Economic Monitoring Report to the Ad Hoc Liaison Committee

September 26, 2019

Public Disclosure Authorized

WORLD BANK GROUP
THE WORLD BANK IBRD • IDA | IFC International Finance Corporation | MIGA Multilateral Investment Guarantee Agency

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Acronyms

AHLC	Ad Hoc Liaison Committee
AML/CFT	Anti-Money Laundering and Combating Financing of Terrorism
CBRs	Correspondent Banking Relationships
DFID	Department for International Development
GDP	Gross Domestic Product
GoI	Government of Israel
IMF	International Monetary Fund
JDECO	Jerusalem District Electricity Company
LGUs	Local Government Units
MENA	Middle East and North Africa
ML/FT	Money Laundering / Finance of Terrorism
MENAFATF	Middle East and North Africa Financial Action Task Force
MoF	Ministry of Finance
MOLG	Ministry of Local Government
NCTP	National Cash Transfer Program
NEDCO	Northern Electricity Distribution Company
NPL	Non-Performing Loans
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PM	Prime Minister
SMEs	Small-Medium Enterprises
TEDCO	Tubas Electricity Distribution Company
UN	United Nations
VAT	Value Added Tax

Executive Summary

i. **After a steady improvement in the fiscal position over the past decade, the standoff over clearance revenues has severely constrained the PA budget, leading to a significant expansion in expenditure arrears.** Following a law enacted in 2018, the GoI started in March 2019 to make unilateral deductions of almost US$12 million per month from the tax revenues it collects on behalf of the PA (clearance revenues). The PA has refused to accept these transfers with unilateral deductions and has demanded that they are transferred in full, resulting in a standoff. Given that clearance revenues constitute 65 percent of the PA's total revenues and 15 percent of GDP, their loss has resulted in a severe liquidity squeeze forcing the PA to adopt an emergency cash management plan that includes paying partial salaries and reducing spending on goods and services. The PA has so far managed to cope well given the significant loss in revenues. However, if the fiscal crisis is not resolved, the PA is facing the prospect of a build-up in arrears to employees, suppliers and the pension fund that could approach US$1.4 billion in 2019 as well as exhausting its credit with domestic banks.

ii. **Going forward, however, uncertainty about a resolution for the clearance revenue standoff will weigh on the economy.** Over the last two decades, the Palestinian economy has been driven by large inflows of transfers as other sources of growth have been long-hindered by the ongoing Israeli restrictions on movement and access. Under a baseline scenario which assumes a continuation of the Israeli restrictions, persistence of the internal divide between the West Bank and Gaza and a decline in aid levels, the Palestinian economy is expected to slip into a recession in 2020 and 2021, even if additional, one-off transfers from clearance revenues are made. As financial buffers are depleted, the reduced revenues will require sizable cuts in public spending, which in turn would translate in reduced consumption and investment. The decline in growth implies a sizable decline in real per capita income and a rise in poverty.

iii. **The Palestinian financial sector continues to face substantial risks against the backdrop of the fiscal crisis.** The negative impact of the deepening fiscal crisis on the quality of loan portfolios across the banking sector has started to materialize as both non-performing loans and classified loans have been on an upward trajectory. With the severe liquidity shortage facing the PA, it has resorted to domestic banks to finance its needs raising the sector's exposure to the PA for the first time in a number of years. Banks are also rescheduling outstanding loans held by PA employees who are receiving a reduced salary, compounding the destabilizing effect on the sector. However, the fact that the PA is simultaneously building up an asset in the form of tax revenues not received from the GoI ameliorates the situation as the increased exposure may be seen as a temporary trend. Another cause of concern is a possible disruption in Correspondent Banking Relationships (CBRs) between Palestinian banks and their Israeli counterparts due to de-risking by Israeli banks. The immunity and indemnity package given by the GoI to banks with CBRs are set to expire in May 2020 and February 2021, respectively, when a longer term and more sustainable intervention is expected to be in place.

iv. **While resolving the fiscal crisis is an immediate priority there remains a broader reform agenda to improve the economy and Palestinian living standards.** The Palestinian economy faces an extremely challenging environment, which has been exacerbated by the standoff over clearance revenues. Some actions to improve the situation are within the control of the PA and need to be advanced. However, in other areas collaboration with the GoI is critical. Donors also play an important role to support reform efforts and critical investments in the Palestinian territories. In past AHLC reports we have examined areas that can support Palestinian economic development and fiscal sustainability, and progress in these areas is summarized in Annex 1.

Recent Economic Developments

A. Economic Growth

1. **Over the last two decades, the Palestinian economy has been driven by large inflows of transfers as other sources of growth have been long-hindered by the ongoing restrictions on movement and access.** Inflows of transfers have significantly dropped in recent years, making it more pressing to unlock growth constrained by a difficult business environment. This is due to Israeli restrictions on movement and access and internal policy and institutional challenges, as outlined in previous AHLC reports. The trade and movement restrictions have created a high risk of disruption in projects or trade and have kept investment levels low, resulting in a bias towards non-traded services which have less potential for productivity growth.

2. **Economic momentum faltered at the start of 2019.** After two strong quarters at the end of 2018, preliminary data by the Palestine Central Bureau of Statistics (PCBS) show that the growth of real Gross Domestic Product (GDP) in the Palestinian territories contracted by 1 percent in the first quarter of the year compared to the previous quarter on seasonally adjusted basis. Contraction was driven by the West Bank as the activity in the first quarter of 2019 declined by 2.1 percent (q/q, seasonally adjusted), while Gaza grew by 3.6 percent (q/q, seasonally adjusted) in the same period. Notably, slowdown in the West Bank was driven by a decline in private and public consumption. However, comparing the first quarter of 2019 with the same quarter of 2018, the Palestinian economy registered a growth of 3.8 percent with the West Bank expanding 4.2 percent while Gaza grew by 2 percent. To a large extent, this is a base effect as the first quarter of 2018 was a particularly weak quarter.

