# Economic Developments in the Palestinian territories

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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 |
| FATF | Financial Action Task Force |
| GDP | Gross Domestic Product |
| GoI | Government of Israel |
| IEC | Israeli Electric Corporation |
| JDECO | Jerusalem District Electricity Company |
| LGUs | Local Government Units |
| MENA | Middle East and North Africa |
| LTD | Loan to Deposit |
| MENAFATF | Middle East and North Africa Financial Action Task Force |
| MFIs | Microfinance Institutions |
| MoF | Ministry of Finance |
| MTO | Money Transfer Operators |
| NPL | Non-Performing Loans |
| PA | Palestinian Authority |
| PCBS | Palestinian Central Bureau of Statistics |
| PCMA | Palestinian Capital Markets Authority |
| PIF | Palestine Investment Fund |
| PMA | Palestine Monetary Authority |
| PoS | Point of Sale |
| PSP | Payment Service Providers |
| SMEs | Small-Medium Enterprises |

# 1. Economic Activity

1. **The COVID-19 crisis impacted an economy already weakened by three years of low economic growth, high unemployment, and persistent fiscal deficits, resulting in a sharp decline in economic activity in the Palestinian territories in 2020.** Despite taking early necessary measures to contain the spread of the pandemic, a second wave of the epidemic returned by the beginning of July, forcing partial reintroduction of measures to restrict movement. The Palestinian economy has been in a very difficult situation in 2020 facing triple crises reinforcing each other: i) a resurgent COVID-19 outbreak, ii) a severe economic slowdown, and iii) a political standoff with the Government of Israel that disrupted clearance revenues for over six months (May-November 2020). For 2020, it is projected that the COVID-19 crisis will have a substantial negative impact on the economy and the Palestinian people.

2. **Measures to restrict the spread of the novel coronavirus were introduced in March, with full lockdown occurring in April and most of May.** The state of emergency that was declared on March 5 and the resultant closures were effectively ended by May 25, following the end of Eid Al Fitr holiday and the start of the 12th-grade exams on May 30. However, by the end of June, the second wave of the epidemic surged (Figure 1). By the beginning of July, new limited measures restricting movement and activity were reintroduced. Nonetheless, the cases peaked until mid-September and have been increasing in October and November, necessitating recent new measures to limit the spread. A similar pattern of infection rates has been observed in Israel (Figure 2) up until late-September when the government announced a second nation-wide lockdown on September 25, 2020 as Israel recorded some of the highest rates of infection per million people of population in the world. The second lockdown was successful in bringing the new infections down.

**Figure 1: New COVID-19 infections in the Palestinian territories**

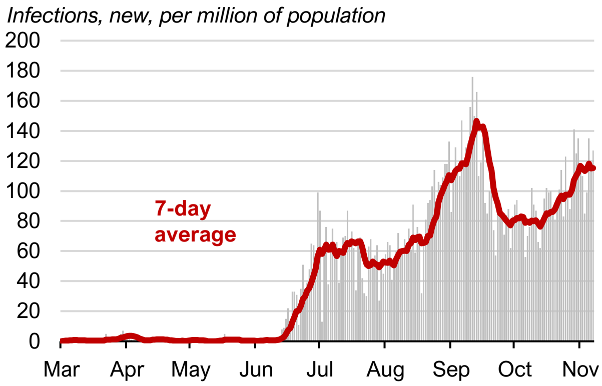
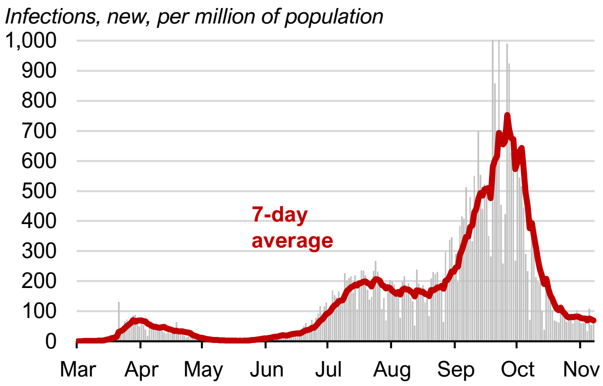



**Figure 2: New COVID-19 infections in Israel**



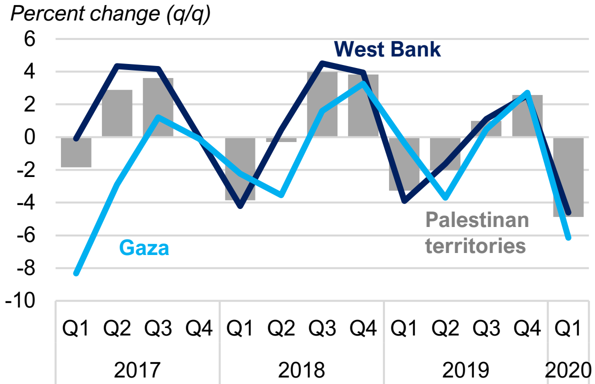

Source: Johns Hopkins University CSEE and World Bank staff calculations.

3. **Economic activity posted a sharp contraction in the first quarter of 2020**. Even though the lockdowns at the start of the pandemic were introduced at the beginning of March, thereby affecting only one month in the first quarter, the declines in activity were rapid and broad (Figure 3). Gross Domestic Product (GDP) for the West Bank and Gaza in the first quarter of 2020 registered a contraction of 4.9 percent compared to the previous quarter (q/q) or 3.4 percent compared to the same quarter of the previous year. All components of GDP declined with public consumption, capital investments, and exports falling the most.

4. **Economic contraction likely deepened further during the second quarter, but activity rebounded partially in the third quarter.** GDP data has not been published for the second and third quarters. However, monthly indicators of economic activity are pointing to a sizable contraction during the second quarter of 2020, linked to the absence of a discretionary fiscal response to mitigate the crisis impact on the private sector, and an improvement in the third quarter.

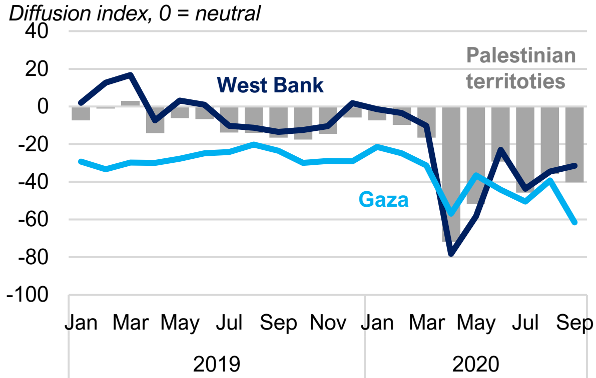
For example, the PMA publishes monthly Business Cycle Index (PMABCI, Figure 4). This index is obtained by surveying a representative sample of businesses on the current conditions in their respective markets.[1] In April, when the index recorded its lowest value, more than two thirds of surveyed firms were completely shut down. The index improved in the subsequent months until July, when the second wave of infections hit, and new, albeit limited, restrictions were announced. Similar movements have been observed in industrial production (Figure 5) and the proportion of returned checks (i.e. the number of checks issued that could not be cleared due to insufficient funds, (Figure 6), where the deepest contractions in economic activity were during the second quarter, followed by an improvement in the third quarter.

