel for estimating imports of the WBGS from Israel. The Israeli ICBS is the only source of data for the West Bank and this data is only for the West Bank's imports from Israel. Estimates for total imports of the WBGS are made as described above for exports, but also taking into account possible imports related to the public investment program.

(iii) **Remittances.** The ICBS is the only source of information for gross receipts and payments relating to remittances. Beginning in 1994, ICBS stopped compiling data for the WBGS on the respective regions' gross service transactions with the rest of the world; the ICBS' current estimates are confined only to Israel's service transactions with the WBGS. This data, on occasion, is broken down into wages and other services. In estimating the WBGS' remittances, the current and past data provided by the ICBS on this series, as well as data provided by both Israeli and Palestinian sources on the number of Palestinians working in Israel, are used.[24]

(iv) **Nonfactor services.** Estimates for these items are made taking into account the relation of the WBGS' nonfactor service receipts from and payments to Israel to past data on the WBGS' nonfactor transactions with the rest of the world.[25]

(v) **Unrequited transfers and capital transactions.** The information on public unrequited transfers relating to UNRWA and Emergency Assistance Program (EAP) and capital account public loan transactions (see Table 9) are derived to a large extent from the

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[21]This method of estimating imports was applied to 1995 and 1996 data.
[22]The ICBS compiled data on the West Bank's exports to the rest of the world, as well as to Israel, through 1994. For the Gaza Strip, the series on total exports to the rest of the world was discontinued in 1994. The same compilation procedures were affected by the ICBS with respect to the WBGS' imports.
[23]This data excludes on occasion certain imports such as vehicles; adjustments are made by the Fund staff from other sources of information (for example, vehicle registrations).
[24]The ICBS collects data on the number of West Bank workers employed in Israel. Collection of similar data for the Gaza Strip was discontinued in 1994. However, DCS does collect data on the number of Palestinian workers from the Gaza Strip in Israel.
[25]As indicated above, through 1993, ICBS compiled the WBGS' service transactions with the rest of the world.

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Matrix of Donors' Assistance put together by the Secretariat of the AHLC.[26] The matrix incorporates information provided by the WBGS' donors to the World Bank and presents information on donors' pledges, commitments, and disbursements (to implementing agencies) for various types of activities, i.e., investment, technical assistance, and transitional support activities. The only information on private unrequited transfers is that provided until 1993 by the ICBS on transfers through nongovernmental organizations.

(vi) **Net foreign assets of commercial banks.** Estimates for the commercial banks' net foreign assets are derived from information provided by the PMA.

As can be discerned from the above description of balance of payments items for which some data are available, there is almost no information on private unrequited transfers and private capital transactions. Similarly, no information is available on net private investment income; estimates of public interest payments are imputed from information provided by donors on loan disbursements. The balance of payments estimates for the WBGS are closed by assuming that the bulk of net errors and omissions are the result of private capital inflows and unrequited transfers.

[26]ICBS provided information on transfers relating to UNRWA through 1993. EAP refers to external financial under the World Bank Emergency Assistance Program that was initiated in 1993. The World Bank has assembled the Matrix of Donors' Assistance with the objective of having the PA assume this responsibility in time. Indeed, MOPIC has recently assumed full responsibility for compiling this information on external financing.

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ROLE OF THE WORLD BANK

The World Bank has been deeply involved in the WBGS in recent years, and is currently a primary donor of funds, with disbursements of about one-fourth of total donor assistance since the signing of the Oslo agreements in 1993. The Bank's current activities fall in three categories: (i) technical and advisory services and trust fund administration, in which the Bank administers the transfer of donor contributions to the WBGS; (ii) the financing of investment projects; and (iii) the coordination of donor activities.

In the first area, the Bank's main activities are the administration of the Johan Jorgen Holst Peace Fund and the Technical Assistance Trust Fund (TATF) on behalf of donors. The Holst Fund has been an important instrument for channeling donor support to the PA's recurrent budget and start-up activities. More recently, it has also served as a key funding instrument for employment generation activities designed to partially compensate for the adverse effects of border closures. Twenty-five donor countries have, by the beginning of December 1996, pledged a total of about US$260 million to the Holst Fund, of which about US$227 million has been paid; of the latter amount, about US$217 million has been disbursed. The TATF is funded by twelve donors and supports such activities as economic and sector policy studies, advisory services, and project preparation work. Donors have pledged a total of US$23 million to the Fund, virtually all of which has been committed to specific works.

The Bank's second area of activity is the financing of investment projects through the Trust Fund for Gaza and the West Bank (TFGWB). A part of IBRD profits are transferred to the TFGWB, then lent to the PA for project financing on standard International Development Association (IDA) terms. The Bank has already provided US$140 million to the fund, of which US$140 million has been committed to the following six investment projects: (i) the Emergency Rehabilitation Project (ERP), whose primary aim is to rehabilitate roads, water and wastewater infrastructure, and schools; (ii) the Education and Health Rehabilitation Project, which is designed to rehabilitate school and health facilities; (iii) the Second Emergency Rehabilitation Project, which in addition to the objectives of the first ERP, seeks to accommodate small-scale labor-intensive works; (iv) the Municipal Infrastructure Development Project which aims to rehabilitate community infrastructure in selected municipalities; (v) the Gaza Water and Sanitation Services Project which establishes private sector management of water and waste under services; and (vi) the Microenterprise Project which initiates a program to finance microenterprises through the banking system.

As regards donor coordination, the World Bank chairs the Consultative Group (CG) meetings and acts as Secretariat of the AHLC. In the latter capacity, it has responsibility for tracking donor pledges, commitments, and disbursements to the PA; it produces regular editions of the "Matrix of Donors' Assistance to the West Bank and Gaza."