3. **The Palestinian Authority has implemented an emergency cash management plan to deal with the loss of nearly two thirds of revenues since the standoff with Israel over additional unilateral deductions from clearance revenues since March 2019.** In short, the PA has relied on increased borrowing from commercial banks, moving receipts of foreign aid forward, and building up arrears to employees, suppliers and the public pension fund (please see details below).

4. **Despite severe fiscal stress, outright recession has so far been avoided by various measures and coping mechanisms which have insulated the impact on disposable income**. The PA has worked with banks and utilities to reduce the mortgage and utility installment payments correspondingly for the affected public employees, who account for around one-quarter of total employment. Large cuts in public spending were likely to have negatively impacted economic activity given the existence of large fiscal multipliers.[1] However, the private sector, which accounts for around two-thirds of total employment, has proven resilient so far to operating on an arrears basis – as it already had done in the past. Thus, liquidity has been preserved through loan rescheduling and forbearance, and underlying indicators of growth have been solid. Several higher frequency indicators—such as industrial production, imports, exports, and the share of returned checks—have not shown signs of deteriorating economic activity up until June 2019. The economic environment in Israel, with growth close to potential, low inflation, and a strong

[1] Fiscal multipliers are estimates of the short-term impact on output of changes in fiscal policy. This is consistent with research that finds that countries in MENA with high unemployment, fixed exchange rates, and low trade-to-GDP ratios have large fiscal multipliers, implying that exogenous reductions in public spending can have large and negative impacts on output. See Lederman D. and Rojas, C., 2018. "On the International Heterogeneity of Fiscal Multipliers," *mimeo*, Office of MNA Chief Economist.

NIS, has also likely generated positive spillovers to the Palestinian economy. Around one in ten working Palestinians are employed by Israeli firms, and this is an important source on the margin of additional income for Palestinian households.

5. **Consequently, the latest labor force data show that the unemployment rate in the Palestinian territories—while still high—remains unchanged in the first half of 2019**. Unemployment reached 26 percent in the second quarter of 2019, which is almost the same level it was in 2018.[2] In the West Bank, unemployment reached 15 percent in the second quarter of 2019—2 percentage points lower than its 2018 average mostly due to more jobs created in domestic commerce, hotels and restaurants. The decline in the West Bank was offset by an increase in Gaza where the unemployment rate increased from 43 percent in 2018 to almost 47 percent in the second quarter of 2019. Unemployment amongst Gaza's youth continues to be extremely high as it reached 64 percent in the second quarter of 2019.

6. **The latest available poverty data is for 2016/17, so it does not reflect the impact of the crisis but shows that living conditions have deteriorated, mainly in Gaza**. Around 24 percent of Palestinians lived below the US$5.5 2011 PPP a day poverty line in 2016/17 (latest available data) – 2.9 percentage points higher than in 2011. The gap between the West Bank and Gaza has increased substantially in 2016/17 with 46 percent of the population below the US$5.5 poverty line in Gaza, compared to 9 percent in the West Bank which saw some improvement compared to the last survey in 2011. Monetary living standards in both regions remained fragile. In the West Bank, poverty status is sensitive to even small shocks in household expenditures, while in Gaza any change in social assistance flows can significantly affect the population's wellbeing. On the non-monetary measures of well-being, like access to water, some 93 percent of households are connected to a water network. However, in practice, the connection does not guarantee timely access to drinking water, let alone adequate quality. Access to improved drinking water in Gaza was almost zero percent – compared to 93 percent in the West Bank. More than 97 percent of the households in Gaza rely on potable water delivered by private tanker trucks.

7. **The outlook for the Palestinian territories is worrisome as buffers to sustain liquidity are depleted and drivers of growth are diminishing**. In August 2019 there was a retroactive transfer of fuel taxes (approximately US$570 million) accumulated with Israel since March.[3] Whether this transfer was a one-off or part of a wider agreement on the handling of fuel taxes going forward is not yet clear. Nonetheless, with this transfer plus some additional external financing, the World Bank estimates that the PA will be able to continue to operate under the same measures announced in the emergency cash management plan for the remainder of 2019. Together with the continued reliance on domestic buffers, this is estimated to yield growth in the Palestinian territories of 1.3 percent in 2019. It is important to keep in mind that this outturn is largely a result of the situation in Gaza improving slightly (growth of 1.8 percent) following a steep recession in 2018 (-6.9 percent). For the West Bank, growth in 2019 is expected to slow to the lowest level over the last five years (1.2 percent), down from 3.1 percent in 2018.

8. **Going forward, however, uncertainty about a resolution for the clearance revenue standoff remains high.** Under a baseline scenario which assumes a continuation of the Israeli restrictions on movement and access, persistence of the internal divide between the West Bank and Gaza and a decline in aid levels, the Palestinian economy is expected to slip into a recession in 2020 and

[2] The PCBS has revised its labor statistics to become in line with the international standards pertaining to labor underutilization and this has resulted in revisions to previously reported data for 2018.
[3] The 3 percent handling fee was not deducted from the NIS2 billion transfer.

2021, even if additional, ad-hoc transfers from clearance revenues are made. As financial buffers are depleted, the reduced revenues will require sizable cuts in public spending, which in turn would translate in reduced consumption and investment. The decline in growth implies a sizable decline in real per capita income and a rise in poverty. If a resolution is reached on the clearance revenues but the other challenges remain then a return to trend growth of about 3 percent could be expected.

