سلطة النقد الفلسطينية

Economic Forecast Report 2016

Research and Monetary Policy Department

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Preface

The Palestinian economy faces numerous challenges that threaten and curb its ability to grow and achieve sustainable development. Most prominent of these challenges and risks are the persistence of the Israeli occupation and the coerced dependence of the Palestinian economy on its Israeli counterpart, the dependence on foreign aid and the escalating political and economic uncertainty.

Hardly a year passes without the exposure of the Palestinian economy to a new shock in relation to the aforesaid challenges, whether at political and security levels, as in a new Israeli aggression, or at the level of public finances, as in the withholding of clearance revenues and the ensuing grave implications on the Palestinian economy. The situation is further aggravated by repeated tightening of the siege on Gaza Strip (GS), the periodically intensified restrictions in the West Bank (WB) and the limitations on the freedom of movement and access for people and goods across the whole of the Palestinian territories. Shocks also include the fluctuation and decline in foreign aid over the past few years and the linking of aid to the political positions of the Palestinian National Authority.

Over the past years, the aforesaid factors have led to economic slowdown. At times, even negative growth rates were realized. This was the case in 2014 -the first such occurrence since 2006; not to mention the repercussions of poor economic performance on unemployment rates, which remained high, particularly in GS, where growth rates realized were insufficient to absorb the increasing labor supply.

Diagnosis of the state of economy 2012- 2014

During 2014, the Palestinian economy witnessed a decline for the first time since 2006. Real GDP dropped by 0.2 percent following two years of slowdown during which growth decelerated to 6.3 percent in 2012 and to 2.2 percent in 2013. The downturn in 2014 came as a result of deteriorating political and security conditions in Palestine, the most prominent of which is the Israeli aggression against GS in the summer of that year and the persisting economic siege. As a result, the infrastructure and the production base suffered heavy damages, reflecting adversely on the overall economic activity. The decline was the upshot of two divergent growth directions in the WB and GS. Economic activity in the WB enjoyed growth at a rate of 5.1 percent during 2014 (compared with 6 percent in 2012 and 1 percent in 2013), all while activity in GS plummeted by 15.2 percent (compared with a growth rate of 7.0 percent in 2012 and 5.6 percent in 2013).

This slowdown posed negative implications for the labor market, giving rise to an increase in unemployment rates, specifically in GS where unemployment witnessed record highs, starting with 31 percent in 2012, to 32.6 percent in 2013, and ending with 43.9 percent in 2014. Concurrently, in the WB decreased only slightly from 19.0 percent in 2012, to 18.6 percent in 2013, and to 17.7 percent in 2014. At the level of Palestine as a whole, unemployment increased from 23 percent of total labor force in 2012, to 23.4 percent in 2013, and to 26.9 percent in 2014.

Furthermore, the slowdown affected the growth rates of real per capita income (real GDP per capita), dropping from about 3.1 percent in 2012 to -0.8 percent in 2013, and to -3.1 percent in 2014 with real per capita income stabilizing at around USD 1,737 in 2014.

The decline in real per capita growth rates contributed to the decline in aggregate consumption, particularly for the private sector from 11.6 percent in 2012, to -4 percent in 2013, which was followed by a rise to 3.5 percent in 2014. Additionally, aggregate investment declined from 19.0 percent in 2012, to 4.2 percent in 2013, and to -13.9 percent in 2014. On the other hand, the slowdown in domestic aggregate demand (for both consumption and investment) reflected on inflation rates, which dropped from 2.8 percent in 2012, to 1.7 percent in 2013 and 2014, consecutively. The decline was primarily influenced by changes to domestic aggregate demand, in addition to changes in the cost of imports and the global food and fuel prices, given that food and fuel account for about 50 percent of the Palestinian citizen’s expenditure (consumer basket).

