

Executive Summary

Numerous political and economic events have taken place in 2007 at the local and international levels that shaped the year's outlook. At the Global level, world economic growth has slowed down to 4.9%, world international markets were influenced by the US's sub-prime market which contributed to the slowdown in economic activity in major industrial economies particularly the US. Developing countries were less susceptible to those developments and as a group their performance was relatively stronger as it was influenced by the strong growth in China and India. The outlook for the world economy is a continued slowdown in its GDP growth to about 3.7%.

Despite the move by major industrial economies' central banks to cut interest rates, they managed to keep inflation at about 2.2% average. This however resulted in a decline in interest rates and a depreciation of the US dollar vis-à-vis most currencies. LDC's were less fortunate in combating inflation, inflation rates soared to 6.8% driven by high fuel and food prices.

The rise in food and oil prices have created current account surpluses and an accumulation in foreign reserves for LDC's; however, its gross debt has risen by 19.2% due to the depreciation of the US \$ among other factors. The value of national debt in relation to GDP fell 26.6% in 2007.

Domestically, some improvement was seen in 2007 in comparison to 2006 were most indicators have deteriorated. The formation of an emergency government¹ and its adoption of the emergency stabilization plan, along with a suspension of the blockade imposed on the government have contributed to the resumption of customs clearances and international aid. In 2007, the PNA received payments in the order of \$ 1.3 billion in aid; this constitutes 25% of GDP. The situation in Gaza Strip has deteriorated due to the continued blockade and siege. As a result, the negative effects have counter balanced the marginal improvements in the West Bank leaving GDP growth at 0%.

The flow of aid did not seem to have increased the productive capacity of the Palestinian economy, it was merely reflected in higher consumption. Consumption / GDP ratio has reached a high 144% and private consumption ratio was 104%. On the other hand, Investment/GDP ratio has declined to 22.2% mostly driven by private investment.

Labor market indicators reveal that the number of employed people has risen by 8.5%; when this is coupled with zero GDP growth, one can infer that productivity growth was negative. Un employment continues to be higher in the Gaza Strip (29.7%) compared to 17.7% in the West Bank; the overall unemployment rate is 21.6%. This may have helped to reduce poverty slightly, however, poverty rates continue to be high. Employment in Israel is still 43% below its 2000 level; this

¹ This government was formed and named as such after the declaration of an emergency status. After that by one month it was renamed by a presidential decree to run the daily business until a new government is formed with the approval of the PLC.

demonstrates Israel's policy of reducing its dependence on Palestinian workers and replacing them with foreign ones.

Although the aggregate inflation rate for 2007 was 2.7%, it did not reflect the sudden acceleration in the second half of 2007. Supply bottlenecks in Gaza resulted in higher inflation there (4.1%) when compared to the West Bank (2.5%). The rise in oil and food prices is largely to blame. The slack in economic performance was a buffer against what inflation would have been otherwise.

Turning to the external sector, a slight improvement was achieved in the current account deficit. This was driven by higher export growth (24.5%) than import of goods and services growth (12.6%), current transfers and income from abroad. Trade deficit however has risen to its usual average of 66% of GDP. The external transfers have once again constituted a security buffer to the Palestinian economy; it helped in the coverage of a big part of this deficit; although more is needed to totally eradicate the deficit. Resource assets available to the PMA rose by \$ 91 million to get to \$443 million. This would cover a mere 1.5 months of imports. For this situation to be sustainable and in line with international standards, it ought to cover 3-6 months.

The new government's priority was to provide enough funds to cover government employees salaries, government current expenditures, and private sector arrears from domestic and international sources. Customs clearances and domestic revenues rose by 124% reaching \$ 1616 million on cash basis. This is despite the situation in Gaza and a stagnant economy. Foreign aid amounted to \$ 1322 million, 75% of which is for budget support. The remaining amount (\$ 310 million) was allocated to development expenditure, in addition to \$ 61 million from PIF. The budget deficit rose by 27.9% constituting 25% of GDP.