9. **There are significant risks to the outlook.** Obviously, if a resolution to the clearance revenue standoff is found, the negative spillovers can be mitigated, and growth can be restored. The resolution of the fiscal standoff requires commitments on both sides. To that effect, a second general election in Israel in the span of six months and a new government on the Palestinian side indicate that the political context for reaching agreement is highly uncertain. This will negatively affect the private sector sentiment for investment and trade.

10. **To achieve sustainable economic growth in the Palestinian territories, growth and job creation going forward will need to be private sector driven.** For a small economy, achieving a sustainable growth path depends to a large extent on having a private sector that is able to compete in regional and global markets and increase its exports of goods and services. The private sector is the only sustainable engine for growth, and the focus should be on removing the constraints and creating the right conditions for it to flourish.

11. **The new Palestinian government has taken initial steps to revise its development plan.** In recent months a review of the National Policy Agenda (NPA) and sector strategies has been initiated. This is expected to lead to a revised NPA being prepared by early 2020, which will inform the planning for the 2021 budget. The revised NPA is expected to incorporate the cluster approach to development that has been promoted by the Prime Minister (PM) and has recently been launched in the Qalqilya region. A key focus of the new strategy is expected to be on employment creation, especially for youth, with reforms aimed at enhancing the provision of vocational training.

Table 1. Palestinian territories Economic Outlook

(annual percent changes unless indicated otherwise)

	2016	2017	2018 e	2019 f	2020 f	2021 f
Real GDP growth, at constant market prices	4.7	3.1	0.9	1.3	-1.1	-0.4
Private Consumption	3.3	-1.8	1.5	1.0	0.0	0.0
Government Consumption	1.8	0.9	0.9	-2.0	-0.8	-0.8
Gross Fixed Capital Investment	-0.9	2.1	3.5	-5.6	-10.1	-3.7
Exports, Goods and Services	1.9	12.4	7.9	4.5	3.2	3.8
Imports, Goods and Services	0.2	-0.8	7.0	-1.3	-0.1	1.4
Real GDP growth, at constant factor prices	4.2	2.8	1.6	1.3	-1.1	-0.4
Agriculture	-8.1	-5.7	7.2	0.5	0.6	0.7
Industry	7.5	3.5	2.4	1.2	1.3	1.6
Services	3.9	3.0	1.0	1.4	-1.9	-1.1
Real GDP growth, West Bank	3.5	8.5	3.1	1.2	-1.1	-0.4
Real GDP growth, Gaza	8.3	-12.5	-6.9	1.8	-1.2	-0.6
Inflation (Consumer Price Index)	-1.0	0.0	1.2	0.0	0.7	1.5
Current Account Balance (% of GDP)	-14.5	-10.8	-11.4	-9.0	-8.1	-7.7
Net Foreign Direct Investment (% of GDP)	-2.5	-1.5	-1.5	-1.5	-1.5	-1.5

Source: World Bank

Notes: e = estimate, f = forecast.

B. Public Finance

12. **Due to fiscal consolidation efforts in recent years, the PA's finances entered the clearance revenues dispute in somewhat better shape than past crises, but still reliant on undesirable financing mechanisms for persistent deficits.** Between 2006 and 2018, the relative size of the PA's total fiscal deficit fell from 30 percent of GDP to below 7 percent—an impressive achievement. This was a result of efforts to streamline public spending, notably the wage bill, which has fallen from 24 percent of GDP in 2006 to 11 percent in 2018, and net lending (*de facto* transfers to municipalities), which has fallen from 7 percent of GDP in 2006 to 2 percent in 2018, as well as to improve domestic revenue collection. Nonetheless, the PA continued to face large fiscal deficits in recent years, mainly emanating from Gaza while fiscal operations in the West Bank mostly break even. Inflows of donor aid have been a major source of financing for the deficit, but those have significantly declined in recent years and have been insufficient to cover the overall financing need. As a result, the PA has resorted to debt financing from the domestic banking sector and used the irregular practice of running up arrears to private suppliers and to the public pension fund to finance its needs.

Fiscal performance January – June 2019

13. **A significant decline in public revenue receipts was witnessed in the first half of 2019 following a cessation of clearance revenue[4] transfers by Israel and a deterioration in the performance of domestic revenues.** Overall public revenue received in the first half of 2019 was around half the amount received in the same period last year. Clearance revenue receipts dropped significantly as a result of an ongoing standoff that has started in early 2019 after additional unilateral deductions by Israel and the resultant PA decision to reject these transfers altogether. According to figures provided by the MoF, clearance revenues received in the first half of 2019 were 68 percent lower compared to the same period last year, forcing the PA to resort to borrowing and arrears to maintain its operations. Between January and June 2019, the PA's domestic taxes also dropped by about 12 percent, year-on-year, while nontax revenues declined by 22 percent. A key driver of this change is that in the same period last year there were Israeli transfers to offset outstanding fiscal leakages[5].

14. **The drop in public revenue forced the PA to adopt an emergency cash management plan in the first half of 2019.** Specifically, the PA has only been paying 60 percent of public salaries to its employees in the West Bank and in Gaza[6] while protecting those that make NIS 2,000 per month and below. Consequently, only 70 percent of the committed wage bill was disbursed. The PA built up arrears to suppliers for goods and services by paying 40 percent of the amount that was committed for the first half of 2019, while commitments for this category were maintained at the 2018 levels. The PA has also not been able to pay all committed transfers as, for example, payments to the poor through the National Cash Transfer Program (NCTP) were cut back.[7] That

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[4] Clearance revenues are mostly VAT and Import duties collected by the GoI on behalf of the PA and should be transferred monthly based on the revenue sharing arrangement instituted by the Paris Protocol.

