

Executive Summary

The year 2006 has witnessed turmoil at the national level, and many economic developments at the international level. It is our pleasure at PMA to forward the annual report for 2006, in which we introduce national and international linkages. Domestically, the political development of a Hamas winning a clear majority in the legislature elections and the subsequent international boycott of the democratically elected government has had drastic ramifications for the national economy. The oil price hike, and balance of payments difficulties for the US economy has also created major exchange rate shocks to international transactions. The annual report provides a comprehensive picture of those developments as well as measures taken by the PMA to enhance the stability for the Palestinian banking and financial sector.

The report is divided into seven chapters: the first chapter begins with international developments, followed by domestic economic developments. The third chapter reviews public finance, and fourth comes the balance of payments and trade. In the fifth chapter, a comprehensive review of Palestinian Banking activities; which is followed by developments and accomplishments of the PMA in 2006. Finally, the report concludes with a review of the strategic transformation plan.

The *world economy* experienced a moderate growth rate of 5.4% during 2006, slightly surpassing the 2005 growth rate of 4.9%. Expectations for the following year are less optimistic due to rising interest rates in the major world economies, inflationary pressures and financial difficulties facing the US real estate market, and buoyant demand for oil in China pushing its prices even higher. In reaction, the central banks of the major industrial countries tightened monetary conditions and raised interest rates.

The weakest growth of the advanced economies has been that of France and Japan (around 2%). However, the overall rate for the advanced economies is a meager 3.1%. In contrast, the overall growth rate for the Asian developing economies is 9.4% with very strong performances for China, India, and the United Arab Emirates. On the other hand, inflation is higher for the developing and other market economies in

transition. The overall inflation rate is roughly half the overall growth in real GDP. For the advanced economies, the average inflation figure is 2.3% compared to the 3.1% real GDP growth. This implies that the output gap (the difference between potential and actual GDP) is narrowing, which requires the tightening of monetary conditions as indicated above.

On a per capita basis, GDP growth rates have been faster for developing economies than for advanced economies. The average growth rate is nearly double, particularly since 2003. This suggests that the per capita GDP gap between developing and advanced economies should be narrowing. Within the developing countries category, the Middle East's performance is below average while that of the Asian developing economies is much above average. The Asian newly industrialized economies score highest in the advanced economies category. In short, Asia's performance has been impressive in terms of growth over the last decade. The report does not take into consideration the purchasing power parity (ppp) adjustment to income; once this variable is taken into consideration, and once the time horizon is expanded the picture turns out to be the opposite. According to the *Human Development Reports*, the average GDP/capita adjusted for ppp for the top ten income countries grew by a total of 46% between 1998 and 2004, while for the lowest ten countries it grew by only 21%. On the other hand, the ratio of the top ten average to the lowest ten average increased from 42 to 53 between the said years. This shows the huge disparity between the rich and poor, which are mostly African countries.

World trade has also been growing in importance; chronological developments indicate that over the last three years world trade has grown at an annual rate exceeding 7%. In particular, the Euro area's export growth has surpassed the US's rate; the trend was reversed starting in 2004. Meanwhile, import growth is nearly always greater than that of the EU's rate. On the other hand, the US maintained a current account deficit throughout the period 1998-2006; in comparison, the EU and developing countries current account was in a surplus. Middle and eastern European countries maintained a deficit, while Middle Eastern countries had a surplus, probably owing higher oil exports.

In comparison to the Western Hemisphere, external debt ratio to GDP, Africa has experienced considerable improvement. In all developing countries, this ratio was 40.5% in 1998 and decreased to 26.3% in 2006. Africa's comparable figures are 65.5% and 28.1%, which makes it in line with that group of countries. In regards to debt service/GDP ratio, Middle Eastern countries have the lowest ratio for the time span under consideration.