**Figure 3: GDP growth in the Palestinian territories**



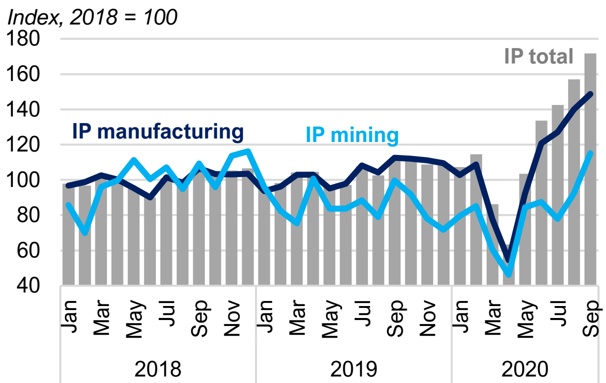

Source: PCBS.

**Figure 4: Business cycle index**



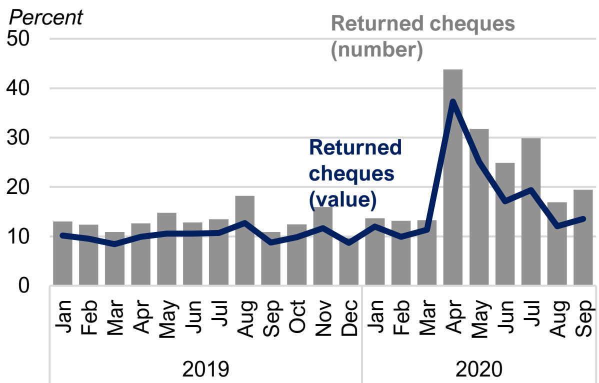

Source: PMA.

**Figure 5: Industrial production index**




Source: PCBS.

**Figure 6: Returned checks as a share of total checks issued**




Source: PMA.

5. **Inflation in the Palestinian territories has turned negative during the second quarter of 2020 reflecting overall weak demand.** Growth in consumer prices had been modest prior to the outbreak of COVID-19, where prices generally moved in the 1-2 percent range. However, since April, growth in prices has turned negative and by September, prices were 1.5 percent lower than in the same month of 2019, reflecting weak demand by consumers. The Israeli Shekel, which is the main currency in circulation in the Palestinian territories, has continued its appreciation and this had a deflationary effect on the prices of imported goods. In addition, the prices of food products (most of which are produced domestically or in Israel) remained stable.

6. **The unemployment rate in the Palestinian territories has increased further as a result of COVID-19.** The unemployment rate rose in the first half of 2019 as a result of the slowdown in the economy resulting from disruptions in clearance revenues, reaching 27 percent. It then eased to 24

[1] PMABCI is represented as a diffusion index, which means that it gives a central tendency within the group of businesses surveyed. A value of 0 indicates unchanged conditions, a positive value indicates improving conditions (up to 100) and a negative value indicates deteriorating conditions (up to -100).

percent in the fourth quarter as the clearance revenue issues were resolved, and economic activity rebounded. However, it deteriorated again in 2020 with the onset of the COVID-19 outbreak. During the peak closures of activity in the second quarter, some 121 thousand people lost their jobs. Of this, some 96 thousand people have lost a job in the Palestinian territories, especially in sectors that have been affected by social distancing measures, such as tourism, restaurants and construction, while some 25 thousand Palestinian workers that cross to Israel lost their job in the second quarter of 2020. The third quarter saw and improvement with some 50 thousand people regaining their jobs. This put the unemployment rate at 28.8 percent at the end of the third quarter of 2020. This headline story, however, masks a regional divergence. In Gaza, 48.5 percent of those in the labor force were unemployed in the third quarter of 2020, while the West Bank recorded an unemployment rate of 18.2 percent during the same time.

7. **The coronavirus pandemic is also expected to result in the largest economic contraction in Israel on record, causing a surge in unemployment and a spike in public borrowing.** Israel's economy is expected to contract in 2020 between 6.2-8.3 percent compared to last year, according to OECD estimates released in June. Unemployment, which was below 4 percent before the onset of the pandemic, could reach 15 percent at the end of 2020, according to a Ministry of Finance forecast. However, with the second wave of the pandemic hampering economic recovery, the unemployment rate was around 22 percent on August 12, according to the National Employment Service. Israel's debt-to-GDP ratio, which was at 60 percent of GDP at the end of 2019, is expected to surge to 76 percent in 2020, according to the Bank of Israel. To counter the adverse effects of the pandemic, the Israeli government has set out a coronavirus rescue package that has ballooned to NIS135 billion ($39.6 billion), according to January-July budget data, from an original NIS80 billion ($23.5 billion) announced in March.

8. **The outlook for the Palestinian economy looks grim especially after the second wave of the COVID-19 outbreak.** Following two challenging years, the Bank's initial estimate for 2020 was for growth of the Palestinian economy to recover and average about 2.5 percent in 2020. From early March until about mid-May, the PA imposed a strict lockdown to combat the spread of the pandemic. While this was successful in keeping the numbers of new infections low, the outbreak of infections returned in July. While some measures to curb movement and gatherings were reintroduced, the great majority of activity remains open. Assuming that the lockdowns remain limited for the rest of the year, we can expect that the severe contraction in the first and second quarters of 2020 will likely improve in the second half, but it would not be enough to offset the losses in the first half. Consequently, GDP for the entire year is expected to contract by about 8 percent. A modest bounce back is expected in 2021 with growth returning to about 2.5 percent, as the daily number of infections stabilizes in the first half of 2021, owing to a combination of voluntary social distancing and widespread pandemic-control policies. Consumer and business confidence are expected to improve on the assumption of vaccine roll out in the second half of 2021.

9. **Poverty has been adversely affected by the slow growth over the last few years as well.** Based on latest available data, 22 percent of Palestinians lived below the US$5.5 2011 PPP a day poverty line in 2016/17. Projections based on GDP per capita growth indicate that the poverty rate is constantly increasing since. It is estimated at 24 percent for 2018 and 27.5 percent for 2020, an increase of 5.5 percentage points in the last four years.

**Table 1: Palestinian territories: Selected Macroeconomic Indicators**

| | | | | Est. | Forecast | | |
|---|---|---|---|---|---|---|---|
| | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** |
| **Real economy, annual percent change, unless indicated otherwise** | | | | | | | |
| Nominal GDP | 10.3 | 4.7 | 0.9 | 4.8 | -8.5 | 2.4 | 2.1 |
| Real GDP | 8.9 | 1.4 | 1.2 | 0.9 | -7.9 | 2.3 | 2.4 |
| GDP per capita (nominal) | 7.1 | 1.9 | -1.7 | 2.1 | -10.8 | -0.2 | -0.7 |
| | | | | | | | |
| Contributions to Real GDP Growth | | | | | | | |
| Private Consumption (growth) | 9.9 | -1.1 | 1.1 | 4.2 | -7.0 | 2.4 | 2.5 |
| Gross Fixed Investment (growth) | 10.9 | 6.9 | 2.5 | -1.9 | -13.0 | 5.0 | 1.7 |
| Exports (growth) | -1.6 | 13.9 | 2.5 | 1.8 | -15.0 | 3.8 | 1.5 |
| Imports (growth) | 2.0 | 1.3 | 4.5 | 1.4 | -8.5 | 5.6 | 2.1 |
| | | | | | | | |
| Unemployment Rate (ILO Definition) | 26.9 | 25.7 | 26.2 | 24.0 | 27.8 | 27.6 | 27.5 |
| | | | | | | | |
| GDP Deflator | 1.3 | 3.2 | -0.3 | 3.8 | -0.7 | 0.1 | -0.3 |
| CPI (year-average) | -1.0 | 0.0 | 1.2 | 0.8 | -1.0 | 0.7 | 0.9 |
| | | | | | | | |
| **Balance of Payments, percent of GDP unless indicated otherwise** | | | | | | | |
| Current Account Balance | -12.6 | -9.7 | -10.2 | -8.7 | -9.3 | -10.1 | -10.1 |
| Imports, Goods and Services | 49.5 | 50.0 | 53.6 | 52.2 | 50.1 | 52.3 | 53.4 |
| Exports, Goods and Services | 15.5 | 16.7 | 17.8 | 17.5 | 16.1 | 16.6 | 16.8 |
| Net Foreign Direct Investment | -2.2 | -1.4 | -1.4 | -0.8 | -0.8 | -0.8 | -0.8 |
| Gross Reserves | 2.0 | 2.8 | 3.3 | 3.3 | 3.9 | 3.8 | 3.7 |
| External Government Debt | 6.8 | 6.5 | 6.3 | 7.8 | 8.5 | 8.3 | 8.2 |
| Terms of Trade (growth) | -1.0 | -5.4 | -1.6 | 9.9 | 3.1 | 0.7 | -0.2 |
| | | | | | | | |
| **Memorandum items:** | | | | | | | |
| GDP nominal (US$ million) | 15,405 | 16,128 | 16,277 | 17,059 | 15,612 | 15,983 | 16,311 |

Source: PCBS for historical data and World Bank for forecast.

