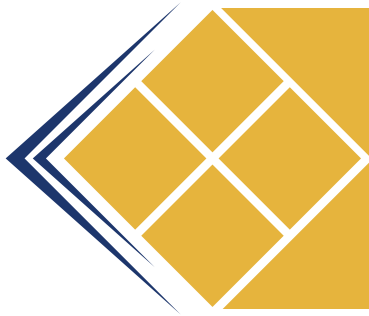




PALESTINE MONETARY AUTHORITY




Inflation Report

Third Quarter 2014

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Executive Summary

The inflation rate in Palestine reached 2.3 percent in the third quarter of 2014 compared with the third quarter of 2013. The inflation rate was higher than that registered in the previous quarter (1.3 percent), and in the corresponding quarter of 2013 (1.4 percent). The rate is also much lower than that registered in the MENA region (8.1 percent), but higher than in Israel (0 percent). The analysis revealed that inflation in Palestine is largely imported and shows high sensitivity to world prices, particularly food and fuel.

The approach followed in this report for inflation analysis and forecasting purposes depends on two variables: (i) cost of imports, which reflects the inflation and exchange rates of Palestine's main trading partners, among which Israel accounts for the highest portion (80 percent of exports and 70 percent of imports on average) of Palestine's trade, and (ii) world food prices, as food has the highest weight in the consumer price index (35 percent) in Palestine.

Inflation forecasts show that consumer prices in Palestine are expected to increase by around 2.0 percent during 2014, on average. Moreover, prices are also expected to rise by around 2.4 percent during the fourth quarter of 2014 on a yearly basis. Forecasts depend on assumptions concerning the most likely future paths for (i) prices and exchange rates in Palestine's most important trading partners, and (ii) prices in the international food markets, as predicted by foreign international organizations such as the IMF and foreign central banks.

Given that Palestine's inflation may deviate from the baseline scenario, due to deviations in foreign prices and exchange rates, the forecast is supplemented with a risk analysis. Beside the baseline, the forecast takes into account four alternative scenarios based on positive and negative one standard deviation shock in Palestine's cost of imports and world food prices. The expected effects on Palestine's alternative inflation outcomes show that a positive one-standard deviation shock in external conditions may increase Palestine's inflation to nearly 2.2 percent, on average, during 2014. On the other hand, a negative one-standard deviation shock may bring Palestine's inflation down to 1.9 percent during the same period.

As for the financial developments in Palestine, 2014Q2 data indicate that lending interest rates on the NIS and JD have decreased compared to the previous quarter, while the rate on the USD has increased during the same period. On the other hand, the deposit rate on the USD and JD has slightly increased, while it remained unchanged on

the NIS. The margin between lending and deposit rates in Palestine remained relatively higher than in the countries that issue the respective currencies; however, it declined on the JD and the NIS to 6.53 percent and 9.65 percent, respectively, during 2014Q2, whereas it increased on the USD to 5.32 percent during the same period.

The performance of the Palestinian stock market has relatively improved during the third quarter of 2014. Thus, Al-Quds index has increased by about 1.7 percent in 2014Q3 compared with the previous quarter, reaching 511.1 points. The increase came as a result of the increase in almost all sectors (investment, industry, insurance, and banks) except for the services sector which remained unchanged during the same period.



Contents

Executive Summary	iii
I. Recent Economic Developments	7
Real GDP	7
Inflation and Prices	10
Aggregate demand	16
Labor force and wages	17
Exchange rates	19
II. Recent Financial Developments	20
Interest Rates	20
Stock market	24
III. Model Based Inflation Forecast	26
Inflation model and estimation technique	26
Baseline inflation forecast	27
IV. The Balance of Inflation Risk	29



Recent Economic Developments



Real GDP

Global economic growth was less than expected in the first half of 2014 reflecting the weaker growth in both advanced countries (AC) and emerging and developing countries (EDC). Based on that, the IMF marked down its projections for the global economic growth in 2014 to 3.3 (0.1 percentage points lower than what was projected in July update) and to 3.8 percent in 2015^[1].

AC grew by 1.7 percent in 2014Q2 compared with around 1.9 percent in the previous quarter and 1.0 percent in the corresponding quarter of 2013. AC are expected to grow by 1.8 percent (the same as what was projected in July update^[2]) and 2.3 percent in 2014 and 2015 respectively according to the latest IMF World Economic Outlook (WEO).

As a result of the increase in manufacturing production and real estate, the United States (US) economy grew by 2.6 percent compared with around 1.9 percent in 2014Q1 and 1.8 percent in 2013Q2. The IMF expects US economy to grow by 2.2 percent in 2014 (0.5 percentage point higher than what was projected in July update) and 3.1 percent in 2015.

The Euro area's (EA) economy slowed down after several periods of continued recovery, as a result of the decline in the industrial sector and in investors' confidence. During 2014Q2, the EA economy grew by 0.8 percent, compared with 1.1 percent in 2014Q1 and -0.6 percent in 2013Q2. The IMF revised down its growth expectations for the EA's economy. Thus, it expects the EA's economy to grow by 0.8 percent in 2014 (0.2 percentage points lower than what was projected in July update) and by 1.3 percent in 2015.

The Japanese economy shrank by 0.05 percent in 2014Q2 compared with a growth of 2.7 percent in the previous quarter and 1.3 percent in the corresponding quarter of 2013. The IMF expects the Japanese economy to grow by 0.9 percent in 2014 (0.7 percentage point lower than what was previously expected) and 0.8 percent in 2015.

EDC continued slowing down during 2014Q2 as a result of a weaker activity in most of EDC like China, Latin America, Russia, and MENA region. Accordingly, the IMF expects

[1] IMF, World Economic Outlook, October 2014.