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Over the next two years, Bank assistance will continue to focus on the improvement of basic infrastructure and social services, and to help in the creation of an environment conducive to private sector development. The following key projects, which are under various stages of preparation, are included in the Bank's program: (i) a Community Employment Project; (ii) a Nongovernmental Organizations Project; (iii) a Housing and Housing Finance Project; (iv) an Industrial Estate Development Project; (v) an Electricity Distribution and Management Project; (vi) an Investment Guarantee Fund (with MIGA); (vii) a Palestinian Expatriate Professional Program; (viii) a Legal Development Project; and (ix) an Agriculture Sector Project. In addition, preparatory work has begun on a financial sector development project, whose aim is to help in the development of the institutional and regulatory framework for more efficient financial intermediation.

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Table 11. West Bank and Gaza Strip: Population and Labor, 1993–96

(In thousands, unless otherwise indicated)

	1993	1994	Est. 1995	Est. 1996
Population	2,271	2,361	2,454	2,554
Labor force	487	507	527	548
Employment	399	382	374	361
In Israel	83	53	32	25
In the West Bank and Gaza Strip	316	329	342	336
Unemployment rate (in percent)	18	25	29	34

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

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Table 12. West Bank and Gaza Strip: National Income Accounts, 1993–96

(In millions of NIS at current prices)

	1993	1994	Est. 1995	Est. 1996
GDP 1/	7,237	9,264	9,702	10,285
Resource gap	–3,079	–2,802	–4,321	–4,235
Imports of goods and nonfactor services	3,773	3,740	5,746	5,548
Exports of goods and nonfactor services	693	938	1,425	1,312
Gross domestic expenditure	10,316	12,066	14,023	14,520
Consumption	8,550	10,222	12,231	12,607
Private	7,778	9,324	10,551	10,248
Government	773	898	1,681	2,359
Gross fixed investment	1,874	1,844	1,792	1,913
Private	1,497	1,587	1,129	1,064
Government	377	257	662	850
Net factor income	1,562	1,162	745	649
Remittances	1,562	1,162	747	649
Receipts	1,658	1,204	789	694
Payments	96	42	42	45
Net investment income	– –	–1	–2	– –
Receipts	– –	– –	– –	– –
Payments	– –	1	2	– –
	– –	– –		
GNP	8,799	10,426	10,447	10,934
Gross domestic savings	–1,313	–958	–2,529	–2,322
Government	64	–89	–67	–112
Private	–1,377	–869	–2,462	–2,210
Gross national savings	249	204	–1,784	–1,673
		(As a percent of GDP)		
GDP	100.0	100.0	100.0	100.0
Resource gap	–42.6	–30.3	–44.5	–41.2
Imports of goods and nonfactor services	52.1	40.4	59.2	53.9
Exports of goods and nonfactor services	9.6	10.1	14.7	12.8
Gross domestic expenditure	142.6	130.3	144.5	141.2
Consumption	118.2	110.3	126.1	122.6
Private	107.5	100.7	108.8	99.6
Government	10.7	9.7	17.3	22.9
Gross fixed investment	25.9	19.9	18.5	18.6
Private	20.7	17.1	11.6	10.3
Government	5.2	2.8	6.8	8.3
Net factor income	21.6	12.5	7.7	6.3
Remittances	21.6	12.6	7.7	6.3
Receipts	22.9	13.0	8.1	6.7
Payments	1.3	0.5	0.4	0.4
Net investment income	– –	– –	– –	– –
Receipts	– –	– –	– –	– –
Payments	– –	– –	– –	– –
GNP	121.6	112.5	107.7	106.3
Gross domestic savings	–18.2	–10.3	–26.1	–22.6
Government	5.2	2.8	6.8	8.3
Private	–23.4	–13.1	–32.9	–30.8
Gross national savings	3.4	2.2	–18.4	–16.3

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

1/ Figures for exports and imports, and thus for GDP, in 1995 and 1996 are not comparable to those for earlier periods, because of a break in the series for exports and imports starting in 1995 (see Section V).

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Table 13. West Bank and Gaza Strip: National Income Accounts, 1993–96

(In millions of U.S. dollars)

	1993	1994	Est. 1995	Est. 1996
GDP 1/	2,557	3,077	3,222	3,233
Resource gap	–1,088	–931	–1,435	–1,332
Imports of goods and nonfactor services	1,333	1,242	1,908	1,745
Exports of goods and nonfactor services	245	312	473	413
Gross domestic expenditure	3,645	4,007	4,657	4,565
Consumption	3,021	3,395	4,062	3,964
Private	2,748	3,097	3,504	3,222
Government	273	298	558	741
Gross fixed investment	662	613	595	601
Private	529	527	375	334
Government	133	86	220	267
Net factor income	552	386	248	204
Remittances	552	386	248	204
Receipts	586	400	262	218
Payments	34	14	14	14
Net investment income	--	--	–1	--
Receipts	--	--	--	--
Payments	--	--	1	--
GNP	3,109	3,463	3,469	3,438

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

1/ Figures for exports and imports, and thus for GDP, in 1995 and 1996 are not comparable to those for earlier periods, because of a break in the series for exports and imports starting in 1995 (see Section V).

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Table 14. West Bank and Gaza Strip: Sectoral Distribution of Employment in 1996

(As a percent of total employed)

	West Bank	Gaza Strip	Total
Agriculture and fisheries	19	11	17
Mining, quarrying, and industry	18	16	17
Construction	13	9	12
Commerce	19	18	19
Transportation	5	4	5
Services and other	26	43	30

Source: Palestinian Central Bureau of Statistics.

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