# 2. Public Finance

## A. Fiscal performance January – September 2020

10. **Fiscal revenues declined more than attributable to the COVID-19 economic slowdown due to the suspension of coordination with the Government of Israel (GoI).** This suspension, which started on May 19, 2020 in response to Israel's proposed annexation plan for parts of the West Bank, compounded the impact of the COVID-19 crisis on the PA's fiscal situation as clearance revenues constitute more than two thirds of public revenue. After more than six months, on November 17, the PA announced its decision to resume all levels of coordination with the GoI, including on clearance revenues. It is estimated that NIS3.1 billion (US$890 million) of revenues have accumulated with the GoI over the period and their flow is expected to significantly ease the PA's fiscal stress.

11. **Domestic revenue dropped by 10 percent, on a commitment basis, in the first nine months of 2020, year-on-year.** The drop was mostly due to a decline in collections from all major domestic tax items including income tax and VAT by 14 and 5 percent, respectively, as a result of the overall economic slowdown. Interestingly, domestic collections from tobacco excise increased by a third during the same period as the closure of the border with Jordan has eliminated tobacco smuggling, resulting in higher public revenues. The increase in this item, however, was not enough to offset the deterioration in other domestic taxes. The performance of nontax revenues in the first nine months of 2020 was very weak with a 17 percent year-on-year drop due to a decline in the collection of fees and charges given the overall economic slowdown.

12. **Clearance revenue receipts were affected by political developments limiting the response to the crisis and worsening the fiscal situation.** The impact of the COVID-19 economic slowdown on clearance revenues was less than its impact on domestic collections, implying a limited decline in Palestinian trade during the first nine months of 2020. In fact, the year-on-year drop in clearance revenues was limited to 3.6 percent, on a commitment basis.[2] However, actual clearance revenues received during the first nine months of 2020 were much lower than the committed amount given the suspension of coordination with the GoI. In fact, on a cash basis, clearance revenues received were only half the committed amount.

13. **The PA's recurrent expenditure was maintained at last year's level—in contrast to the mitigation role for fiscal policy seen in many countries, which would have warranted higher spending.** Despite an increase in some spending items, overall constancy was enabled by a 15 percent drop in spending on goods and services, year-on-year, as a large share of public employees worked from home for several months as part of the national emergency announced to deal with the COVID-19 breakout. On a commitment basis, the wage bill increased by 2.8 percent partly reflecting additional hiring of medical staff. However, cash numbers show a different story as the suspension of clearance revenue receipts in May forced the PA to only pay 50 percent of salaries to its employees in the West Bank and in Gaza while protecting those that make NIS1,750 per month and below.[3] Despite an increase in social and unemployment benefits provided by the PA to families and workers affected by the pandemic, the increase in overall transfers was limited to 1 percent in the first nine months of 2020, year-on-year, due to changes in the accounting methodology used to record civilian and military pensions. In contrast, net lending[4] grew by 9 percent due to an increase in water-related costs as local government units struggled to collect enough revenues to cover utility bills amid the economic crisis and also due to higher lending by the PA to a number of public entities

[2] Figures published by the MoF were amended to provide the analysis on a commitment basis.
[3] The reduction in wage spending is expected to be temporary and reversed once clearance revenue transfers resume.
[4] Net lending represents deductions made by the GoI from clearance revenues to offset utility bills owed by Local Government Units and distribution companies to Israeli suppliers.

in 2020. The PA's development spending on projects dropped by a third in the first nine months of 2020, due to the decision to ration non-core spending as well as having very low external financing for projects. Large cuts in public spending were likely to have negatively impacted economic activity given the existence of large fiscal multipliers. [5]

14. **To maintain core recurrent spending, the PA had to accrue large arrears and increase borrowing from domestic banks.** On a commitment basis, the PA's total deficit amounted to US$804 million in the first nine months of 2020, while aid received was US$380 million. After accounting for the loss in clearance revenues between May and September, the financing gap after aid amounted to US$1.27 billion in the first nine months of 2020. To finance the gap, the PA had to accrue arrears to its employees, private suppliers, and the public pension fund, which have resulted in liquidity constraints. According to data provided by the MoF, the net accumulation of arrears in 2020 reached US$950 million. The PA has also resorted to additional borrowing from the domestic banking sector, raising its stock of debt from US$1.6 billion as of end-2019 to US$2 billion, as of September 2020.

## B. Fiscal Forecast

15. **The COVID-19 crisis is expected to continue to weigh heavily on the PA's finances for the remainder of the year as a large financing gap is expected.** Starting mid-May 2020, the PA has significantly eased lockdowns related to COVID-19, with the exception of limited sectors, enabling economic activity to start recovering. On November 23, additional measures were imposed over the weekends and to limit movement during evening hours. Those are supposed to be for a short period of two weeks. Assuming that the lockdowns remain limited for the rest of the year, allowing domestic revenues to slowly recover, the year-on-year decline in the PA's revenues is expected to be limited to about 7 percent in 2020, especially given the resumption in clearance revenue transfers.[6] Public expenditure is expected to decline by 4 percent as the PA continues to ration non-essential spending including on minor capital, development projects, and some spending on goods and services, while increasing unemployment benefits and social support to needy households. Under these assumptions, the PA's deficit is expected to reach US$1.23 billion, on a commitment basis. The PA has worked diligently with development partners to secure additional external financing in 2020. In fact, aid through the budget is now projected at US$470 million - up from US$377 million stated in the World Bank's report to the June 2020 AHLC meeting. Despite these successful efforts, the amount pledged so far is the lowest in decades. Hence, it will not be enough to cover the deficit, leaving the PA with a large financing gap of about US$760 million in 2020.

[5] 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.

[6] The 2019 clearance revenue figure that was used to calculate the year-on-year change is before the additional unilateral deductions made by the GoI during that year.

**Table 2: Fiscal forecast for the Palestinian Authority's central government operations, 2020**

| US$ million | 2020 Projection |
|---|---|
| Net revenues | 3245.8 |
| Domestic revenues | 1018.4 |
| Clearance revenues | 2336.0 |
| Tax refunds | 108.5 |
| | |
| Total expenditure | 4258.0 |
| Wages and salaries | 1944.7 |
| Social contributions | 192.5 |
| Use of goods and services | 498.4 |
| Transfers | 1187.8 |
| Minor capital | 18.3 |
| Interest | 58.5 |
| Net lending | 357.8 |
| | |
| Recurrent balance | -1012.1 |
| | |
| Development expenditure | 219.2 |
| | |
| Total balance | -1231.3 |
| | |
| External financing | 470.8 |
| Budget support | 384.1 |
| Development financing | 86.8 |
| | |
| Gap | -760.5 |

Source: World Bank staff calculations.