[5] Fiscal leakages are revenue losses suffered by the PA under the revenue sharing arrangement instituted by the Paris protocol between the two parties more than twenty years ago. Examples include the undervaluation of Palestinian imports, and inadequate documentation of invoices for VAT purposes on exports to the Palestinian territories.

[6] The alignment of the treatment of employees in the West Bank with those of Gaza is a revised policy of the PA as previously Gazan employees were alone in facing reductions in salaries.

[7] The Q2 2019 NCTP payment was delayed until August without a PA contribution. The payment was only made possible as the World Bank and the European Union doubled their contributions.

said, the PA has continued to make full payments to Palestinian prisoners in Israeli prisons and the families of those deceased as a result of violence.

15. **To make ends meet, the PA had to accrue large arrears and increase its borrowing from domestic banks in the first half of 2019**. On a commitment basis, the PA's total deficit amounted to US$415 million in the first half of 2019, while aid received was much less, reaching US$194 million. After accounting for the loss in clearance revenues, the financing gap exceeded US$1 billion in the first half of 2019. To finance the gap, the PA had to accrue large arrears to its employees, private suppliers, local government units and the public pension fund in the amount of US$686 million in the first half of 2019, on a net basis. According to data provided by the MoF, the total stock of arrears accrued to the private sector over the years now exceeds US$700 million, creating large liquidity challenges.[8] The remainder of the gap was financed through additional borrowing from the domestic banking sector significantly raising the PA's stock of debt to US$1.6 billion, as of June 2019. Notably, the PA has been operating under an emergency budget so far in 2019 as a regular budget is yet to be passed.

Fiscal forecast

16. **The recent transfer of fuel taxes made by the GoI in August is expected to enable the PA to muddle through in 2019 with reduced spending, while continuing to accrue large arrears.** In August, the GoI transferred to the PA around US$560 million in fuel import taxes that have been accumulated since the standoff started in March. Whether this transfer was a one-off or part of a wider agreement on the handling of fuel taxes going forward is not yet clear . After the recent transfer, the total amount of clearance revenues remaining with the GoI is estimated at about US$0.6 billion. The recent transfer has eased the fiscal stress and will allow the PA to muddle through the remainder of 2019, while continuing to pay partial salaries and reduce other categories of spending. With this transfer, the PA's financing need after accounting for the loss of other clearance revenues would reach US$2.3 billion, on a commitment basis. External support is expected to be around US$414 million, resulting in a financing gap after aid of around US$1.8 billion. US$500 million of this amount could be financed through borrowing from domestic banks, while honoring previous agreements with the PMA to restrict the direct exposure of the banking system to the PA. Notably, this amount of borrowing would exhaust the PA's ability to resort to domestic banks in the future until its debt level goes down. Qatar has also pledged US$250 million as a foreign loan to the PA that would be provided in monthly installments. Two US$25 million installments have so far been disbursed in June and July 2019.[9] The Arab league has announced the activation of its US$100 million per month safety net, but no amounts have yet been deposited. If no additional donor aid is identified, the PA would be forced to fill most of the remainder of the gap with arrears to the private sector, public employees, LGUs and the public pension fund.

17. **Going forward, the uncertainty regarding a comprehensive resolution of the clearance revenue standoff will continue to weigh on the fiscal situation.** If the clearance revenue standoff is not resolved, the PA would embark on the year 2020 after largely exhausting its domestic sources of financing, including borrowing from domestic banks, which will put it in a much worse position than in 2019. Assuming donor support levels remain similar to 2019, the PA could be facing a financing gap after aid, on a commitment basis, exceeding US$2.4 billion.

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[8] This figure excludes promissory notes issued by the MoF to its private suppliers.

[9] Total Qatari funds amount to US$480 consisting of the following: US$50 million grant to the PA, US$250 million loan to the PA from the Qatar National Bank that will be provided in installments and paid back after a 6-month grace period, and US$180 million to Gaza some of which have already been disbursed.

Given the already high stock of arrears to the private sector, additional public credit could eventually choke economic activity. Prolonged reduced wages will also negatively impact consumption by public employees, which will also harm economic activity.

18. **The two sides should accelerate efforts to bring this standoff to an end**. The recent transfer of fuel taxes without the 3 percent handling fee is an encouraging step. This revenue source comprises about a third of total clearance revenues that could be exempted from the clearance process. However, a more comprehensive agreement needs to be reached covering the mechanism and nature of Israeli deductions from clearance revenues.

19. **While the PA needs to further accelerate reforms that align its spending and revenue capacity, in the short-term actions by the PA alone will not be enough to close the financing gap.** The PA has already implemented severe spending cuts to deal with the loss of clearance revenues. A more drastic reduction in PA expenditures in the short term would be harmful to the economy, given the sizable fiscal multipliers, and may also bring about negative social consequences.

20. **Long term fiscal sustainability, however, cannot be achieved without a prudent and stringent fiscal reform program by the PA, with donor support**. By necessity, the cuts adopted recently by the PA to deal with the clearance revenue issue have been envisaged as temporary, blunt, and across the board. However, going forward, to support a more sustainable fiscal position, the fairness, effectiveness and efficiency of public spending need to be improved through a program that addresses the generous public pension system, civil service reform (administrative performance and payroll), untargeted transfers and public financial management. Furthermore, chronic infrastructure deficits are related to the need for extensive reforms in municipal finance and service delivery, without which increased private investment will be difficult to mobilize.

21. **Budget support remains a key source of reform financing in an environment where fiscal stability is still needed to support growth.** By 2020, the PA would have exhausted all its domestic financing options and public employees would have depleted their buffers. Hence, the continued uncertainty about clearance revenues is expected to have a negative impact on consumption and investment patterns. Donor support during these critical times is essential to enable provision of services to the Palestinian population. The PA should work closely with development partners to identify additional external aid as without it, a fiscal and economic crisis cannot be avoided in the absence of clearance revenues in 2020.

