PALESTINIAN TERRITORIES

Recovering from the 2014 recession, the Palestinian economy expanded by about 4 percent in 2016 due to transitory factors, mainly an uptick in Gaza reconstruction. At 27 percent, unemployment continues to be stubbornly high. Given the ongoing constraints to economic competitiveness, medium-term growth is projected at 3.5 percent. Lower than expected aid and the possibility of further conflict pose downside risks to growth and employment.

Recent developments

Since the 2014 Gaza war, the Palestinian economy has been on a recovering trend, albeit driven by unsustainable factors. The severe economic impact of the Gaza war pushed the Palestinian economy into recession in 2014. Since then, the economy has rebounded with the real GDP growth rate reaching 3.4 percent in 2015 and an estimated 4.3 percent in 2016. Drivers of the recent growth, however, are not sustainable. Growth in the Gaza Strip is estimated to have reached 7.4 percent in 2016 driven by a surge in construction activity, while the West Bank economy expanded by 3.4 percent mainly due to an increase in household consumption financed by bank loans.

At 27 percent, the unemployment rate in the Palestinian territories remains stubbornly high. The overall figure masks wide regional differences with unemployment in Gaza, at 42 percent, more than twice as high as that in the West Bank. Youth unemployment continues to be a major concern in the Palestinian territories, particularly in Gaza where more than half of those aged between 15 and 29 are out of work.

2016 witnessed a slight deflation in Palestine with the Consumer Price Index declining by 0.2 percent. The Israeli Shekel is the main currency in circulation in the Palestinian territories, and hence low inflation has been affected by deflation in Israel, in addition to a fall in global fuel and food prices.

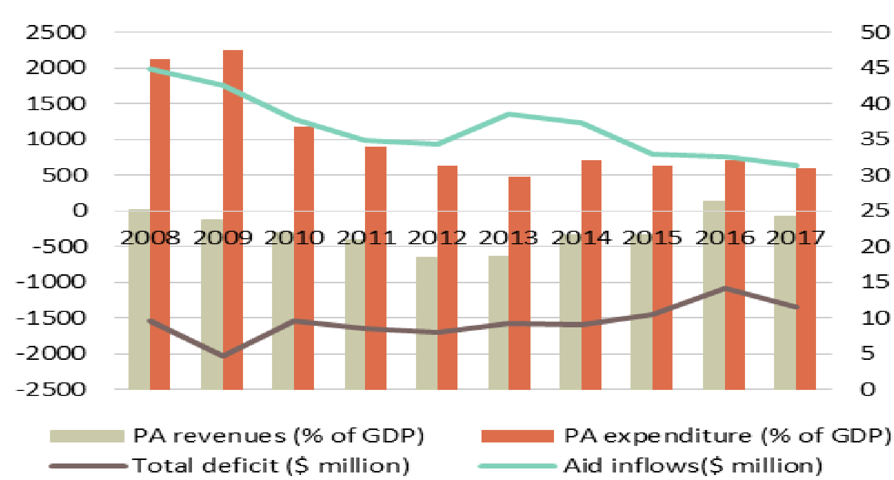
The Palestinian Authority's (PA) fiscal situation remained difficult in 2016 despite a strong revenue performance. Public revenues grew by about 5 percentage points of GDP reaching 26 percent in 2016, on account of one-off revenue transfers by the Government of Israel (GoI) and advance receipts of telecom license fees. This offset the higher than budgeted increase in public expenditures which reached 32 percent of GDP in 2016, mainly driven by wage increases for teachers and engineers, and led to a decline in the total deficit (before grants) to 8 percent of GDP. In parallel, aid to the PA continued its declining trend in 2016, resulting in a US$330 million financing gap (2.5 percent of GDP) and further arrears accumulation to the private sector and the public pension fund.