16. **The potential for additional domestic and external borrowing by the PA is limited without raising sustainability and stability concerns.** The PA has already increased its borrowing from domestic banks significantly so far and additional credit should be viewed as a last resort given that the banking sector is already highly exposed to the PA, directly and indirectly. In addition, with banks already liquidity constrained, any borrowing by the PA would crowd out the availability of credit to the private sector. Alternative options for concessional finance from other sovereigns or Development Finance Institutions could be explored but the impact of these loans on public sustainability needs to be carefully considered.

17. **This leaves grants from the donor community as the least encumbered source of additional finance, although most likely significantly limited given the new realities created by the global pandemic**. The traditional donors are proposing to provide US$470 million, as mentioned above. Efforts are being made to increase the overall resources available, and to reallocate from projects to budget support. But these resources would only make a partial contribution to the gap, especially as shifting from project to budget support will not increase the overall funding envelope. Substantial increases in support from outside this group will be important if the donor community is to make a significant contribution to closing the financing gap.

18. **The GoI could be a major stakeholder with potential to increase its contribution, especially now as coordination between both parties has been resumed**. If progress on this front materializes, this would ease some of the fiscal stress. This would also enable the activation of the clearance revenue agreement that was reached between the parties earlier in the year and which requires the GoI to disburse to the PA a loan of NIS800 million (US$230 million) in clearance revenue advances.[7] In addition, there are outstanding tax claims from the PA that, if resolved, would make an important contribution.[8] The PA and GoI have been diligent over the past couple of years

[7] According to the agreement, the loan will be provided at a 1 percent interest rate and in monthly installments to top up actual earnings of clearance revenues by the PA and maintain a floor of US$143 million. The monthly top-ups will take place until the loan is fully used, or for four months, whichever comes first.
[8] For more information, see: http://documents.worldbank.org/curated/en/780371468179658043/main-report

in trying to resolve some of these outstanding files through MoF-to-MoF meetings. Now that coordination has been resumed, it is possible for additional discussions to take place.

19. **The PA will confront difficult decisions if the GoI and the donor community cannot collectively provide the needed resources.** In this scenario, the PA will be forced to further cut spending impacting basic service delivery and resulting in a much deeper economic contraction than discussed above with severe negative social consequences for the Palestinian people. Lack of additional financing would also force the PA to scale back medical and social expenditures in response to the crisis, thereby increasing the hardship. Neither option is desirable and will have severe implications for the livelihoods of vulnerable households, the depth of the recession, and the speed with which the economy will emerge from the impact of Covid-19. The extent of the economic malaise that results would increase the demands for future support but could also raise broader security and operational challenges.

## C. Clearance Revenues: A Potential Stabilizer for the Palestinian Economy?

20. **Revenue sharing arrangements between the GoI and the PA were instituted by the Paris Protocol.** The Protocol was signed on April 29, 1994[9] and it regulates economic relations between the GoI and the PA. It established a quasi-customs union[10] between Israel and the West Bank and Gaza whereby the two parties apply the same tariff policy on trade with third countries[11] and maintain free trade in all goods between them.12 Since the PA's customs officials are not present at the points of entry, the Protocol defined specific arrangements through which the GoI collects import taxes on Palestinian trade with third countries and shares them with the PA. The Protocol also sets up a mechanism for the collection of indirect taxes (VAT) on bilateral trade between the PA and the GoI. The Protocol provides that both parties shall maintain a normal movement of labor between them and it introduced provisions to regulate the transfer of fees collected by the GoI from Palestinian workers in Israel. Revenues collected by the GoI on behalf of the PA including import taxes, VAT on bilateral trade and revenues collected from Palestinian workers constitute the bulk of the so-called clearance revenues.

21. **Clearance revenues are a key source of public revenues and they play a key role in the sustainability of public spending and, hence, in the stability of economic conditions in the Palestinian territories.** Clearance revenues have grown faster than domestic revenues since the early years of the PA. According to data published by the PA's MoF, domestic revenues have remained almost constant as a share of GDP at around 8-9 percent between 1996 and 2019 while clearance revenues grew from 10 to 14 percent. As a result, clearance revenues currently comprise more than two thirds of the PA's total revenue and cover more than 50 percent of its spending. The PA is highly dependent on clearance revenues to cover wage and other recurrent spending. Any shock to these revenues adversely affects not only the PA's finances, but also economic output, given their relative size in the economy, Research has shown that countries in MENA with high unemployment, fixed exchange rates, and low trade-to-GDP ratios—all a characteristic of the Palestinian economy—have large fiscal multipliers, implying that exogenous reductions in public spending has a large and negative impacts on output.[13] Even though a quantitate value for the fiscal multiplier in the Palestinian territories is not available, data from 2019 show that the suspension of

[9] In 1995, the Protocol was slightly amended and incorporated as Annex V to the 1995 Interim Agreement on the West Bank and the Gaza Strip.

[10] The GoI refers to it as a customs "envelope".

[11] An exception to this general rule applies to goods on the A1 and A2 lists for which the PA can define an independent import policy (including the rate of import taxes, standards, licensing and other regulations) and to the goods on list B for which the PA can define the rate of import taxes.

[12] The Protocol also enabled free trade in some services including banking (Art IV), tourism (Art X) and insurance (Art XI).

[13] See Lederman D. and Rojas, C., 2018. "On the International Heterogeneity of Fiscal Multipliers," *mimeo*, Office of MNA Chief Economist.

clearance revenues for 6 months during that year resulted in a reduction in GDP growth to 0.9 percent down from 1.9 percent projected by the Bank in scenario where the revenues continued to flow without interruptions.

22. **Given the role that clearance revenues play in the Palestinian economy, ensuring their uninterrupted flow is a key prerequisite for reducing volatility and maintaining economic stability**. According to the Paris protocol, the GoI should collect these revenues on behalf of the PA and transfer them on a monthly basis. However, over the years, the flow of these revenues has been interrupted more than ten different times. For example, in 2011 the GoI delayed the transfer of clearance revenues in response to the signing of the reconciliation agreement between Fatah and Hamas.[14] In November 2012, the GoI withheld the transfer of clearance revenues to clear electricity arrears owed by the Jerusalem District Electricity Company (JDECO) to the Israeli Electric Corporation (IEC). In 2019, the GoI started making additional deductions from clearance revenues to offset payments made by the PA to Palestinian prisoners in Israeli prisons which prompted the PA to stop accepting these revenues for several months. Most recently, as an act of defiance to the announcement by the GoI to annex parts of the West Bank, the PA has refused to accept clearance revenues since May 2020. Besides interruptions, clearance revenues have been subject to recurring deductions for unpaid utility bills of municipalities (the "net lending" issue) and to cover other costs assessed by GoI, for example for healthcare provision. Notably, these costs are not under the direct control of the PA, but their budget is affected by them.