The Palestinian external sector witnessed significant fluctuations during this period. Growth in exports revealed a drop by 0.6 percent in 2012, to increase afterwards by about 3.3 percent, and 9.6 percent in 2013 and 2014 consecutively. Imports, on the other hand, surged by 14.3 percent in 2012, to drop to -7.2 percent in 2013 and rise again by 4.1 percent in 2014. These developments culminated in an increase in trade deficit by 21.9 percent in 2012, dropping by about 11.6 percent in 2013, and increasing again in 2014 by 1.4 percent.

Growth projections for 2015

From its onset, the year 2015 witnessed political and economic instabilities, the implications of which reflected on the overall economic activity. The Palestinian economy started the year with further decline in all sectors during Q1, owing to the continued deterioration in GS, in the wake of the recent Israeli aggression, and the modest growth realized in the WB as a result of aggravated fiscal difficulties. Such difficulties rose due to the Israeli government withholding clearance revenues, which resulted in the suspension of salaries, accumulation of arrears and slowing private sector consumption. Against this background, economic activity declined during Q1 by 0.8 percent on y-o-y and on quarterly basis (compared with the previous quarter).

In contrast, the second quarter (Q2) witnessed a gradual pick-up in activity, following the return of regular inflow of clearance revenues. This resulted in an accelerated growth in the WB and a relative recovery in GS, leading to an increase in economic growth in Palestine by about 2.1 percent[1] on y-o-y and about 6.0 percent on q-o-q. Furthermore, it was possible to discern certain positive changes in GDP components, such as a deceleration of aggregate consumption to 2.7 percent y-o-y, as opposed to a growth by 5.7 percent q-o-q, whereas aggregate investment expenditure witnessed a relative recovery recording a growth of around 8.2 percent y-o-y (as opposed to a decline by about 8.7 percent q-o-q). Exports grew by 29.9 percent y-o-y (as opposed to 18.2 percent on q-o-q) whereas imports decelerated to 11 percent y-o-y (as opposed to 12.4 percent q-o-q). These developments have contributed to inhibiting growth in the trade balance deficit, which rose by 2.3 percent on y-o-y and by 9.4 percent q-o-q, to constitute about 40.4 percent of real GDP for Q2.

Available data for the third quarter (Q3) point to a continued recovery in economic activity, supported in essence by increased consumption, mainly for the private sector, and the improvement in government domestic revenues in light of accelerating economic activity[2], the sustained work to expand the taxation base, as well as the boost in clearance revenues due to rising economic activity. Moreover, other economic indicators picked up, such as the Palestinian workers in Israel and the number of

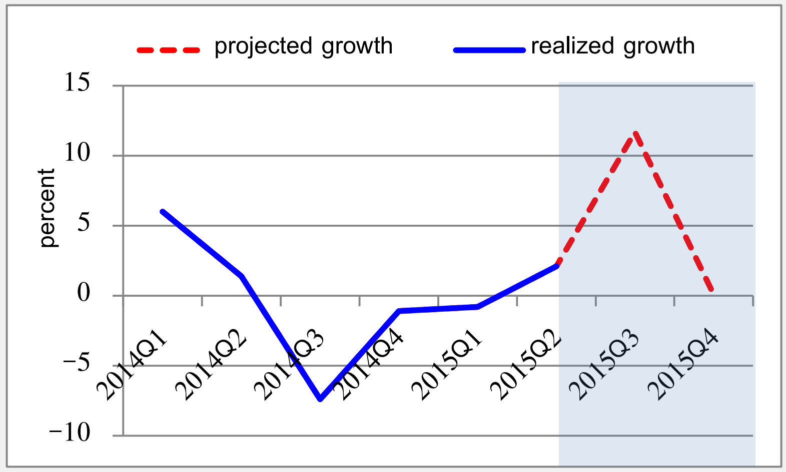
[1] Palestinian Central Bureau of Statistics (PCBS), Quarterly National Accounts Data, 2015Q1, and 2015Q2.