The *Palestinian economy's* indicators turned in the opposite direction of world indicators in 2006. Worsening economic conditions are reflected in a 8.8% decline in real GDP, a nearly 12% decline in real GDP per capita between 2005 and 2006, and roughly a 37% decline in net factor income between 2000 and 2006. In 2006, the construction sector contributed 2.5% of GDP, compared to 13.7% in 1999. At the expenditure side, there has been no reversal of continuing trends. Consumption/GDP ratio has been increasing from 1.23 in 1996 to 1.48 in 2006, meanwhile investment ratio is moving in the opposite direction with acceleration in 2006; the ratio was 41% in 1999 down to 19% in 2006. The implications for the future are bleak. If the economy's productive capacity is deteriorating this fast, future prospects are alarming. This makes the Palestinian economy a consuming economy. Living on transfers, such that net exports have reached almost negative 70% of GDP and domestic savings are up to a negative 48% of GDP.

Labor market dynamics show that there has been an increase in the number of employed people despite the drop in GDP. In total, 45 thousand individuals joined the labor force, 33 thousand employed and 12 thousand unemployed. The public sector absorbed 6000 employees in 2006, but employment in Israel is down by 1000 individuals. Most of the Palestinian employment continues to be in the service sector.

The average daily wage increased by 4.6% in the West Bank, 11% in Gaza and 3.7% for Palestinians employed in Israel in 2006. In contrast, the CPI respective growth rates are 4%, 5% and 3% for the West Bank, Gaza, and Jerusalem respectively. With unemployment running twice as high in the Gaza Strip as in the West Bank, one would expect the wage to be higher in the West Bank (which it is), however, the larger increase in the daily wage is harder to explain.

Political developments in early 2006 resulted in an international boycott of the elected Palestinian government, suspension of customs revenue clearances from Israel and a stoppage of salary payments for government employees for most of the 2006 **fiscal year**. Despite the weak tax base in the domestic economy, the situation got even worse in 2006. Domestic revenues contributed 23% in 2006 compared to the 27% the year before. This is mostly attributed to the regression of income during 2006. Total revenues (not including aid) also declined by \$875 million, part of which (\$187 mil) were from domestic tax and non-tax sources. The remaining (\$ 688 mil) are due to withholding revenue clearances. Donor assistance increased by \$339 mil in 2001 and \$353 mil in 2006; in other years, the increment was generally negative. Although expenditures also fell during 2006, the decline was smaller than that of revenues leading to an increase in the deficit from \$717 to \$1367 mil. The accumulation of deficits has increased 8 folds since 1996. The distribution of public debt has been on average 27% internal and 73% external, which constitutes a large drain of foreign resources.

Turning to the BOP data, the current account balance has improved mainly due to a larger reduction in imports than exports. The total improvement in the current account amounted to \$162 mil, the bulk of which can be attributable to current transfers which amounted to \$1.1 billion in 2006. Regarding net factor income from Israel, the change has been in the order of \$ 3 million. The capital account typically moves in the opposite direction. The improvement (deficit reduction) in the current account was almost totally offset by deterioration in the capital account (surplus reduction). The official balance was positive in 2006 indicating an increase in foreign reserves.

The unified balance sheet of the banking system shows that deposits have continued its trend growth, however, at a much slower pace. This slower pace came as a reaction to a large drop in the deposits of bank operations offshore, which experienced a 5% decline. The security of the banking system as a whole may be looked at from the developments of bank capital; its growth was 7% compared to 75% a year earlier. Bank capital amounted to \$589 million in 2006 constituting 12.6% of total deposits. On the other hand, provisions for loans at risk grew at 21% compared to 33% a year earlier. To the contrary, allocations to meet default losses have increased by 8.6%

compared to 3.6% the year before. Overall, both allocations constituted roughly 9.2% of total loans.

On the asset side of the balance sheet, loans constituted about 33% of total assets compared to 32% a year earlier. Although total assets grew by 2%, loans grew by 6%. Therefore, 2006 witnessed an increase in lending due to worsening economic conditions and along with that banks experienced a moderate increase in its allocations for loans at risk of default or troubled loans. The majority of loans were for the private sector, while public sector loans took 25% of the total. The distribution indicates that construction lending and general trade are the biggest recipients of loans.

The report concludes with 2 chapters on the accomplishments of the PMA during 2006 and the strategic transformation plan. Regarding the first of those two chapters, despite the worsening economic conditions, PMA's operations continued to prosper. Its capital and net profits both increased. One of PMA's functions that was influenced by economic conditions is check clearing. The number and volume of checks submitted for clearance both grew at a much slower pace compared to a year earlier. On the other hand, the number and volume of returned checks increased. Interbank transfers also grew sluggishly; however, net external transfers increased.