23. **Each time the flow of clearance revenues has been interrupted, public spending was abruptly curtailed, adversely affecting the Palestinian economy and resulting in economic hardship to the population through increased unemployment and poverty.** Consequently, ringfencing these revenues from political developments and reducing fiscal losses would directly reduce economic volatility and improve outcomes for the population. The following are recommendations that could achieve this objective and that both parties could benefit from:

    i. **Establishing an e-VAT clearance system.** The Palestinian and Israeli authorities both suffer from fiscal leakages on bilateral trade because the currently used paper-based system allows for underreporting and fraud. The Paris protocol clearly allows the parties to replace the paper-based system with an "interconnected computer system for tax rebates to dealers and for VAT clearance between the two sides".[15] This system will allow both parties to share real time data on transactions taking place between traders, which has the potential to significantly reduce revenue losses. The parties are advised to start carrying out technical work to identify gaps that need to be filled to ensure that both systems are ready to be electronically linked. In the meantime, while the link between both systems is being established, each party is advised to "provide the other side, upon demand, with invoices for verification purposes." [16] This exchange of information will inform each tax authority about the actual amount of VAT paid by its registered businesses rather than what was reported to it. It will also enable tax officials to go after businesses that do not report their purchases and take legal action against them. Notably, the parties have already implemented a similar arrangement for sharing information on Palestinian imports cleared through Israeli ports, which has helped Palestinian customs combat undervaluation of Palestinian imports from third countries. Expanding the already-existing arrangement to include data on bilateral trade could generate similar benefits for both parties.

    ii. **Transferring customs responsibilities to the PA and establishing Palestinian bonded warehouses.** During the past two years, a number of meetings between the Palestinian and Israeli Ministries of Finance have resulted in a draft MoU on the transfer of customs responsibility from the GoI to the PA, signaling a positive outlook towards this issue from both sides. Nonetheless, a number of contentious issues remained, including the type of goods that

[14] IMF. West Bank and Gaza: recent developments in Clearance Revenues. October 2011.
[15] See article VI paragraph 9 of the protocol on economic relations.
[16] Article VI (6) and (10) of the Paris Protocol on information sharing.

would be subject to the transfer of responsibilities, specifically cigarettes, tobacco and alcohol, the scope of the transfer of responsibilities, and the number and location of the customs transfer points to be established. On the PA side, assessments of the existing legal framework and customs capacity have shown that despite recent improvements, more efforts are needed to successfully implement the transfer of authorities. For example, the PA is still operating under a customs law from 1962, which needs to be amended to further regulate the processes for clearance, valuation, collection, risk management, and post-audit. The law also needs to cover the work of customs brokers and bonded warehouses, especially given their centrality to the transfer of authorities. The PA has recently made progress with the finalization of a first draft of proposed legal amendments to the customs law. Once ratified, this will create a sound legal framework for the PA to assume this responsibility.[17]

iii. **Transferring VAT on bilateral trade with Gaza to the PA**. The PA rarely receives information on purchases made by Gaza businesses from Israel because its tax officials have not operated in the Strip since the internal divide. Hence, the PA has been unable to claim VAT on the majority of these imports, since 2007. Given that the GoI controls and approves the entry of all Israeli goods that physically enter Gaza (the Israeli border with Gaza is completely sealed and there is only one commercial crossing, Karem Abu Salem, controlled by Israeli officials), it should be in a position to estimate and transfer to the PA VAT collected on bilateral trade with Gaza. As a next step, PA officials could be present at Karem Abu Salem to collect trade invoices and formalize their claims for VAT returns.

iv. **Establishing greater transparency regarding deductions from clearance revenues**. During recent years, the PA has faced challenges reconciling Israeli deductions from clearance revenues with actual expenditures made by Local Government Units (LGU) on energy, water, wastewater and health services provided by Israeli suppliers. Discrepancies have widened over the years creating the need for a mechanism that would reconcile data provided by LGUs on units consumed and that allows for the verification of billing by Israeli providers on an ongoing basis.

v. **Renegotiating the handling fee charged by the GoI to handle Palestinian imports.** In 1995, the parties agreed that for the GoI to cover its administrative costs in collecting import taxes and VAT on Palestinian trade, it will deduct 3 percent from these revenues before it transfers them to the PA[18]. Given the size of Palestinian trade in 1995, the fee was considered acceptable for both parties. However, Palestinian imports have almost tripled over the last twenty years, and even though costs borne by the GoI to handle these imports have understandably increased, fees collected have been higher than needed to recover the costs. Estimates show that the fee is significantly high as it exceeds costs endured by the GoI to handle Palestinian imports and it should be significantly reduced. Reducing the handling fee will result in additional revenues for the PA.

vi. **Exempting the PA's fuel imports from taxes.** According to the Protocol, fuel imported by the PA should be of specific standards that are not met by fuel produced by regional countries. As a result, the PA purchases all its fuel from Israeli companies on which it pays all applicable taxes. These taxes are then remitted to the PA after 45 days, as part of the clearance process, minus the 3 percent handling fee. Discussions were held between the parties in 2019 to allow the PA to purchase fuel without embedded taxes as this would help maintain the financial liquidity of the PA. This adjustment was actually applied on a one-off basis to a single transfer in 2019 and it is advised that the parties reach a long-term agreement on this issue. Further, the PA could consider eliminating the subsidy on the retail price of fuel that it provides which averaged 0.6 percent of GDP in recent years.

[17] Office if the Quartet Report to the Ad Hoc Liaison Committee, September 2019.

[18] Paragraph 4 of the supplement to the Protocol on Economic relations, Annex V of the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip signed on September 28, 1995.

vii. **Exit fees collected at the Allenby Bridge should be allocated between the parties according to the shares specified in the Paris protocol.** Also, the amount of fee should be agreed upon between both parties. Fees should be shared between the PA and the GoI on a 46/54 basis for the first 750 thousand passengers, and on a 62/38 basis for each passenger, thereafter, as required by the protocol. The GoI should remit to the PA its full share from previously collected funds according to the above-mentioned sharing arrangement, and future transfers should be made on a regular basis.

# 3. Money and Banking

24. **The COVID-19 crisis has further compounded financial sector risks, driving stability concerns to new highs.** The Palestinian financial sector entered the COVID-19 crisis with already limited liquidity or capital buffers and significant vulnerabilities due to the 2019 clearance revenue standoff. This pre-existing level of stress means that it has limited ability to absorb large shocks or play alone a significant counter-cyclical role, creating a challenge for the authorities when managing the financial implications of this crisis – especially given the lack of control of the monetary base. It also reinforces the importance of more effective coordination between the PA, the PMA, and the financial industry to conduct fact-based analysis of the impact of the crisis and of measures already adopted to assist banks and firms through the financial sector. On that basis, the authorities and the industry would then be in a better position to mobilize as effectively as possible limited resources for impact and targeting.

25. **Policies to mitigate the financial impact of COVID-19 need to be targeted, well-designed, maintain sound prudential regulations, and ensure trust and confidence in the banking system.** The four- and six-month moratoriums on credit repayment announced in March 2020 by the PMA, and the temporary suspension of the classification of bad checks, had the advantage of providing fast relief. They are also extraordinary measures that do not discriminate between impacted and non-impacted borrowers and can increase credit risk going forward. The downside risk is also an unintended decline in new lending to truly distressed or recovering solvent enterprises. This is especially relevant in the Palestinian context, given the increase in Loan-to-Deposit Ratio over recent years (reaching 70 percent in September 2020), raising liquidity concerns and hampering the ability of banks to continue serving the financial needs of the public and private sectors.

26. **In an attempt to partially mitigate the economic implications of the pandemic and inject additional liquidity, the PMA launched an SME-focused COVID-19 response program, Istidama (Sustainability).** The program aims to inject low-cost financing into the market using existing bank channels, targeting "borrowers who have been directly affected by the current economic situation only".[19] The success of the program hinges on (among other things) take-up by financial intermediaries and the perceived risk-reward calculation of participating banks (taking into account the cap on interest rate, and level of credit-risk within the targeted sectors).