[2] Q3 witnessed a marked increase in economic activity due to seasonal activities associated with the month of Ramadan, the feasts and the reopening of schools after summer break.

building licenses. Accordingly, PMA projections point to an economic growth rate of 11.7 percent during Q3 y-o-y[3] and 0.3 percent q-o-q.

In contrast, Q4 witnessed a discernable deterioration in the political and security conditions against the background of Israeli discriminatory \practices in Jerusalem, the frequent attacks by Israeli settlers and the recent popular upheaval against such practices. Alongside the adverse ramifications of this deterioration on economic performance, the Palestinian economy is expected to suffer further from a likely slowdown in the Israeli economy in view of worsening security conditions and slowing domestic demand in Israel. Such developments are also expected to impact the number of Palestinian workers joining work in Israel, on one side, and the volume of Palestinian export to Israel, on the other. Consequently, PMA forecasts point to a timid economic growth during Q4, not exceeding 0.1 percent y-o-y, against a drop by about 5.1 percent q-o-q.

Figure 1: Real Growth Rates, 2014-2015



The aforesaid developments, in addition to several leading indicators used to project GDP (the Business Cycle Index (PMABCI), indices of the construction sector, the external sector and other Israeli-economy associated indices) have all contributed to 2015 forecasts. PMA projections indicate that the Palestinian economy is expected to witness real GDP growth by 3.1 percent[4], compared to a contraction of around 0.2 percent in 2014. The growth is primarily underpinned by an increase in investment associated with the reconstruction of GS, some recovery in consumption fuelled by further growth in credit, and the increase in the number of Palestinian workers in Israel. This is expected

[3] This escalating growth reflects the relative recovery from the shock that followed the recent Israeli aggression against GS, which culminated in an acute drop in real GDP during 2014Q3 (-7.4 percent), consequently marking a gradual resumption of recovery.

[4] Expected high growth for Q3 has helped amend projections for overall growth in 2015.

to cause a slight increase in real GDP per capita by 1.3 percent, compared to a drop of 3.1 percent in 2014. PMA projections also indicate an upturn in value added by the private sector by 5.9 percent in 2015. Pushing private sector contribution to GDP at factor costs to 78.8 percent in 2015, as compared to 78.3 percent in 2014, and opposed to a drop in public sector contribution to real GDP to 21.2 percent compared to 21.7 percent in 2014. Unemployment rates are also expected to drop to around 25 percent of total labor force, compared to 26.9 percent in 2014, alongside a decline in inflation rate to 1.5 percent, from 1.7 percent in 2014.

PMA growth forecasts for 2016

1. Growth forecasts

PMA forecasts for economic performance included predictions for key Palestinian economic variables during 2016 (under the baseline scenario)[5], accompanied by a risk assessment of different shocks of varying likelihood (an optimistic scenario and a pessimistic scenario), expected to have positive and negative repercussions on economic performance. It is acknowledged that the forecasts are sensitive to any revisions of actual data introduced by the different data-producing agencies. Most important among these are the Palestinian Central Bureau of Statistics and the Ministry of Finance.

Basic forecasts for Palestinian economic growth during 2016 were founded on a set of basic assumptions (baseline scenario) and their associated implications on economic conditions. These assumptions were:

- No significant change will affect political or security conditions, particularly concerning the restrictions imposed at crossings and on freedom of movement and access. Likewise, no change (or almost none) will occur to the number of Palestinian workers in Israel, which will stand around the same level of the previous year, with the slow pace of reconstruction in GS unchanged.

[5] The forecasts for Palestinian economic key variables were based on economic models developed by the PMA, most importantly the Reduced Form Equation, to predict GDP on quarterly basis. In concordance with this model, the structural model was used to predict key macroeconomic indicators (such as GDP components, employment and wages). For further details concerning these models, please check the working papers published on PMA website at www.pma.ps

- The government will continue to follow a fiscal austerity policy and implement current-expenditure rationing, while growth in government revenue and expenditures remains relatively unchanged at previous-year levels.
- Foreign aid, extended by donor countries to the government's treasury, will continue to flow to reach a total of USD 1.0 billion during 2016.
- Private sector transfers from abroad will amount to USD 1.2 billion during 2016.
- Credit facilities granted to the private sector by banks operating in Palestine will rise by 17 percent, as compared to 2015.
- The cost of imports (inflation rate and exchange rate with trading partners) will rise by 3.1 percent.
- The weighted economic growth of Palestinian main trading partners will increase to 3 percent.