Table 2: Central government fiscal operations 2017-2019, commitment basis
(in millions of US$)

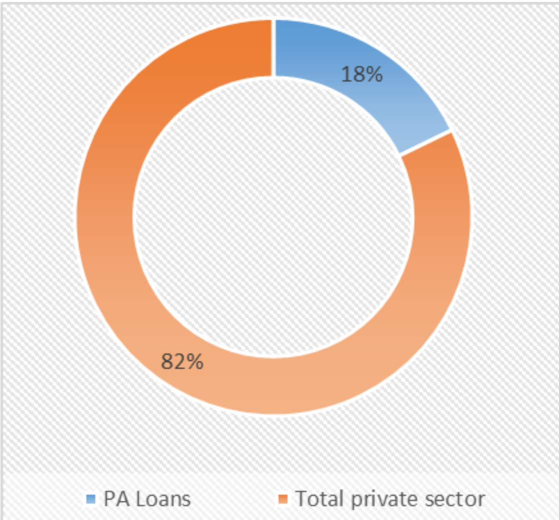
	2017 (actual)	2018 (actual)	2019 (forecast)
Net revenues	**3,495**	**3,355**	**3,356**
Gross domestic revenues	1,151	1,272	1,112
Clearance revenues	2,416	2,254	2,380
Tax refunds	72	171	136
Recurrent expenditure	**4,358**	**4,068**	**3,929**
Wage bill	2,114	1,798	1,800
Nonwage spending	1,978	1,999	1,812
Net lending	266	271	318
Recurrent balance	**-863**	**-713**	**-573**
Development spending	366	363	250
Overall balance	**-1,229**	**-1,076**	**-823**
Financing	**1,229**	**1,076**	**823**
Clearance revenue adjustment	**0**	**-12**	**1,463**
External financing	**719**	**675**	**414**
Budget support	544	515	486
Development financing	175	160	-72
Gap after external financing	**510**	**389**	**1,872**
Domestic financing	**442**	**386**	**1,872**
Net domestic Bank financing	85	159	500
Arrears	357	227	1,372
Other	68	0	0
Residual	**68**	**3**	**0**

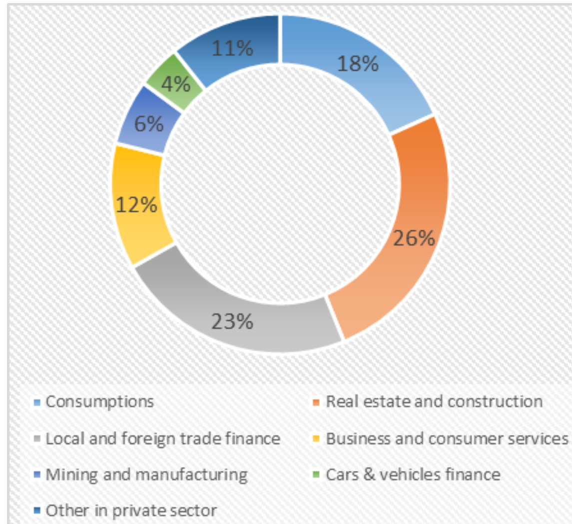
Source: PA MoF and WB Staff Estimates.

C. Money and Banking

22. **During the first half of 2019, the Palestinian financial sector, composed primarily of traditional banking, continues to face substantial risks against the backdrop of a deepening fiscal crisis.** According to reporting by the Palestine Monetary Authority (PMA) through June 2019, the banking system's assets exceeded USD16 billion. Direct credit continued to grow at a faster rate than deposits, reaching USD8.9 billion by June 2019. The resulting slight uptick in overall credit-to-deposit ratio - driven by growth in both public and private lending - currently at 71 percent, should be monitored given the historical range of 50-60 percent over recent years. A review of credit exposure to the private sector indicates persistent sectoral concentration, with two thirds of all private lending going to construction, trade finance, or consumer loans. The negative impact of the deepening fiscal crisis on the quality of loan portfolios across the Banking sector has started to materialize. Both non-performing loans (NPLs) and classified loans have maintained an upwards trajectory from 2018, respectively growing by approximately 36 and 38 percent over the past 12-month period. NPL ratio (which represents the percentage of nonperforming loans out of all direct loans), exceeded 3.5 percent for the first time in recent years – signaling a deterioration in the quality of loan portfolios. While this NPL ratio is moderate given the context, discussions with several local banks indicated that the NPL ratio has been dampened through the rescheduling and restructuring of outstanding loans based on PMA guidance issued during 2017, 2018 and 2019. If the underlying causes persist, the delayed impact on NPLs will eventually materialize through further deterioration in the quality of SME (Small-Medium Enterprises) and consumer loan portfolios, particularly for banks with a substantial exposure to PA employees.

Figure 1: Distribution of credit by sector (left) and by economic activity in the private sector (right)