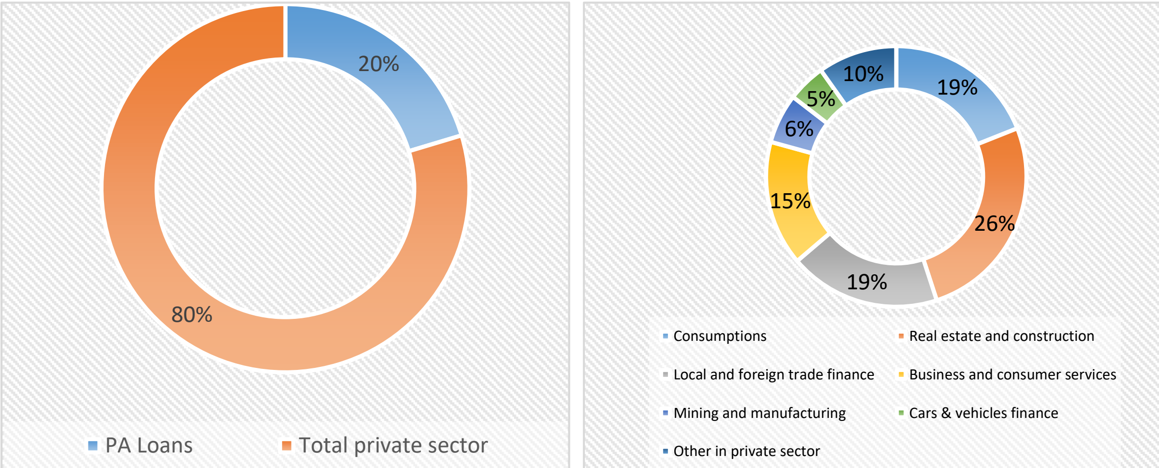
27. **Credit guarantees should be considered complementary to prudential and stability measures.** In addition to direct lending, credit guarantees are a crucial and customizable instrument that should be further used to direct financial sector support in response to the current crisis. Partial credit guarantees are not new to the Palestinian market, and some adjustments to existing schemes have been implemented as a COVID-19 response window by the PA and donors. Expanding the role of existing partial credit guarantees serves both the immediate need to inject additional liquidity to MSMEs, and the longer-term recovery needs of distressed borrowers. That being said, the use of robust credit guarantees should be reflected in the PMA's and PCMA's prudential and risk requirements (e.g. with regards to provisioning). Special consideration should be given to use across different financial intermediaries (e.g. microfinance institutions and non-bank financial institutions such as leasing).

28. **The impact so far of the protracted shocks in 2020 have a clear and increasing effect on the performance of the Palestinian financial sector, composed primarily of traditional banking activities.** According to reporting by the PMA through September 2020 (latest data available), the profitability of the sector declined significantly to the lowest in recent years, primarily due to a sharp increase in provisions. Net income reported in Q3 represents a 36 percent decline when

[19] https://www.pma.ps/en/Media/Press-Releases/palestine-monetary-authority-issues-instructions-to-mitigate-the-effects-of-covid-19-crisis

compared to 2019. Return on equity dropped to 4 percent compared to 8.3 (2019) and 9.4 (2018); return on assets dropped below the 0.5 percent mark, reaching 0.45 percent compared to 0.95 (2019) and 1.15 (2018). Bank deposits and direct credits grew by 8 and 10 percent respectively, resulting in no significant changes to the credit-to-deposit ratio of 70 percent. A review of credit exposure to the private sector indicates unchanged sectoral concentration, with two thirds of all private lending going to construction, trade finance, or consumer loans.

**Figure 7: Distribution of credit by sector (left) and by economic activity in the private sector (right)**

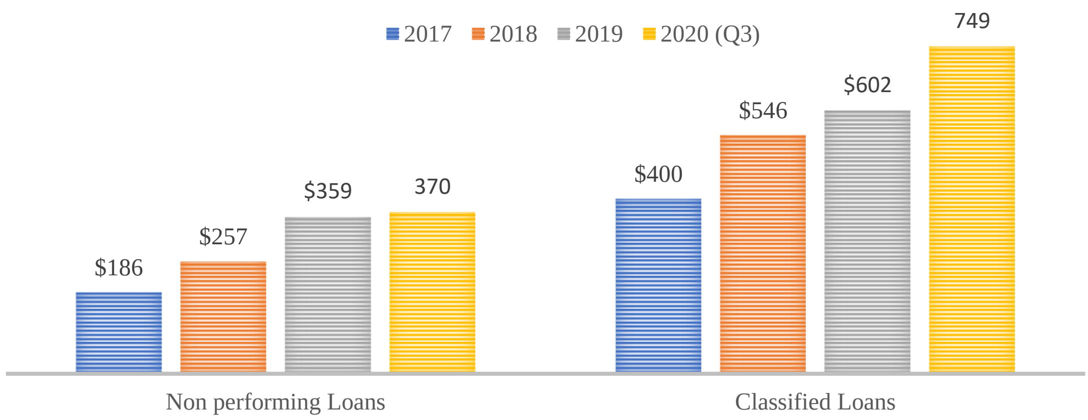


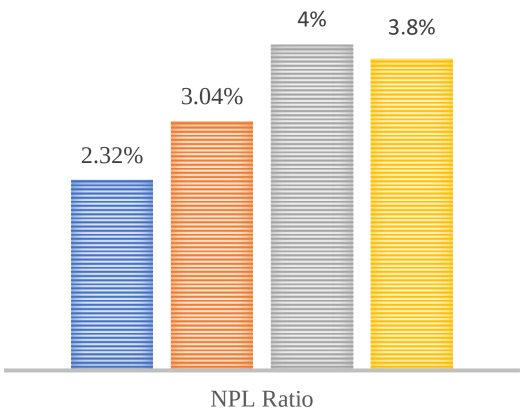

Source: Palestine Monetary Authority.[20]

29. **The impact of COVID-19 on the economy and the PA's decision to only pay partial salaries has deteriorated the quality of loan portfolios across the banking, and further deterioration is likely.** Both non-performing loans (NPLs) and classified loans have maintained an upwards trajectory from 2018. The NPL ratio (which represents the percentage of nonperforming loans out of all direct loans and is a lagging indicator) stands at approximately 4 percent as of September 30, 2020. While this NPL ratio appears manageable given the context, discussions with several local banks indicated that NPLs are concentrated in critical portfolios (e.g. SMEs), and that aggregate NPL indicators are likely underestimated as a result of the COVID-19 moratorium and the subsequent rescheduling of PA employee loans (based on PMA guidance issued in recent years). The expected further deterioration in the quality of SME and consumer loan portfolios could translate soon in delayed higher NPLs, particularly in banks with substantial exposure to SMEs and PA employees.

[20] According to September 2020 Data.

**Figure 8: Growth in non-performing and classified loans (US$ million & % of gross loans)**




Source: Palestine Monetary Authority.

30. **The PA borrowing practices from the local banking sector to finance fiscal imbalances, and the disruption in clearance revenues for more than 6 months in 2020, may generate new risks.** Following a few years of relative stability in PA borrowing (about US$ 1.3-1.4 billion), the banking system's exposure to the public sector (through domestic public debt) registered an increase in 2020, exceeding US$ 2 billion as of September 2020. With declining revenues due to COVID-19 implications and clearance revenue transfer issues, the PA has significantly increased borrowing from domestic banks, exceeding bank exposure limits set by the PMA. Borrowing by PA employees also represents an indirect channel of exposure to the public sector, reaching US$1.7 billion by September 2020. When combined, PA and public employees account for US$3.7 billion, or 38 percent of total banking sector credits.