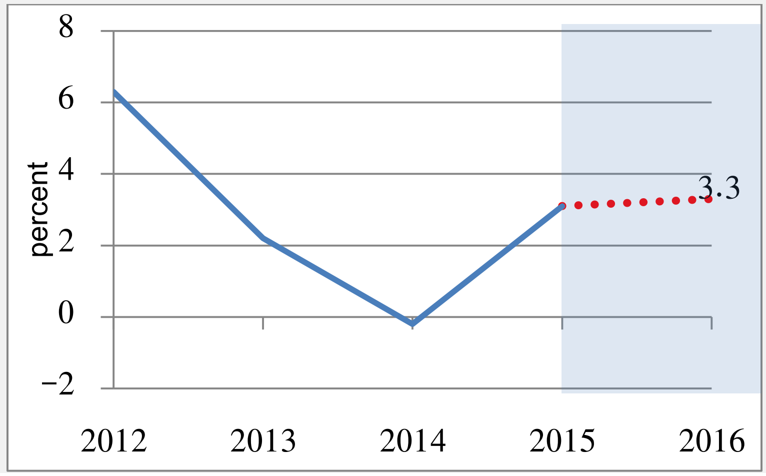
Based on such assumptions, PMA forecasts point to a real GDP growth during 2016 by 3.3 percent, to reach around USD 7,952 million, compared with 3.1 percent during 2015[6]. As a result, real per capita income (real GDP per capita) is expected to enjoy an increase by 1 percent, compared to about 1.3 percent in 2015, to reach USD 1,774. Real GDP growth during 2016 will be primarily underpinned by an increase in consumption, fuelled by further expansion in bank credit, in addition to an upturn in total investment, subject to the implementation of several investment projects and the continuance of the reconstruction in GS.

Likewise, the private-sector value added is expected to grow by 3.0 percent during 2016, raising the sector's contribution to real GDP at factor costs to 79 percent as opposed to a drop in the public sector's contribution to 21 percent for the same year. Additionally, PMA forecasts point to an expected upsurge in consumption by 4.7 percent during 2016 (of which 6.1 percent is for private consumption and 2.1 percent for public consumption), pushing its contribution to real GDP up to 118.1 percent during 2016 (which inevitably increases imports). Total investment spending is expected to grow by about 5.8 percent to constitute 21.3 percent of GDP.

[6] The latest IMF forecasts in September 2015 expected that the Palestinian economy is poised for real economic growth at 3.9 percent in 2016.

As for the Palestinian external sector, predictions point to a growth in exports by 6.6 percent and in imports by 8.3 percent, mainly associated with an increase in consumption. Subsequently, it is expected that these changes in exports and imports will culminate in exacerbating the trade balance deficit by about 9.2 percent to constitute 39.4 percent of the real GDP predicted for 2016.