The structure of expenditure did not depart from previous trends. Expenditure and net arrears growth was 68.5% (\$ 2.88 billion). The largest share went for current expenditure (roughly 90%). Wages and salaries constituted 47.6% from total expenditures followed by operating expenditures (23%) and net lending (18%). Despite the government's efforts to reduce net lending by putting more controls, it continues to exert substantial pressure on the government's finances. Meanwhile, government debt to banking sector has declined to \$ 429 million and private sector arrears rose to \$ 1.3 billion constituting 30% of GDP. This was a consequence of the banking sector's hesitation to provide funds to the government in anticipation of higher probability of default risk.

The Strategic Transformation Plan led to noticeable changes at the PMA. One of which relates to its institutional structure, a restructuring of PMA employees and departments took place and was concluded in 2007. The institutional structure improvement was enhanced by an organizational and legal framework that governs its operations. The PMA also raised its capital and became more open to local and international societies.

Maintenance of financial stability in the banking sector was promoted by putting new regulations and controls. As a result, the number of branches has risen, banking sector assets also rose, bank capital increased. Work on a new payment system was introduced and is still work in progress.

Among the banking sector developments during 2007 were the increased levels of domestic liquidity, and assets. Customer deposits rose by 21.4% and maintained its share of liabilities. Although, customer deposits concentration in the West Bank has increased. Banks also improved their financial stability by increasing their capital and retained earnings. They were also successful in attracting non-customer deposits such as PMA and other deposits.

On the other hand, the net change of credit facilities decreased by 10.6% and investment by 3.4% as a result of the situation in Gaza, the increased risk level, tightening credit policy. The alternative was to increase outside placements by 33.8% because this is considered as a more secure alternative for them. Vault cash increased by 97.7% and the PMA balance increased by 34.5%. As result of this banks' profits rose by 42.7% compared to the last year. In summary, banking system performance was also influenced by political developments, a decline in credit facilities, and increase in placements abroad did serve the needs of the domestic economy, however, improved banking system capital risk and profits.

The Palestine Stock Exchange (PSE) was also influenced by the economic and political environment. Lack of progress on the political front meant lower expectations of returns on investment, this applies to domestic and foreign investors alike. As a result, lower demand was reflected in a regression of Al-Quds Index by 12.9%, and the liquidity indicator (asset turnover) decreased to 32.9%, a decrease of 6 percentage points.

The future prospects for the Palestinian economy depend heavily on progress at the political front. Optimistic expectations lead to improvements in investment, trade and public finance. Claims of intensified road blocks for security reasons have contributed to much of the decline in economic activity. International reactions to the Palestinian democratic elections have also been responsible for the stagnation of economic activity. In order to jump start the economy, the removal of barriers to trade and labor movements is a necessary condition. An increased effort from the donors is also needed in the form capital, rather than current, expenditure.

Government finances showed a continuation of previous trends despite some signs for improvement in the future. The reform and development plan aims at reducing current expenditure to 42% of GDP, and strengthening development expenditure. It also aims controlling the wage bill by freezing wage rates and limiting public employment. Other policies followed by the current government are limiting the net lending item by coordinating with local governments, and improving collection rates. To achieve a long term sustainable development, the government plans to improve public finance management, tax collection, sustainable retirement system, and increasing capital expenditure.

The key Economic Indicators in Palestine During (1999-2007)