As a regulator of banks, the PMA increased its attention to the requirements for bank stability and security. The formalities and procedures are more compliant with international practices; accounting and bank supervision were also enhanced, and the banks' role in activating the local economy was also emphasized.

The 2006 strategic transformation plan was a step in the right direction for transforming the PMA into a fully fledged central bank. Among the main features of this plan are the price and financial stability in the domestic economy. To achieve this end, a comprehensive restructuring of the PMA was initiated. International and national consultants were involved in this effort to lay the ground works of having an effective monetary policy framework.

The key Economic Indicators in Palestine During (2000-2006)

Indicator	2000	2001	2002	2003	2004	2005	2006
PA Population (Thousand persons)	3,149	2,275	3,394	3,515	3,638	3,762	3,888
Growth rate (%)	4.32	4.00	3.62	3.56	3.49	3.42	3.36
Of which: West Bank (Thousand persons)	2,011	2,087	2,158	2,229	2,300	2,372	2,444
Growth rate (%)	4.10	3.77	3.37	3.29	3.21	3.13	3.05
Gaza Strip (Thousand persons)	1,138	1,188	1,236	1,286	1,338	1,390	1,444
Growth rate (%)	4.69	4.41	4.06	4.02	3.98	3.93	3.89
Economic Development							
GDP at constant prices (USD million)	4,261.10	3,917.80	3,556.40	3,995.00	4,247.70	4,502.60	4,107.00
Growth rate (%)	-5.55	-8.06	-9.22	12.33	6.33	6.00	-8.79
GDP per capita (USD)	1,523.00	1,287.90	1,126.50	1,220.30	1,252.10	1,281.80	1,129.90
Growth rate (%)	-5.55	-15.44	-12.53	8.32	2.61	2.37	-11.85
GNI at constant prices (USD million)	5,059.30	4,385.30	3,995.90	4,525.30	4,723.80	5,037.30	4,607.10
Growth rate (%)	-7.60	-13.32	-8.88	13.25	4.39	6.64	-8.54
GNI per capita (USD)	1,731.80	1,441.60	1,265.80	1,382.30	1,392.40	1,434.00	1,267.50
Growth rate (%)	-11.51	-16.76	-12.20	9.20	0.74	2.98	-11.61
GDP at current prices (USD million)	4,442.00	3,746.00	3,156.00	3,624.00	4,077.00	4,478.00	4,394.00
GNI at current prices (USD million)	5,274.00	4,193.00	3,546.00	4,105.00	4,534.00	5,017.00	4,929.00
Unemployment Rate (%)	14.10	25.20	31.30	25.60	26.80	23.50	23.60
Of which: West Bank	12.10	21.50	28.20	23.80	22.90	20.30	18.60
Gaza Strip	18.70	34.20	38.00	29.20	35.40	30.30	34.80
Inflation Rate (%)	2.79	1.22	5.71	4.44	2.96	3.48	3.76
Of which: West Bank	3.20	2.63	6.07	4.30	2.90	2.89	4.00
Gaza Strip	2.97	-1.19	2.26	2.48	3.17	1.18	5.09
Consumption Expenditure as % of GDP	125.75	136.52	140.87	138.85	142.19	143.08	147.72
Investment Expenditure as % of GDP	31.52	20.72	24.72	26.82	25.12	24.14	19.30
Local Saving as % of GDP	-25.75	-36.52	-40.87	-38.85	-42.19	-43.08	-47.72
Public Finance							
Total Revenue and Grants (USD million)	1,449.00	1,124.00	992.00	1,383.00	1,563.00	1,782.00	1,260.00
As % of GDP	32.62	30.01	31.43	38.16	38.34	39.79	28.26
Of which: local revenues (USD million)	939.00	275.00	295.00	763.00	954.00	1,233.00	358.00
As % of GDP	21.14	7.34	9.35	21.05	23.40	27.53	8.15
Total Expenditure & Net Lending (USD million)	1,668.00	1,437.00	1,251.00	1,651.00	1,784.00	2,194.00	1,734.00
As % of GDP	37.55	38.36	39.64	45.56	43.76	49.00	39.46
Of which: Current Expenditure (USD million)	1,199.00	1,097.00	999.00	1,256.00	1,492.00	1,950.00	1,725.00
As % of GDP	26.99	29.28	31.65	34.66	36.60	43.55	39.26
Public Debt (USD million)	794.77	1,190.61	1,089.58	1,580.62	1,804.80	1,841.25	1,760.89
As % of GDP	17.89	31.78	34.52	43.62	44.27	41.12	40.07
As % of Total Exports	91.67	212.61	234.32	339.92	337.35	313.14	329.75
Foreign Sector and Balance of Payment							
Current Account (USD million)	-949.70	-571.80	-735.20	-903.20	-1,281.70	-1,064.23	-993.00
As % of GDP	21.38	15.26	13.80	24.92	31.44	23.77	22.60
Export of Goods and Services (USD million)	731.30	506.80	418.40	435.80	482.10	497.00	482.10
As % of GDP	16.46	13.53	13.26	12.03	11.83	11.10	10.97
Import of Goods and Services (USD million)	2,985.70	2,338.50	2,128.80	2,404.90	2,749.40	2,954.80	2,925.30
As % of GDP	67.22	62.43	67.45	66.36	67.44	65.98	66.57