Figure 2: Growth forecasts in 2016



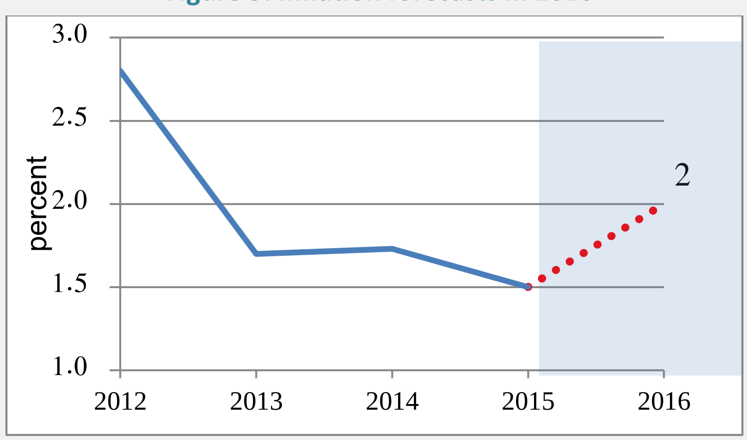
It is also expected that this predicted positive growth will reflect favorably on job opportunities and employment, leading to a decline in unemployment rate in Palestine to about 24 percent of labor force in 2016.

2. Inflation forecasts

PMA forecasts[7] indicate that prices will grow at an escalating pace during 2016. As a result, inflation is expected to rise again to around 2.0 percent, on average, compared to about 1.5 percent in 2015. During the first quarter of the year, inflation is expected

to exceed the level of 2 percent, only to drop again slightly over the three successive quarters of the year.

Figure 3: Inflation forecasts in 2016



[7] In preparing the inflation forecasts, the inflation forecasting model was used, which takes into account the impact of both exogenous and endogenous factors on inflation in Palestine by employing the methodologies of "co-integration analysis" and "autoregressive distributed lag (ARDL)". For more on this model, please check working papers published on the PMA's official website www.pma.ps.

These forecasts come in light of an expected surge in the cost of import by about 3.1 percent, and a persistent decline in global food prices, by around 3.4 percent, during 2016.

Risk analysis (shocks)

Regardless of probable statistical or methodological errors, the uncertainty associated with many disparate factors continues to loom. This is particularly so because the Palestinian economy operates within a high risk environment, both internally and externally. These risks are deemed responsible for numerous possible shocks affecting economic performance through influencing consumption modes and the movement of trade and investment.

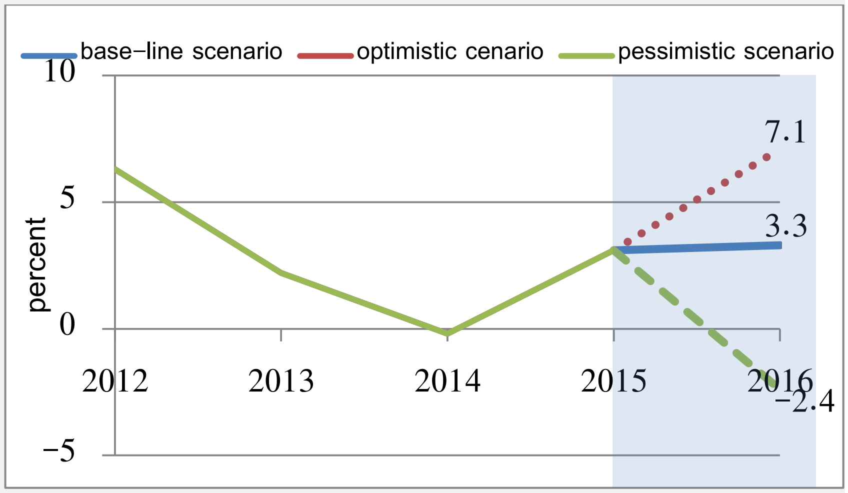
In this context, PMA forecasts for 2016 remain subject to several potential shocks of varying likelihoods, whether positive or negative, which, together with their repercussions, may affect several key economic indicators.

A positive shock to the Palestinian economy (the optimistic scenario) presumes serious progress being made on the political track, security conditions and peace talks, as well as the acceleration of reconstruction in GS, the launch of major projects and the introduction of measures to stimulate the economy. It also presumes the uplifting the siege and closure of the Strip, the easing of restrictions on movement of people and goods in general, the increase in the number of Palestinians workers in Israel, in addition to a rise in donor aid inflows for budget support and development expenditure, as well as an excess in private sector transfers from abroad over normal annual levels.

