PALESTINIAN TERRITORIES

Following a period of recovery after the 2014 Gaza war, growth in the Palestinian territories dropped to 0.7 percent in Q1 2017 as reconstruction efforts decelerated and private consumption slowed down. At 29 percent, unemployment continues to be stubbornly high. Given the ongoing constraints to economic competitiveness, medium term growth is projected at 3 percent. Lower than expected aid and the possibility of further conflict pose downside risks to growth and employment.

Recent developments

The latest war in Gaza had severe social and economic consequences and caused the Palestinian economy to slip into recession in 2014. Reconstruction efforts allowed growth to recover to an annual average of 3-4 percent in 2015-16. However, aid receipts for reconstruction have significantly slowed in 2017 leading to a sharp deceleration in reconstruction activities. This, along with a slowdown in private consumption in the West Bank due to political tensions pushed real GDP growth down to a mere 0.7 percent in the first quarter of the year.

At 29 percent, the unemployment rate in the Palestinian territories remains stubbornly high. Unemployment in Gaza, at 44 percent, is more than twice as high as that in the West Bank; more than 60 percent of those aged between 15 and 29 in Gaza are out of work.

Following a slight deflation of 0.2 percent in 2016, price trends picked up in the first months of 2017 before a return to deflation mid-year. Overall prices declined by 0.7 percent in June 2017 (year-on-year), mainly reflecting a decline in food prices and deflation in Israel driven by the appreciating New Israeli shekel – the main currency in circulation in the Palestinian territories.

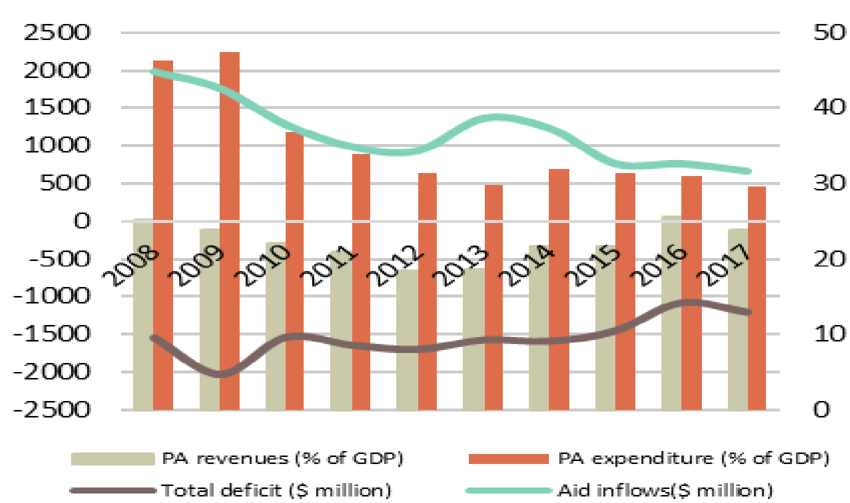
The Palestinian Authority's (PA) fiscal situation remained tight in the first half of 2017 due to lower than needed aid. Public revenues performed well due to better tax administration by the PA and one-off revenue transfers by the Government of Israel (GoI). The PA also managed to reduce its spending in the first half of 2017 mainly due to lower transfers and the initial impact of decisions to cut spending in Gaza. As a result, the total deficit (before grants) dropped by 16 percent year-on-year. In parallel, aid to the PA treasury declined by 19 percent resulting in a US$167 million financing gap and further arrears accumulation to the private sector and public pension fund.

The external current account deficit (including official transfers) is estimated to have declined in 2016 to 10.4 percent as the trade deficit dropped and private transfers increased. The trade deficit reached 38.6 percent of GDP in 2016 down from 41.0 percent in 2015 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 18 percent of GDP. Private transfers as a share of GDP doubled in 2016 reaching 12.1 percent due to an increase in remittances from Palestinians working abroad.

Outlook

The economic outlook for the Palestinian territories remains unfavorable. Assuming that the current restrictions remain in place, the security situation stays relative-

FIGURE 1 Palestinian territories / Estimates and outlook: Public finances



Sources: Palestinian MoF and World Bank staff estimates.

ly calm and aid disbursements accelerate throughout the year to reach their projected level, the real GDP growth rate of the Palestinian economy in 2017 is projected at 3.0 percent: 2.7 percent in the West Bank and 4.0 percent in Gaza. This modest growth implies a stagnation in real per capita income and an increase in unemployment.

The fiscal deficit (before grants) is projected to reach 3.8 percent of GDP (US$1.2 billion) in 2017. At the same time, foreign aid in 2017 could fall to about US$666 million. After accounting for external debt repayment, this results in a financing gap in excess of US$580 million (4 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.

The Palestinian territories' current account is expected to remain unfavorable in the coming years due to the persistently large trade deficit. The share of Palestinian exports in the economy is expected to remain stagnant at about 17-18 percent in the medium term due to the ongoing GoI restrictions on trade. With heavy dependence on imports to meet even some of their basic needs, the share of imports in the economy will hover around 55 percent. Consequently, the current account deficit is expected to remain high in the coming years at about 13 percent of GDP.

Risks and challenges

A sustainable economic recovery in the Palestinian territories is not possible given the stalemate in the peace process, ongoing restrictions imposed by Israel on trade, movement, and access to resources alongside internal political divisions and a challenging business environment. As a result, downside risks to growth and employment remain significant. First, clashes recently witnessed in the West Bank may erupt again, and if this happens, the security situation will significantly worsen negatively impacting economic activity. Also, growth in the West Bank may be worse than expected if the decline in donor support is sharper than current projections. As for Gaza, setbacks to the reconstruction process are possible and under such a scenario, the resumption of armed conflict cannot be ruled out which may cause the economy to slip back into recession. Recent expenditure cuts by the PA in Gaza may also lead to social tensions. While there is upside potential in Gaza if relations with Egypt improve, this could destabilize the political situation in the West Bank.

TABLE 2 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	4.1	3.0	3.0	2.9
Private Consumption	3.5	6.2	3.6	4.5	4.5	4.3
Government Consumption	3.7	5.8	0.1	3.5	3.2	3.2
Gross Fixed Capital Investment	-10.1	8.1	-0.2	3.0	-1.3	-1.6
Exports, Goods and Services	9.6	2.6	5.5	-5.2	1.2	4.0
Imports, Goods and Services	4.1	9.5	1.8	2.9	3.4	4.1
Real GDP growth, at constant factor prices	-2.3	1.6	3.3	3.1	3.0	2.9
Agriculture	-7.6	-7.2	-11.0	0.5	1.4	1.6
Industry	-13.8	-2.6	6.6	4.0	4.0	4.0
Services	3.1	3.8	3.0	2.9	2.7	2.5
Inflation (Consumer Price Index)	1.7	1.4	-0.2	0.5	1.6	2.0
Current Account Balance (% of GDP)	-7.4	-16.3	-10.4	-13.1	-13.2	-13.4
Financial and Capital Account (% of GDP)	4.4	19.4	8.7	10.9	11.2	11.5
Net Foreign Direct Investment (% of GDP)	-0.2	0.2	1.2	1.1	1.1	1.1
Fiscal Balance (% of GDP)	-2.8	-5.1	-2.4	-3.8	-3.3	-3.2

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