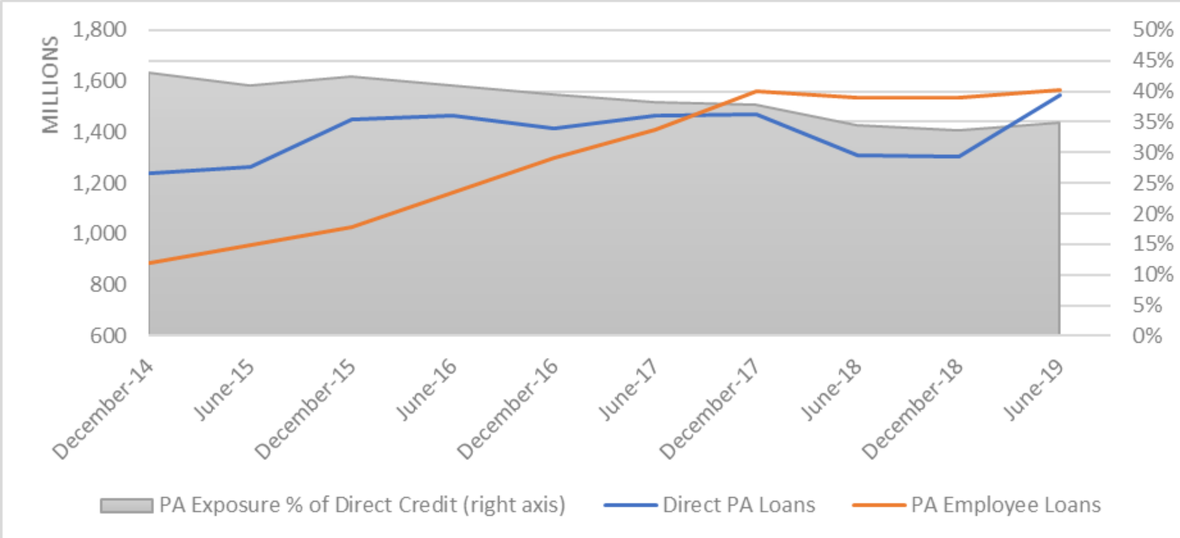




Source: Palestine Monetary Authority.

23. **In the absence of clearance revenue transfers, the exposure of domestic banks to the PA is on the rise and expected to increase, significantly undermining the stability of the banking system.** In light of the growing fiscal challenges faced by the PA over the past decade, the banking sector's credit exposure to the public sector has been a cause of unease. Reliance on bank financing grew steadily, raising concerns over credit concentration risk. Following a few years of stability in PA borrowing (around US$ 1.3-1.4 billion), exposure to the public sector registered an increase in 2019, reaching US$1.6 billion, or 18 percent of total bank lending as of June 2019. With the recent standoff over clearance revenues, a further increase in PA exposure is likely, which is a potentially destabilizing factor for the local banking system. As mentioned earlier, the fact that the PA is simultaneously building up an asset in the form of tax revenues not received from the GoI ameliorates this concern somewhat as the increased exposure may be seen as a temporary trend. It's important to note that the banking sector's exposure to the PA is not limited to direct credits to the PA. Borrowing by PA employees has been on the rise in recent years, surpassing direct PA loans for the first time since 2017. As of June 2019, borrowing by PA employees reached US$1.6 billion. When combined, PA and public employees account for US$3.11 billion, or 35 percent of total banking sector credits.

Figure 2: Direct and Indirect Exposure to the PA ($million)



Source: Palestine Monetary Authority

24. **The potential negative impact of de-risking by Israeli banks remains a cause for concern.** Citing money-laundering and financing of terrorism concerns, key Israeli banks signaled plans to limit or terminate correspondent banking services to Palestinian Banks in 2016. Such termination of correspondent banking relationships (CBRs) by Israeli banks could have significant economic impact due to the highly interlinked structure of the two banking systems, and the use of Israeli Shekel as the primary currency in the Palestinian economy. In January 2017, the GoI approved a temporary indemnity and immunity package for Israeli banks working with Palestinian banks, thereby taking on part of the risks, to alleviate the potential for immediate disruptions to CBRs between the two banking systems. This temporary immunity and indemnity package is set to expire in May 2020 and February 2021, respectively. Due to the potential destabilizing impact of CBR disruptions at the expiry of this package, a longer term and more sustainable arrangement must be jointly agreed and implemented.

25. **The PMA has been taking steps towards upgrading the Palestinian anti-money laundering and combating financing of terrorism (AML/CFT) system to be more in line with international practices.** With World Bank's technical support, the PMA conducted its first self-assessment of ML/FT risks. The aim is to enhance the ability of relevant AML/CFT stakeholders in the Palestinian territories to identify, assess, and understand the money laundering and terrorism financing risks they face. In parallel to the self-assessment process, the PA requested, and has been granted approval for, an evaluation of its AML/CFT regime by the regional Financial Action Task Force (MENAFATF). The evaluation, currently scheduled to start during 2020, in combination with the self-assessment, represent key milestones towards aligning the PA's AML/CFT systems with international standards. It is worth noting that civil litigation related to financing of terrorism has been recently filed in a United States federal court against three licensed banks operating in the Palestinian territories.

Annex I: Stock Take of World Bank Recommendations to the AHLC Meetings Over the Years

26. **The Palestinian economic outlook is worrying, and bold actions are needed by all parties to get the Palestinian economy out of its deteriorating trajectory.** A number of necessary actions have been identified in previous reports by the World Bank to the AHLC meeting, but implementation has been limited. In the World Bank's September 2016 report to the AHLC, a stock take of all previous World Bank recommendations to the meeting was conducted. This exercise was intended to provide a baseline for evaluating progress in achieving the Palestinian territories' development priorities. In addition, it was hoped that it would galvanize the reform efforts of all parties to address the immediate need while setting in place reforms that will deliver over time. In this report, the stock take is updated to show progress since April 2019 using the same three pillars 1) fiscal sustainability, 2) economic development and 3) Gaza reconstruction and recovery.

