

# Managing Headwinds

By Ragnar Gudmundsson



This last year has been a very challenging period for the Palestinian Authority (PA), with conflict in Gaza and political tensions that started in the second half of 2014 complicating economic management. The West Bank and Gaza economies contracted for the first time since 2006, with GDP for Gaza dropping by 15 percent. Unemployment in Gaza spiked to 47 percent in the third quarter of 2014 before receding slightly to 43 percent. These statistics point to a sharp rise in the hardships faced by the people of Gaza, who were already facing dire conditions. Growth in the West Bank reached 5 percent, driven by strong credit growth and a pickup in exports, domestic consumption, and public investment in the first half of the year. Unemployment reached 17 percent for the West Bank, and 27 percent for the West Bank and Gaza combined.

Despite this difficult context, the PA managed to steer through the crisis and preserve macroeconomic stability. The recurrent fiscal deficit continued declining, from 11.1 percent of the GDP in 2013 to 9.9 percent of the GDP in 2014, supported by strong revenue performance and efforts to contain expenditures and limit the accumulation of new arrears.<sup>1</sup> Moreover, the health of the financial system was preserved, supported by enhanced supervision by the Palestinian Monetary Authority (PMA), good crisis preparedness measures, and strong capitalization of banks.

For 2015, we project a small rebound in Gaza, provided the reconstruction process gains momentum, with GDP growth reaching 7 percent. We estimate that, following a weak first quarter, with reduced consumption and low investor confidence as a result of withheld

Photo by Mohamad Zarandah.

clearance revenue, growth for the year will remain subdued, at about 1 percent in the West Bank, and 2.5 percent for the West Bank and Gaza combined. This growth rate is negative in per capita terms, and is insufficient for adequate job creation. Inflation is projected to remain under control in 2015, at about 2 percent.

The report points to significant challenges and short-term risks on the fiscal front in particular. During the first four months of 2015, Israel withheld clearance revenue—which accounts for two-thirds of total revenue—creating a fiscal crisis that led to the adoption of an emergency budget and cash rationing measures. Looking forward, the predictability of revenue is key to preserving economic stability and sound fiscal management. Another potential risk highlighted by the report is that, to finance its budget and maintain debt sustainability, the PA remains highly dependent on donor support, which accounts for almost a third of total spending.

Moving towards fiscal sustainability and reducing dependence on aid will require continued efforts to broaden the tax base, improve revenue collection, strengthen budget preparation and execution, and shift the composition of expenditures in the social sectors

Looking forward, it is clear that sustainable economic development in the West Bank and Gaza is tied to a sustainable political solution.



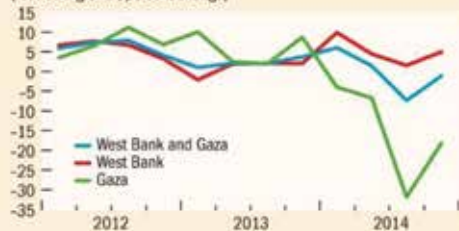
and infrastructure development. Further fiscal consolidation efforts should especially focus on eliminating the stock of arrears to private sector suppliers, rationalizing the wage bill, replacing energy subsidies with well-targeted cash transfers, and ensuring adequate contributions to the pension fund. On that basis, we are projecting a further reduction in the recurrent fiscal deficit in 2015 by about half a percentage point of the GDP.

In the financial sector, the progress made in establishing sound macro-prudential policies should be complemented with close monitoring of the exposure of the banking system to the PA and its employees, as well as efforts to promote financial inclusion, all based on the strategy that is currently being articulated by the PMA. Promoting private-sector-led growth remains a challenge while Israeli restrictions are in place and access to resources is constrained. However, there is still room to improve the business climate by simplifying procedures, improving

## Plunge in growth

Economic activity in Gaza collapsed as a result of last summer's conflict, with GDP contracting sharply.

(real GDP growth, percent change)



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

legislation, and leveling the playing field for businesses.

Looking forward, it is clear that sustainable economic development in the West Bank and Gaza is tied to a sustainable political solution. Even without factoring in last year's conflict, growth in recent years has not been sufficient to absorb the rapidly growing labor force. Progress on the political front should translate into a relaxation of existing restrictions on the free movement of goods and labor,

a lifting of the blockade on Gaza, faster integration into the global economy, and the resumption of much-needed foreign direct investment.

To summarize, our key messages are, first, that fiscal discipline based on predictable revenue is essential to instill confidence and enhance economic prospects. The PA deserves credit for its efforts to contain the fiscal deficit in a very tough environment. Over the medium term, the focus should be on moving from a fiscal approach

that emphasizes current spending financed by donor aid to one that delivers gradually lower deficits, with a pro-growth reorientation of government spending.

Second, strong efforts by the PA can only go so far. Donor aid remains crucial in the short term to build the economy and improve social conditions. Rigorous economic management by the PA should help mobilize that additional donor support.

And third, without progress on peace and national reconciliation, the Palestinian economy will not be able to realize its long-term growth potential. It is vital that the PA and the new government in Israel launch a constructive dialogue

leading, eventually, to a lasting peace. Without a political solution to the Israeli-Palestinian conflict, a sustainable Palestinian economy will remain elusive. And national reconciliation is required, not least to enable the reconstruction effort in Gaza.

*Dr. Ragnar Gudmundsson is the current resident representative of the IMF for the West Bank and Gaza. He previously held the position of the IMF's resident representative in Kenya. Dr. Gudmundsson holds a PhD in economics from the Institut d'Etudes Politiques de Paris and a master's from Columbia University. A native of Iceland, he speaks fluent French, English, and Icelandic.*

## Our Readers Say ...

*"... The Palestinian public tends to save, which does not contribute heavily to our development. Funds are not circulated highly enough to lead to economic growth, which is why we have been stagnant since the second Intifada.*

*— Anonymous (Jericho, 22)*

<sup>1</sup> A payment "falls into arrears" if it is not made due. Arrears constitute a stock of debt. Most of the arrears for West Bank and Gaza are due to the private sector and contributions to the pension fund.



Photo by Mohamad Zarandah.