31. **Palestinian policymakers must carefully balance fiscal, monetary, and financial considerations and interrelations.** The independence of the PMA, as supervisor and prudential regulator of the banking system, should be respected and upheld especially during times of crisis. The rising direct and indirect exposure of the banking system to the PA continues to pose a significant risk to financial sector stability, and potentially crowds out private sector borrowing. 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, exceeding PMA set limits on multiple occasions. With banks already constrained by growing credit risks and potentially liquidity problems, additional borrowing by the PA may also crowd-out private sector borrowers impacted by COVID-19 implications.

32. **The PMA and Financial Follow-up[21] Unit have been taking steps toward upgrading the Palestinian anti-money laundering and combating financing of terrorism (AML/CFT) system to be more in line with international practices.** The authorities have been making steady progress toward upgrading integrity standards across the financial sector. In 2018, the local authorities conducted their first self-assessment with the aim of enhancing the ability of relevant AML/CFT stakeholders to identify, assess, understand, and mitigate the money laundering and terrorism financing risks they face. The assessment was officially endorsed by the Palestinian Cabinet in October 2018, followed by the adoption of the national AML/CFT strategy by the Cabinet in November 2018. In 2019, the PMA's Inspection and Supervision Department issued instructions (15/2019) and circular (74/2019) setting requirements for banks to maintain adequate policies and procedures to prevent the abuse of financial services, and instructing banks to implement strengthened Risk Based internal controls in accordance with the national AML/CFT strategy. Other improvements on AML/CFT internal controls that are currently under implementation include reforms to governance and reporting procedures. This represents a step towards the commitment to, and implementation of, the Financial Action Task Force (FATF) AML/CFT standard conditions of membership to the MENAFATF. MENAFATF's first mutual evaluation of West Bank and Gaza is planned for 2020.[22]

## A. New Drivers of Growth for Financial Sector Development

33. **A large increase in bank credit has been one of the main drivers of economic growth over the past decade.** Despite efforts to diversify the financial system, banks still controlled 94 percent of financial assets at end-2018. Three banking groups (two domestic and one from Jordan) dominate the market. Banks have dramatically shifted their business models over the past decade, resulting in a near doubling of the ratio of credit to GDP (53 percent in 2019 compared to 26 percent in 2009). Such achievements were fostered by improvements in financial infrastructure and supportive policies, and overwhelmingly benefited the private sector, driving economic growth (while other factors explain a slowdown in economic growth, it would have been much lower without such progress in credit availability).

34. **There remain large unmet needs for financial services, as illustrated by low financial inclusion figures, and new drivers for financial development need to be identified.** Only a quarter of the population above the age of 15 has a basic bank or payment account.[23] SME, housing and long-term finance are in short supply, and cash and checks still play an essential role (due to an insufficient development of digital finance, see below). Credit growth was made possible by leveraging the ample deposits available but not used in the local economy, as shown by an increase in the loan to deposit (LTD) ratio (from a low of 29 percent in 2012 up to 70 percent in 2020). There has simultaneously been a decline in the share of FX assets placed abroad, reducing banks' liquidity buffers (an issue compounded by a growing share of medium-term placements and investments which are not immediately liquid, as well as large NIS cash holdings which are currently difficult to repatriate with Israeli correspondent banks). As a result, liquidity buffers sharply declined, and a large share of deposits are now backed by claims on the local economy rather than liquid placements with correspondent banks. In an environment without a local currency, with a limited lender of last resort function and no liquid domestic markets, it is unlikely that additional large increases in the LTD could be the main driver of future improvements in credit availability, without generating excessive risks.

35. **System-wide efforts are needed in the financial sector**. First, there is a need to improve payment systems and digital finance (see detailed recommendations below) – and strengthen the financial infrastructure - including insolvency and creditors' rights frameworks, which remain legally complex and outdated, and lack the necessary supporting services (e.g. insolvency practitioners).

[21] This corresponds to the Palestinian Financial Intelligence Unit.
[22] Delayed due to travel restrictions related to COVID-19.
[23] Findex 2017.

In addition, the sector needs to be enabled to deal with corporate restructuring. Finally, initiatives to support bank intermediation and financial diversification and broadening could be implemented, including the recently adopted financial inclusion strategy and priorities highlighted below to strengthen SME, housing, and long-term finance.

36. **Financial stability requires immediate attention to preserve recent gains in financial intermediation, considering the potential impact of COVID-19 (even if large banks entered the crisis with significant buffers).** Although declining, the Tier 1 capital ratio still stands a 14.3 percent at end-2019 (well-above the minimum of 8.5 percent - including a 2.5 percent capital conservation buffer - recommended by the international Basel III agreement for non-systematically important banks) and liquid assets represent more than a third of total assets. Moreover, the main banks have repeatedly demonstrated their ability to weather large shocks (and provide some countercyclical support) and the PMA has strengthened its financial oversight in recent years.

37. **The pandemic, however, not only creates increased financing needs to support the real sector, but also generates new risks.** Experiences globally show the dramatic and long-lasting negative impact a financial crisis could have on post-COVID-19 recovery (with a disproportionate impact on the poor). While the crisis originated outside the financial sector, its impact on the real sector may be larger than past shocks (including because of its global dimension). Moreover, the banking system faces this new shock with much larger credit exposures than in the past -exposing it to credit losses- and lower available liquidity, affecting its ability to swiftly deploy new resources. Preserving financial stability should be on top of policymakers' agendas, requiring close risk oversight (including enhanced supervisory scrutiny), and sound decision making based on technical considerations and free from external influence, as well as realistic expectations from banks in terms of new support (considering limited available room ex ante).

38. **Public efforts to mitigate the impact of the shock and foster new progress need to be realistic and anchored in strong institutional arrangements.** The operational independence, credibility, and professionalism of the PMA will continue to be key assets and should be safeguarded from fiscal related pressures. New policy initiatives should start with a clear diagnostic of binding constraints (e.g. funding or credit risk, uncertainty or increased risk levels etc.), identify possible tools to address such constraints rather than start with institutional arrangements (e.g. setting up a development bank, including in light of poor experience in many developing countries), and ensure strong buy-in from financial institutions.

39. **There is room to further strengthen the environment for MSME finance, including to address some of the potential impacts of the COVID-19 crisis**. Bank credit represents the bulk of MSME financing (9 percent of GDP), but it has increased more slowly than overall credit and microfinance institution (MFIs) lending, which are the main financiers of micro-enterprises. Limited information is, however, available, and a unified SME definition would be useful to collect harmonized information to guide policy making. While real-sector constraints affecting MSME viable credit demand are significant and need to be addressed (including a lack of skills, informality, lack of access to markets etc.), there are also specific bottlenecks affecting credit supply, which tend to grow in times of shock (e.g. banks' funding constraints, crowding-out by the public sector and large companies, high defaults, uncertainty regarding borrowers' viability etc.). Additional efforts to mitigate SME credit risk could start with a structured and thorough review of experiences with donor-funded partial credit guarantee schemes to explore how to strengthen them (including making them operationally much more attractive for financial institutions), better coordinate and leverage this offering, and reflect international good practices (this should be a precondition to considering creating a new public PCG from scratch, as contemplated). Moreover, the implementation of the national financial inclusion strategy should facilitate the important role of MFIs for micro-firms and the large informal sector.

40. **Housing finance is another key activity where significant progress has been made, but new initiatives are needed to address risks and foster sound development (especially in terms of**

**affordable housing finance and to address informal housing issues) over the medium-term**. The ratio of banks' housing loans to GDP (7 percent GDP in 2018) has significantly improved but is still below the most advanced MENA markets. There are both housing supply constraints and a large gap between housing needs and effective demand, particularly for the poorest (i.e. creditworthiness allowing access to finance). The financing of developers generates significant credit risks which are not yet well identified and monitored: sales are on an installment basis, purchasers of new units provide post-dated checks to cover payments up to 10 years, and these checks are discounted by developers with their banks. There is an immediate need to identify banks' financing of developers using discounted customer checks and set rigorous prudential requirements. Initiatives could also be considered to regulate the developers' industry. More broadly, further progress in housing finance will require a holistic approach, involving multiple public stakeholders to address both supply and demand constraints. They should include initiatives to stimulate the construction of affordable housing and slow down price appreciation in large cities.