Under such assumptions, PMA forecasts indicate economic growth by 7.1 percent, to push real GDP up to a total of USD 8,245 million. A consequent increase in GDP per capita of 4.7 percent to USD 1,839 is expected. The private sector value-added is expected to grow by 7.6 percent, increasing its contribution to GDP at factor costs to 79.1 percent, while the contribution of the public sector is presumed to drop to 20.9 percent. Under this scenario, unemployment rates are also expected to improve noticeably dropping to around 22 percent of total labor force.

Under such a scenario, total consumption is expected to grow by around 9.7 percent (of which 10.9 percent is growth in private consumption and 5.8 percent is growth in public consumption), driving its contribution to GDP to 119.3 percent. Likewise, total investment expenditure is expected to grow by around 12.2 percent to register GDP contribution of about 21.8 percent. Similarly, forecasts indicate a growth of around 15.6 percent in exports as opposed to a higher growth in imports by around17.2 percent, conducive to an increase in trade balance deficit by about 18.2 percent that aggravates the deficit of predicted real GDP for 2016 to around 41.1 percent.

Figure 4: Growth potential risks in 2016



In contrast to the aforesaid scenario, the economy remains susceptible to negative shocks (the pessimistic scenario). Such a scenario assumes a sharp deterioration in political and security conditions, a decrease in the number of Palestinian workers in Israel, tightening restrictions on the movement of people and goods, an increase in the days of closures to workers and trade, persistent withholding of Palestinian clearance revenues by Israel, in addition to a decline in foreign aid to support the budget and development expenditure, and a cessation of the process of reconstruction in GS.

In the event of such a scenario, the PMA predicts further deterioration of economic conditions, with the Palestinian economy contracting by 2.4 percent coupled with a subsequent decline of real GDP to around USD 7,514 million.

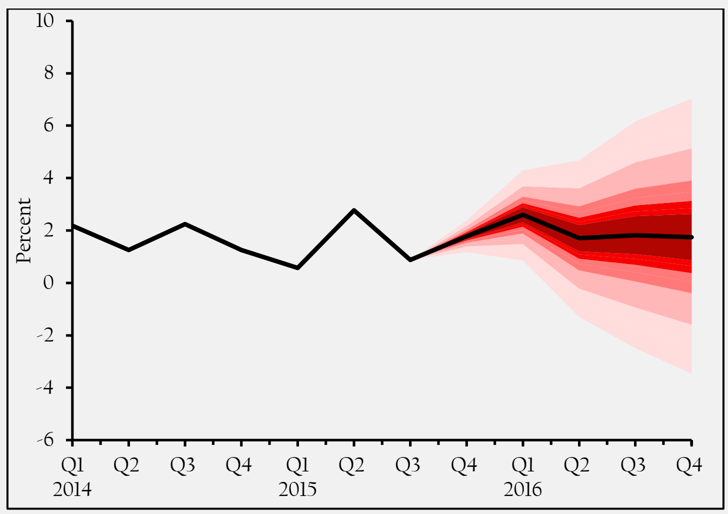
It is also expected that the decline in growth will adversely affect real GDP per capita, leading to a drop by 4.6 percent, to reach around USD 1,676. Moreover, forecasts point to a decline in private sector value-added by 4.3 percent during 2016, pushing private sector contribution to GDP at factor costs to 78.6 percent, as opposed to an increase in public sector’s contribution to 21.4 percent. Such a scenario is expected to have a tangible adverse impact on unemployment, bringing it up to 31 percent of total labor force during 2016.

As a result of this scenario, total consumption is expected to fall back by around 3.0 percent (of which 0.2 percent is private consumption and 12.3 percent is public consumption). This drop is expected to bring the contribution of total consumption expenditure to GDP to around 115.7 percent. Additionally, gross investment is expected to recede by around 10.0 percent, bringing its contribution to GDP to around 19.2 percent.