A. Fiscal Sustainability

27. **The PA has reduced payments as an emergency response to the lack of clearance revenue receipts, but more needs to be done on structural reforms that are key to achieving long term fiscal sustainability.** As mentioned earlier in the report, recent measures have been adopted to curtail payments as a response to the clearance revenue crisis. For long term fiscal sustainability, the PA needs to address a number of long-standing areas of ineffective expenditure. In particular, they need to adopt a comprehensive plan for civil service reform that looks at inefficiencies and overstaffing – especially in the West Bank. Parametric reforms are also needed to support the public pension system's sustainability. The Ministry of Health has finalized harmonizing standard procedures for medical referrals and five out of eight have been published online. These procedures are being fully utilized by the medical referral committees and they have proved their effectiveness in guiding the referral process. Eighteen Memoranda of Understanding (MoUs) have also been signed with service providers to better organize the purchasing and packaging of services for outside medical referrals. Despite these efforts, referral costs continued to rise, and new initiatives have now been taken to stem the growth. For instance, in an attempt to minimize costs, referrals to Israeli hospitals have been limited to follow up cases or critical emergency conditions where there are no alternative service providers. Additionally, cost-effective contracts have been established with two Jordanian hospitals and two Egyptian hospitals for more specialized and advanced health care services. Progress has been made on steps to control electricity net lending – although the problem is increasing with other utility payments, mainly water and sewerage.

28. **Even though domestic revenue collections improved in 2018, collections have declined so far in 2019**. Despite strong performance in 2018 due to administrative measures introduced to widen the tax base, the PA's revenues declined in 2019 as a result of the fiscal crisis. Regardless the crisis, however, tax avoidance is still widespread, particularly amongst high earning professionals, and the PA needs to focus efforts on this group of taxpayers. Progress has been made on updating public fees and charges with a notable recent decision to increase the license fee for petrol stations. Further, the PA and the government of Jordan have recently agreed to further cooperation on customs through electronically linking both customs systems, which is expected to significantly reduce smuggling.

29. **Payments that the GoI had been making to the PA to offset fiscal leakages have ceased during the clearance revenue stand-off, and a more systematic approach to fully eliminate these losses is yet to be adopted.** Efforts should focus on implementing the Paris Protocol's provisions regarding full information sharing on trade that takes place between both parties, including Israeli sales to Gaza. The parties should also reach an agreement regarding the sharing of Allenby bridge exit fees. Talks have been underway for some time between the GoI and the PA to initiate the introduction of bonded warehouses for Palestinian imports and the transfer of some customs authority to the PA over the coming years. The transfer of fuel taxes without the 3 percent handling fee is an encouraging step as this revenue source comprises about a third of total clearance revenues that could be exempted from the clearance process.

30. **The PA is starting to make progress on improving the public financial management (PFM) system.** The PA has a comprehensive PFM strategy, which is now informed by a recently completed PEFA assessment. A World Bank funded project is providing support with a focus on budget execution, reporting and procurement. A highlight is the catch up on implementation of the procurement law with the Higher Council for Public Procurement Policy now resourced, and the new procurement portal operational. Progress has also been made on addressing the major delays in the production and audit of financial statements. The audit of the 2012 financial statements was completed in 2017, and the 2013 financial statements' audit was completed in 2018. The 2014 and 2015 audits will be issued jointly in the coming months, and the 2016 and 2017 financial statements should also be audited jointly in 2019. In line with the PFM strategy progress has been made to improve accounting procedures, and expenditure controls are being strengthened as a step towards a new commitment control system. In addition, the functional design of a new payroll system is complete, and the EU is planning to procure a new system based on the design that will allow the PA to better manage its payroll. A new DFID funded PFM project is also in its inception phase, which will focus on budget management, revenue administration, and improving the policy development / planning processes led from the Prime Minister's Office.

31. **Budget support from donors has significantly declined in recent years and 2019 projections seem to be following the same trend as expected funds remain insufficient to close the large financing gap.** As a share of GDP, budget support has fallen from 32 percent in 2008 to 3.5 percent in 2018 and expected to remain around the same level in 2019.

B. Economic Development

32. **The constraints on movement, access and trade continue to be the main impediment to economic growth in the Palestinian territories.** In particular, Israeli restrictions related to Area C and movement and access restrictions in Gaza represent the biggest challenges to growth, and their removal can generate momentous economic benefits. Nonetheless, progress in easing these constraints has been limited. Area C continues to be mostly off limits for Palestinians and the number of master plans approved by Israel for this Area has not increased since our last reporting. Further progress has been made on the piloting of door to door transport through the West Bank crossings with the initial Hebron pilot being extended to Nablus and Qalquilia regions, however the current scope of this activity remains limited. There has been some easing on the movement of people in and out of Gaza with up to 5000 businessman cards now authorized of which 3500 have been issued. The long list of dual use items key for the development of the economy and whose access is restricted has been updated but not significantly eased. Encouragingly, the GoI has granted one off permits for certain items in recent months, particularly in Gaza. The fishing zone in Gaza has been extended to 15 nautical miles although this is sometimes reduced as a response to security incidents.

33. **At a domestic level, the PA has initiated steps to reduce the cost of doing business and improve the business climate, but these have yet to be fully implemented.** The Ministry of National Economy is consulting with the public on the revised draft of the Companies Law and is aiming to have the new law in place before the end of the year. Once implemented, the new law would enable major improvements in the business environment including positively impacting business start-ups, strengthening the rights of minority shareholders, addressing corporate governance principles, and introducing new provisions related to insolvency. Similarly, a draft competition law has been prepared although it has yet to be introduced. With support from the World Bank, the PA has also updated the Law of Crafts and Industries of 1953 to facilitate business licensing through simplifying the approval process and reducing the cost. The amendments took effect from 1 January 2019 and the focus is now on removing administrative obstacles to faster processing of the licenses. To establish strategic and policy oversight of institutions in land administration, the Cabinet adopted a draft Amendment to the Palestine Land Authority (PLA) Laws. The amendment calls for the establishment of a Board of Directors that would oversee the operations of the PLA and would facilitate increased transparency in the land sector in line with the ongoing reform process. Further, land registration is proceeding well in the West Bank under the mandate and direction of the Land Water Settlement Commission (LWSC) in cooperation with the local government units.