The external current account deficit (including official transfers) is estimated to have slightly widened in 2016 and reached 16.3 percent of GDP mainly due to a fall in aid inflows. On the other hand, the trade deficit witnessed a slight decline in 2016 to 41 percent of GDP following a drop in imports from Israel—the Palestinian territories' main trading partner—due to lower fuel prices and a trend among Palestinian consumers to boycott Israeli products. Exports continue to be constrained by the ongoing trade restrictions, and have remained low and stagnant at around 19 percent of GDP.

Outlook

The recent pickup in growth was driven by Gaza reconstruction and is not sustain-

FIGURE 1 Palestinian territories / Estimates and outlook: Public finances



Sources: MoF and staff estimates.

able without an easing of external restrictions and efforts to improve the domestic business environment. Therefore, the economic outlook for the Palestinian territories remains unfavorable, with projected growth levels insufficient to improve living standards. Assuming that the current restrictions remain in place and that the security situation stays relatively calm, the real GDP growth rate of the Palestinian economy in 2017 is projected at 3.5 percent: 2.7 percent in the West Bank and 5.5 percent in Gaza. In the medium term, real GDP growth could hover around 3.5 percent. This sluggish growth implies near stagnation in real per capita income and an increase in unemployment. The fiscal deficit (before grants) is projected to increase to 10 percent of GDP (US$1.35 billion) in 2017. At the same time, foreign aid in 2017 could fall to about US$640 million, leaving a financing gap in excess of US$0.7 billion (5 percent of GDP). PA actions alone will not be enough to fully close the gap. Unless donor aid is significantly stepped up, the gap will mostly be financed through arrears to the private sector and borrowing from local banks.

Due to the persistently large trade deficit, the 2017 current account deficit - including official transfers - is projected to stay high. Constrained by the restrictions system, Palestinian export growth is expected to remain sluggish and the Palestinian territories will continue to heavily depend on imports to meet even some of their basic needs. Consequently, the current account deficit is expected to remain high in 2017, at about 15.5 percent of GDP.

Risks and challenges

Lack of progress in the peace process and the Israeli constraints on trade, movement, and access to resources, alongside the internal political divide between the West Bank and Gaza and a challenging business environment continue to stand in the way of a sustainable economic recovery in Palestine. Therefore, downside risks to growth and employment remain significant. First, despite some progress in recent months, setbacks to the reconstruction process in Gaza are possible. The resumption of armed conflict cannot be ruled out and if this happens, the Gaza economy is expected to slip back into recession. Also, if tensions erupt again throughout the West Bank, they will result in elevated security risks that may negatively impact economic activity. Finally, growth in the West Bank may be worse than expected if the decline in donor support is sharper than current projections.

TABLE 1 Palestinian territories / Macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	-0.2	3.4	4.3	3.5	3.4	3.4
Private Consumption	3.5	6.2	4.5	4.5	5.0	5.0
Government Consumption	3.7	5.8	2.9	4.0	4.0	4.0
Gross Fixed Capital Investment	-10.1	8.1	-4.3	-8.3	-10.5	-12.2
Exports, Goods and Services	9.6	2.6	0.0	4.5	4.0	4.0
Imports, Goods and Services	4.1	9.5	-0.5	1.5	2.1	2.1
Real GDP growth, at constant factor prices	-2.3	1.6	3.5	4.2	4.0	4.0
Agriculture	-7.6	-7.2	-10.9	0.5	1.4	1.6
Industry	-13.8	-2.6	5.2	4.0	4.0	4.0
Services	3.1	3.8	3.7	4.4	4.1	4.1
Inflation (Consumer Price Index)	1.7	1.4	-0.2	1.1	1.5	1.2
Current Account Balance (% of GDP)	-6.7	-15.9	-16.3	-15.5	-15.4	-15.8
Financial and Capital Account (% of GDP)	2.4	12.1	13.9	13.1	13.2	13.7
Net Foreign Direct Investment (% of GDP)	-0.2	-0.5	1.2	0.1	0.1	0.1
Fiscal Balance (% of GDP)	-12.5	-11.4	-8.1	-9.7	-9.4	-9.2

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice.
Notes: e = estimate, f = forecast.