At the level of the external sector, forecasts point to a decline in exports by around 10.2 percent, as opposed to a lesser decline in imports by around 9.1 percent. These results are expected to worsen Palestine's trade deficit by around 8.6 percent and consequently deepen its deficit to around 34.9 percent of the predicted real GDP for 2016.

As for inflation risks, these mainly relate to changes to global prices (particularly of food and fuel), in addition to changes in inflation rates in Palestine's trading partners, particularly Israel. Inflation forecasts in Palestine also depend on potential internal shocks that may affect domestic demand in Palestine. Figure (5) illustrates the inflation rate in Palestine in 2016.

Figure (5): Potential risks to inflation in 2016



It is worth mentioning that the range of likely results is a broad one, as apparent in figures (4 and 5). Of course, this is a reflection of the degree of uncertainty of predictions due to the potential risk factors highlighted earlier. These figures illustrate the expected growth and inflation rates by order of likelihood of occurrence. For example, the darker the shades in Figure (5) are, the higher the possibility is in arriving at the expected inflation rate, and vice versa.

Appendix: PMA forecasts in 2016

	2012	2013	2014	2015	2016 Forecasts		
		Actual		Projection*	Baseline Scenario	Optimistic Scenario	Pessimistic Scenario
			Annual percent change (%)				
Real GDP	**6.3**	**2.2**	**-0.2**	**3.1**	**3.3**	**7.1**	**−2.4**
Real GDP per capita	3.1	-0.8	-3.1	1.3	1.0	4.7	−4.6
Private sector value added	6.3	1.8	-3.5	5.9	3.0	7.6	−4.3
Public sector value added	7.3	5.3	2.9	2.7	3.8	5.4	−3.4
Unemployment rate	**23.0**	**23.4**	**26.9**	**25.0**	**24.0**	**22.0**	**27.5**
Inflation rate	**2.8**	**1.7**	**1.7**	**1.8**	**2.0**	**2.0**	**2.0**
Total final consumption	**9.6**	**-3.5**	**3.6**	**1.6**	**4.7**	**9.7**	**−3.0**
Public	3.3	-1.6	4.5	1.3	2.1	5.8	−12.3
Private**	11.6	-4.0	3.5	1.7	6.1	10.9	−0.2
Total investment	**19.0**	**4.2**	**-13.9**	**13.2**	**5.8**	**12.2**	**−10.0**
Net export of goods and services ***	**21.9**	**-11.6**	**1.4**	**3.7**	**9.2**	**18.2**	**−8.6**
Total exports	-0.6	3.3	9.6	7.9	6.6	15.6	−10.2
Total imports	14.3	-7.2	4.1	5.2	8.3	17.2	−9.1
			As percent of real GDP				
Total final consumption	**120.6**	**113.9**	**118.2**	**116.4**	**118.1**	**119.3**	**115.7**
Public	27.2	26.2	27.2	26.7	25.8	26.4	24.0
Private	93.4	87.7	90.9	89.7	92.3	92.9	91.7
Total Investment	**21.6**	**22.0**	**19.0**	**20.8**	**21.3**	**21.8**	**19.2**
Net export of goods and services	**-42.2**	**-36.5**	**-37.1**	**-37.2**	**-39.4**	**-41.1**	**-34.9**
Total Exports	17.6	17.8	19.6	20.5	21.1	22.1	18.9
Total Imports	59.8	54.3	51.2	57.7	60.5	63.2	53.8
Net error and omissions	**0.0**	**0.6**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum Items							
Real GDP (USD million)	7,314.8	7,477.0	7463.4	7,698	7,952	8245	7513.6
Real GDP per capita (USD)	1,807.5	1,793.3	1737.4	1,757	1,774	1839	1676
USD/NIS exchange rate	3.85	3.61	3.58	3.88	3.85	3.85	3.88

* Projections of PMA research team

** Includes non-profit institutions serving households (NPISH).

***Negative sign denotes decrease in trade balance deficit