Indicator	1999	2000	2001	2002	2003	2004	2005	2006	2007
PA Population (Thousand persons)	3,019	3,149	3,275	3,394	3,515	3,638	3,762	3,888	4,016
Growth rate (%)	4.2	4.3	4.0	3.6	3.6	3.5	3.4	3.4	3.3
Of which: West Bank (Thousand persons)	1,932	2,011	2,087	2,158	2,229	2,300	2,372	2,444	2,517
Growth rate (%)	4.0	4.1	3.8	3.4	3.3	3.2	3.1	3.1	3.0
Gaza Strip (Thousand persons)	1,087	1,138	1,188	1,236	1,286	1,338	1,390	1,444	1,499
Growth rate (%)	4.6	4.7	4.4	4.1	4.0	4.0	3.9	3.9	3.9
Economic Development									
GDP at constant prices (USD million)	4881.0	4617.0	3906.0	3539.0	3744.0	3969.0	4207.0	4005.0	4005.0
Growth rate (%)	8.9	-5.4	-15.4	-9.4	5.8	6.0	6.0	-4.8	0.0
GDP per capita (USD)	1745.0	1580.0	1284.0	1121.0	1144.0	1170.0	1198.0	1102.0	1065.0
Growth rate (%)	4.4	-9.4	-18.8	-12.7	2.0	2.3	2.4	-8.0	-3.4
GNI at constant prices (USD million)	5845.0	5447.0	4354.0	3956.0	4217.0	4414.0	4712.0	4478.0	4461.0
Growth rate (%)	8.4	-6.8	-20.1	-9.1	6.6	4.7	6.8	-5.0	-0.4
GNI per capita (USD)	2089.0	1865.0	1431.0	1253.0	1288.0	1301.0	1341.0	1232.0	1186.0
Growth rate (%)	3.9	-10.8	-23.2	-12.5	2.8	1.0	3.1	-8.2	-3.7
GDP at current prices (USD million)	4517.0	4442.0	3746.0	3156.0	3624.0	4077.0	4478.0	4533.0	5045.0
GNI at current prices (USD million)	5454.0	5274.0	4193.0	3546.0	4105.0	4534.0	4015.0	5068.0	5620.0
Unemployment Rate (%)	11.8	14.1	25.2	31.3	25.6	26.8	23.5	23.6	21.6
Of which: West Bank	9.5	12.1	21.5	28.2	23.8	22.9	20.3	18.6	17.7
Gaza Strip	16.9	18.7	34.2	38.0	29.2	35.4	30.3	34.8	29.7
Inflation Rate (%)	5.5	2.8	1.2	5.7	4.4	3.0	3.5	3.8	2.7
Of which: West Bank	6.5	3.2	2.6	6.1	4.3	2.9	2.9	4.0	2.5
Gaza Strip	4.0	3.0	-1.2	2.3	2.5	3.2	1.2	5.1	4.1
Consumption Expenditure as % of GDP	122.5	125.8	136.6	140.9	138.9	142.2	143.1	145.6	144.0
Investment Expenditure as % of GDP	42.0	31.4	20.7	24.7	26.8	25.1	24.1	21.1	22.2
Domestic Saving as % of GDP	7.1	6.2	11.8	17.1	10.0	3.8	3.9	11.2	14.6
Public Finance									
Total Revenue and Grants (USD million)	1439.0	1449.0	1124.0	992.0	1383.0	1403.0	2006.0	1740.0	2938.0
As % of GDP	31.9	32.6	30.0	31.4	38.2	34.4	44.8	38.4	58.2
Of which: local revenues (USD million)	942.0	939.0	275.0	295.0	763.0	1050.0	1370.0	721.0	1616.0
As % of GDP	20.9	21.1	7.3	9.3	21.1	25.8	30.6	15.9	32.0
Total Expenditure & Net Lending (USD million)	1411.0	1668.0	1437.0	1251.0	1651.0	1528.0	2281.0	1707.0	2877.0
As % of GDP	31.2	37.6	33.4	39.6	45.6	37.5	50.9	37.7	58.0
Of which: Current Expenditure (USD million)	937.0	1199.0	1097.0	999.0	1256.0	1528.0	1994.0	1426.0	2567.0
As % of GDP	20.7	27.0	29.3	31.7	34.7	37.5	44.5	31.5	50.9
Public Debt (USD million)	391.5	794.8	1190.6	1089.6	1235.8	1421.8	1602.2	1493.8	1439.4
As % of GDP	8.7	17.9	31.8	34.5	34.1	34.9	35.8	33.0	25.5
As % of Total Exports	43.9	91.7	212.6	234.3	266.3	265.3	272.5	279.2	216.1
Foreign Sector and Balance of Payment									
Current Account (USD million)	-1577.0	-1119.0	-334.0	-241.0	-609.0	-870.0	-906.0	-448.0	-383.0
As % of GDP	34.9	25.2	8.9	7.6	16.8	21.3	20.1	9.9	7.6
Export of Goods and Services (USD million)	892.0	867.0	560.0	465.0	464.0	535.0	588.0	535.0	666.0
As % of GDP	19.7	19.5	14.9	14.7	12.8	13.1	13.1	11.8	13.2
Import of Goods and Services (USD million)	3805.0	3404.0	2705.0	2535.0	2844.0	3279.0	3598.0	3558.0	4005.0
As % of GDP	84.2	76.6	72.2	80.3	78.5	80.4	80.3	78.5	79.4
Income from Abroad (USD million)	937.0	832.0	447.0	390.0	481.0	457.0	537.0	535.0	575.0
As % of GDP	20.7	18.7	11.9	12.4	13.3	11.2	12.0	11.8	11.4
Of Which: Comp. of Employees (USD million)	887.0	784.0	389.0	223.0	269.0	261.0	337.0	386.0	475.0
As % of GDP	19.6	17.7	10.4	7.1	7.4	6.4	7.5	8.5	9.4
Current Transfers (USD million)	399.0	586.0	1364.0	1439.0	1290.0	1417.0	1567.0	2040.0	2381.0