41. **Beyond housing finance, domestic long-term finance remains low and faces major structural challenges which will take time to overcome**. The Palestine Investment Fund (PIF), as a sovereign wealth fund and development finance institution, is a significant source of investment, with consolidated assets close to US$1 billion (2019)[24]. The PIF has placed an increased focus on the impact of investments in strategic sectors of the economy, operating under a double bottom line, i.e. both economic and social impact and financial return. The authorities should continue to enhance the catalytic role of PIF by focusing on additionality and leveraging private financing. More broadly, they should focus on the development of a pipeline of bankable projects (which could attract external and domestic financing). While capital market development is a long-term agenda, subject to the overall economic constraints, sukuk may be an instrument that can be realistically explored to attract certain investors, with suitable legal and regulatory frameworks in place.

## B. Digital financial services payments in the West Bank and Gaza

42. **The economy of the West Bank and Gaza remains marked by a high degree of reliance on cash and low levels of financial inclusion combined with a dependency on the inflow of funds from abroad and especially from Israel.** The general use and penetration of basic financial services in the West Bank and Gaza, including digital payment services, is low overall and the reliance on cash and checks as the primary means of payments remains very high where, for example, more than 80 percent of utility bills are paid using cash only.[25] A push toward the use of digital payment services such as bank transfers, card payments, and mobile money will have significant positive implications in terms of improving access, reducing costs, increasing transparency, and reducing the excess cash. Reliance on cash could also be reduced if the use of Israeli credit cards is facilitated in the West Bank[26]. Several initiatives are under way to facilitate the use and uptake digital payments, which will require further focus to reach a critical mass in terms of both the supply and demand for digital payments.

43. **Payments from the government to citizens are predominantly made by check and payments by citizens to the government are predominantly in cash,** followed by payments by check where, for example, 57 percent of the taxes due are paid by cash and 43 percent are paid by check.[27] A unified government online portal is under development for the general digitization of various government services. The online portal, which will be integrated with a payment gateway function, will facilitate payments by cards, e-money, or bank accounts, and assist in the push toward digital payments.

[24] http://www.pif.ps/wp-content/uploads/2020/09/PIF-English-2019-WEB.pdf
[25] Findex 2017. It should be noted that the level of up-to-date payment data is somewhat limited.
[26] One of the reported reasons for the high inflow of NIS Cash is the inflow of Israelis shopping in cash in the West Bank.
[27] Global Payment Systems Survey. World Bank.

44. **The PMA is in the process of putting in place a comprehensive legal and regulatory framework in support of developing the market for payment services, which will have considerable direct impacts on digital payment services.** One of the cornerstones of the legal and regulatory framework is to open the market for payment services to non-banks. The PMA adopted instructions on the licensing of payment service providers in 2018, which was complemented with a number of additional Instructions regarding stored value products (e-money) covering the issuing of pre-paid cards and e-wallets in April 2020. These Instructions will facilitate more competition in the market regarding payment services and assist in increasing the use of digital payments. Three new payment service providers (PSP) have received final approval by the PMA under the new regime and two PSPs have already commenced operations. With two additional applicants in the licensing process there will likely be five new PSPs active in the market in 2021. The Instructions already in place will benefit from further clarification in relation to their particular scope and application to ensure legal clarity and legal certainty and should also be further complemented by a general legal framework regarding payment services.

45. **Payment cards are the principal digital retail payment instruments in the West Bank and Gaza. Only 14 percent of the population are in possession of a debit card, and in 2017 there were 843,000 debit cards and 125,000 credit cards issued in the market.** There is no domestic debit card scheme and payment cards are issued under international card schemes. Payment cards are predominantly used for cash withdrawals and the use of payment cards for making purchases remains low, with 1.2 million point of sale (POS) transactions in 2018, but with significant growth of more than 30 percent in recent years.[28] All banks issue payment cards, while there is currently only one card acquirer actively servicing merchants in relation to card acceptance. The PMA operates a national card switch which is solely used for ATM transactions, but which is being further developed to also be able to process POS transactions. The West Bank and Gaza remain in the bottom half in relation to progress toward cashless payments and digital financial services when compared to other territories in the MENA region.

46. **Cross-border inward remittances are of critical importance for the domestic economy and it is estimated that these remittances amounted to US$ 2.6 billion, representing more than 17 percent of GDP.[29]** Currently, only banks and money changers can offer remittance services. As most inward remittances are disbursed in cash, steps should be taken to facilitate crediting remittance proceeds to bank accounts and electronic money accounts. At present, only two Money Transfer Operators (MTO) are permitted to operate locally and the choice and competition is further limited by agents only being allowed to operate on behalf of one MTO. The current efforts in banning such exclusivity agreements should be accelerated to further open up the market for remittances.

47. **Efforts are currently underway to establish a National Payments Company to achieve the strategic goals of improving access to retail payment systems in the country, promoting a cashless ecosystem and providing low-cost, safe, and efficient retail payment services.** The PMA plans to transition the retail payments system currently operated by the PMA to the National Payment Company, which would further expand the product offering through the building of new capabilities, such as faster payments.

48. **Due to the global heightened money laundering and terrorist financing concerns, banks operating in the West Bank and Gaza are experiencing difficulties in maintaining their correspondent banking relations with foreign banks, including Israeli banks, which to some extent also affects their ability to offer digital financial services.** Payment activity between Israel and the West Bank and Gaza has an estimated yearly value of more than NIS44 billion. In 2016 Israeli banks canceled their correspondent banking relations with Palestinian banks as part of a general de-risking strategy. Following this decision, Israeli banks have continued to provide

[28] Palestine Monetary Authority.
[29] The World Bank's Migration and Remittances Brief (September 2019).

correspondent banking service to Palestinian banks under temporary letters of indemnification and immunity approved by the Israeli Cabinet, while a broader and longer-term solution is to be worked out for payments between Israel and the West Bank and Gaza. Work has been under way to address these issues and maintain continuity of the correspondent banking services in relation to payments between the two economies, with a focus on bank transfers, check payments, and cash payments,[30] and with the overall joint policy objective of significantly increasing the volume and number of electronic payments overall.

49. **Various initiatives are underway to provide long-term solutions for solving the current issues in correspondent banking and in further facilitating the use of electronic payments between Israel and the West Bank and Gaza.** Through funding from the World Bank, and with the assistance of PricewaterhouseCoopers, the PMA is exploring the different options available for establishing a separate cross-border payments company which would serve as the dedicated interface for incoming and outgoing payments from the West Bank and Gaza.[31] The new set-up would effectively replace the current correspondent banking relations between Israeli and Palestinian banks. The planned cross-border payments company will represent the PMA in the Israeli banking system vis-à-vis a similar payments company which has already been established on the Israeli side. The PMA will need to consider decisions regarding the establishment of the cross-border payments company during H2 2020. The COVID-19 crisis and the general relations between Israel and the PA have made coordination between the PMA and the Bank of Israel difficult.

[30] Banks in the West Bank and Gaza are having to manage large amounts of excessive cash due to limits on the amount of cash which can be shipped to Israel. Part of the strategy is to reduce the amount of cash stored and the costs associated with this.
[31] The project also includes the preparatory work regarding the establishment of the National Payments Company.