Indicator	2000	2001	2002	2003	2004	2005	2006
Income from Abroad (USD million)	669.20	326.10	224.10	253.80	230.40	356.00	300.00
As % of GDP	15.07	8.71	7.11	7.00	5.65	7.95	6.85
Of Which: Compensation of Employees (USD million)	620.00	200.20	141.10	204.00	204.30	268.30	235.00
As % of GDP	13.96	5.34	4.47	6.63	5.01	5.99	5.35
Current Transfers (USD million)	635.60	933.90	1,051.60	793.30	756.10	1,037.60	1,150.00
As % of GDP	14.31	24.93	33.32	21.89	18.55	23.17	26.17
Capital and Financial Account (USD million)	1,086.00	720.00	413.90	1,130.10	1,319.50	986.43	1,017.00
As % of GDP	24.45	19.22	13.11	31.18	32.36	22.03	23.15
Banking Sector & P. S. E.							
Assets of PMA (USD million)	412.35	372.72	396.56	519.90	569.34	588.09	558.70
Growth Rate (%)	17.25	-9.61	6.40	31.10	9.51	3.29	-5.00
Assets of Banks (USD million)	4,592.79	4,429.79	4,278.23	4,727.72	5,101.21	5,604.00	5,737.07
Growth Rate (%)	19.06	-3.55	-3.42	10.51	7.90	9.86	2.37
Direct Facilities (USD million)	1,346.65	1,220.70	953.70	1,071.22	1,422.63	1,791.36	1,903.29
Growth Rate (%)	33.93	-9.35	-21.87	12.32	32.80	25.92	6.25
Direct Facilities as % of GDP	30.32	32.59	30.22	29.56	34.89	40.04	43.36
Balances with banks abroad	2,149.95	2,176.25	2,328.50	2,267.40	2,329.86	2,338.76	2,405.05
Growth Rate (%)	7.20	1.22	7.00	-2.62	2.75	0.38	2.83
Customer's Deposits (USD million)	3,507.66	3,397.83	3,432.10	3,624.50	3,946.19	4,190.09	4,202.56
Growth Rate (%)	22.00	-3.13	1.01	5.61	8.88	6.18	0.30
Customer's Deposits as % of GDP	78.97	90.71	108.75	100.01	96.79	93.57	95.64
Equity (USD million)	242.56	205.62	186.62	217.36	315.18	552.19	589.32
Growth Rate (%)	-1.24	-15.23	-9.24	16.47	45.01	75.20	6.72
Palestine Securities Exchange Index (% point)	207.62	195.00	151.16	179.81	277.56	1,128.59	605.00
Turnover Ratio (%)	24.67	10.31	7.82	8.97	18.29	47.03	38.63



Palestine Monetary Authority (PMA)

Eleventh Annual Report 2006

Department of Research & Monetary Policy

May 2007

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