As % of GDP	8.8	13.2	36.4	45.6	35.6	34.8	35.0	45.0	47.2
Capital and Financial Account (USD million)	1542.0	1210.0	318.0	256.0	710.0	897.0	932.0	470.0	474.0
As % of GDP	34.1	27.2	8.5	8.1	19.6	22.0	20.8	10.4	9.4
Change in Foreign Assets	-35.0	91.0	-16.0	15.0	101.0	27.0	26.0	22.0	91.0

Indicator	2007	2006	2005	2004	2003	2002	2001	2000	1999
Banking Sector & P. S. E.									
Assets of PMA (USD million)	351.7	412.4	372.7	396.6	519.9	569.3	588.1	558.7	764.9
Growth Rate (%)	19.2	17.3	-9.6	6.4	31.1	9.5	3.3	-5.0	36.9
Assets of Banks (USD million)	3857.4	4592.8	4429.8	4278.2	4727.7	5101.2	5604.0	5737.1	6983.3
Growth Rate (%)	15.6	19.1	-3.6	-3.4	10.5	7.9	9.9	2.4	21.7
Direct Facilities (USD million)	1005.5	1346.7	1220.7	953.7	1071.2	1422.6	1791.4	1903.3	1758.5
Growth Rate (%)	20.7	33.9	-9.4	-21.9	12.3	32.8	25.9	6.3	-7.6
Direct Facilities as % of GDP	22.3	30.3	32.6	30.2	29.6	34.9	40.0	42.0	34.9
Balances with banks abroad	2005.6	2150.0	2176.3	2328.5	2267.4	2329.9	2338.8	2405.1	3217.7
Growth Rate (%)	18.4	7.2	1.2	7.0	-2.6	2.8	0.4	2.8	33.8
Customer's Deposits (USD million)	2875.1	3507.7	3397.8	3432.1	3624.5	3946.2	4190.1	4202.6	5099.9
Growth Rate (%)	19.1	22.0	-3.1	1.0	5.6	8.9	6.2	0.3	21.4
Customer's Deposits as % of GDP	63.7	79.0	90.7	108.7	100.0	96.8	93.6	92.7	101.1
Equity (USD million)	245.6	242.6	205.6	186.6	217.4	215.2	552.2	589.3	707.2
Growth Rate (%)	10.5	-1.2	-15.2	-9.2	16.5	45.0	75.2	6.7	20.0
Palestine Securities Exchange Index (% point)	236.8	207.6	195.0	151.2	179.8	277.6	1128.6	605.0	522.3
Turnover Ratio (%)	17.7	24.7	10.3	7.8	9.0	18.3	47.0	34.8	32.9