34. **Recent progress in the energy sector has stalled, and more needs to be done.** The interim Power Purchase Agreement (PPA) signed between the GoI and the PA continues to be successfully implemented. Based on this agreement, the Palestinian Electricity Transmission Company (PETL) has started to supply electricity from the Israeli Electricity Company (IEC) through Jenin substation to Northern and Tubas Distribution Companies (NEDCO and TEDCO). The same infrastructure is also allowing PETL to provide solar energy, supplied by two independent power producers (IPPs) in Northern West Bank. PETL is building a good payment record under the interim and solar PPAs. A Revenue Protection Program, along with updated management information systems is being rolled out to the distribution companies in the West Bank and Gaza. PENRA is implementing reform measures that are starting to improve collection and payment related performance. However, improvements in the sector are being hampered by lack of progress in other areas. Most importantly, negotiations on the main PPA for electricity purchases by PETL from the IEC have stalled over multiple issues, including institutional arrangements with PETL, settlement of the Jerusalem District Electricity Company (JDECO) debt, which is continuing to increase, and access to the electricity infrastructure in Area C. Diversification of electricity supply from other neighboring countries and distribution grid reinforcements are needed to enable stable supply, but are hindered primarily by problems of land access. Restrictions of access and construction in Area C are major obstacles to strengthening the energy supply and sustainability through renewable IPPs and interconnections. Most urgent, though, is the need to pursue a comprehensive energy strategy for Gaza to enable increased supply, improved operations and institutional reforms. This requires coordinated efforts and support by all parties as a priority measure.

C. Gaza Reconstruction and Recovery

35. **Most physical damages after the last Gaza war have been fixed, except for housing, but recovery needs remain large and the shortfall of donor funds pledged at the Cairo Conference is unlikely to be further reduced.** Good progress has been made in most sectors, with physical damages repaired. However, the lion share of fully damaged houses is yet to be replaced and recovery needs that go beyond physical destruction remain enormous. Despite some progress in accelerating materials entry through the Gaza Reconstruction Mechanism (GRM), materials remain in short supply and long delays in approval and delivery prevail, particularly for more complex infrastructure projects.

Table 3: Summary of World Bank recommendations to AHLC meetings

Actions	Responsible Party	Progress as of Sept 2016	Progress as of Sept 2019
<u>FISCAL SUSTAINABILITY</u>			
Expenditures			
Control the oversized wage bill	PA		
Control medical referrals to Israel	PA		
Control medical referrals to local facilities	PA		
Implement administrative reforms for the pension system	PA		
Implement parametric reforms to restore the pension system's sustainability	PA		
Reduce the size of net lending	PA		
Revenues			
Enhance the PA's tax effectiveness in Gaza	PA		
Increase the number of registered large taxpayers	PA		
Strengthen legislation to penalize non-compliant taxpayers	PA		
Revise government fees and charges upwards	PA		
Transfer to the PA fiscal losses accumulated over the years	GoI		
Implement institutional measures to reduce fiscal losses on clearance revenues	PA and GoI		
Public Financial Management			
Improve budget preparation procedures	PA		
Align budget execution with available resources	PA		
Clear the backlog of outstanding financial statements 2012-2015	PA		
Develop systems for monitoring and reporting expenditure arrears	PA		
Budget support			
Provide sizeable, predictable and timely support to the PA's budget	Donors		
<u>ECONOMIC DEVELOPMENT</u>			
Area C			
Expand spatial plans for Palestinian villages in Area C	GoI		
Increase number of building permits approved in Area C	GoI		
Grant approval to Palestinian business projects in Area C	GoI		
The Gaza economy			
Allow exports out of Gaza to reach pre-2007 level	GoI		
Significantly reduce items on restricted dual use list for Gaza	GoI		
Create a unified legal system in the West Bank and Gaza	PA		
The business climate			
Adopt the Secured Transactions Law & establish a movable asset registry	PA		

Actions	Responsible Party	Progress as of Sept 2016	Progress as of Sept 2019
Adopt the new Companies Law & the Competition Law	PA		
Accelerate land registration in Areas A and B	PA		
Improve access to finance for SMEs	PA		
Reform the education system to bridge gap between graduates' skills and labor market needs	PA		
Securing energy for development			
Sign an interim PPA to energize the Jenin substation	GoI and PA		
PETL operating on commercial basis	PA		
Diversify electricity supply	GoI and PA		
Access to dual use items			
Making the process to import dual use goods more transparent	GoI		
Allow access to potent fertilizers in the West Bank	GoI		
Facilitate access to machinery in the West Bank	GoI		
Adopt a risk-based approach in the West Bank and Gaza to control Dual use items	GoI		
Meet international standards for controlling and regulating dual use goods	GoI and PA		
GAZA RECONSTRUCTION AND RECOVERY			
Complete a DNA to guide reconstruction and recovery	PA		
Accelerate disbursements of Cairo Conference pledges	Donors		
Establish and monitor time line indicators for review and approval of dual use items	GoI		
Include delivery monitoring in GRM system	GoI and PA		
Set-up results-based tracking program to monitor recovery	PA		
Establish Gaza import mechanism able to handle long-term recovery needs	GoI and PA		
Strengthen NORG (National Office for the Reconstruction of Gaza) and institutional structure for cross-sector coordination of decentralized recovery planning	PA		
Gaza Development[10]			
Streamline trade procedures at commercial crossing and expand capacity	GoI		
Expand Gaza's fishing zone	GoI		
Implement donor-financed labor-intensive projects	PA, GoI, donors		

Legend

- On track
- Some progress achieved
- No progress

[10] These are additional recommendations that were made in the World Bank's March 2018 report to the AHLC.