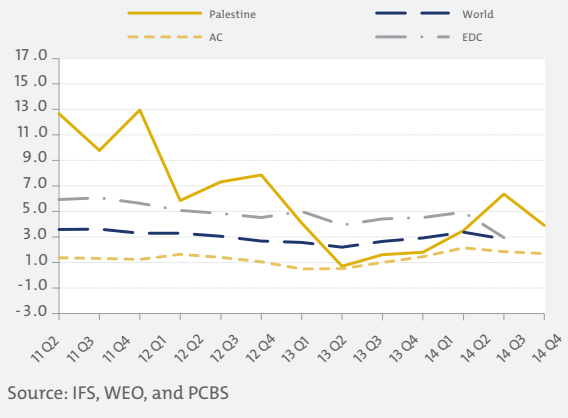
[2] IMF, World Economic Outlook Update, July 2014.



EDC to grow by 4.4 percent and 5.0 percent in 2014 and 2015 respectively, which are lower than the July expectations.

The Chinese economy grew by 7.5 percent in 2014Q2 compared with 7.4 percent in both 2014Q1 and 2013Q2. The IMF estimates that the Chinese economy would continue slowing down, growing by 7.4 percent and 7.1 percent in 2014 and 2015 respectively.

Figure 1: Real growth rates in the World and Palestine

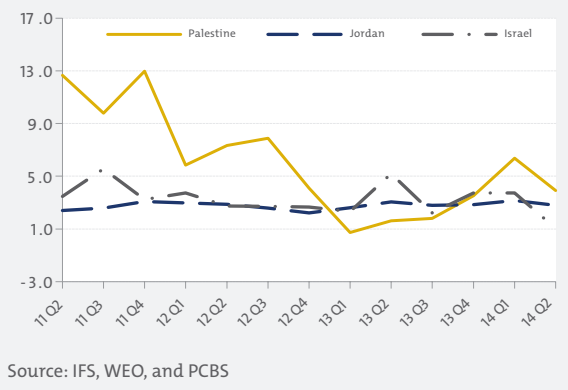


Many countries in the Middle East and North Africa (MENA) region continued to suffer from several political and economic problems, as in Iraq, Syria, Egypt, Libya, Yemen and, to a lesser extent, Tunisia. MENA economies are expected to grow by around 2.6 percent in 2014 (0.5 percentage point lower than what was previously expected) and 3.8 percent in 2015, according to the IMF.

Looking at the region, the Israeli economy slowed down in 2014Q2 to 1.0 percent from 3.7 percent in 2014Q1 and 5.2 percent in the corresponding quarter of 2013. Accordingly, IMF revised down its expectations of the Israeli economic growth from 3.2 percent to 2.5 percent in 2014 and from 3.4 percent to 2.8 percent in 2015. It should be noted that the impact of the Israeli attack on GS on the Israeli economy played an important role in these expectations.

The Jordanian economy also slowed down to 2.8 percent in 2014Q2 from 3.2 percent in the previous quarter and 3.1 percent in the corresponding quarter of 2013. IMF kept its expectations of the Jordanian economy the same as the previous expectations, with a growth rate of 3.5 percent and 4.0 percent in 2014 and 2015, respectively.

Figure 2: Real growth rates in Palestine, Jordan, and Israel



The economic growth in Palestine slowed down from 6.4 percent in the first quarter of 2014 to 3.9 percent in the second quarter, yet it remained higher than the growth rate achieved in the corresponding quarter of 2013 (1.6 percent). This sluggish growth came as a result of the slowdown in the WB, where real GDP dropped from 10.6 percent in the previous quarter to 8.0 percent in 2014Q2. In GS, real GDP shrank from -4.4 percent to -7.1 percent.

The main drivers for growth in the WB were internal trade and service activities, which grew by 24.1 percent and 14.1 percent respectively in 2014Q2 compared with 2013Q2. It is worth mentioning that both activities account for 38.9 percent of real GDP in the WB.

The decline in GS's real GDP came as a result of the huge decline in services, industry, and construction activities, where they declined by 3.8 percent, 5.3 percent, and 72.9 percent respectively between 2013Q2 and 2014Q2. Those three activities accounted for 37.9 percent of real GDP in 2014Q2.

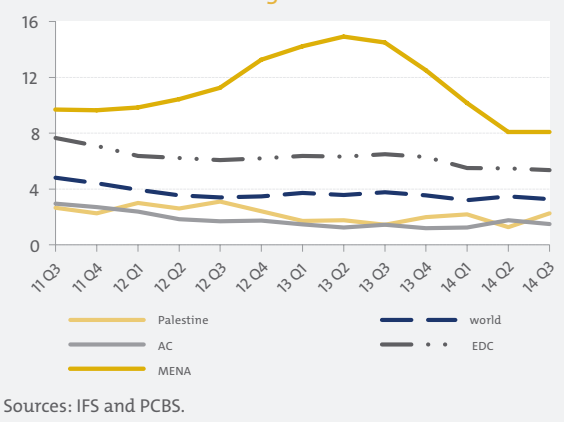
Inflation and Prices

The global inflation rate declined slightly in the third quarter of 2014, as a result of declining inflation in both AC and EDC. As depicted in Figure (3), global inflation declined to 3.3 percent in 2014Q3 from 3.5 percent in the previous quarter.

Two reasons stood behind the decline in global inflation rates; the first is the fall in oil prices driven by a well-supplied oil market; and the second is the decline in food prices, thanks to the favorable weather conditions which continued to boost supply.

As a result, inflation in AC declined to 1.5 percent compared with 1.8 percent in 2014Q2. The US inflation rate declined from 2.1 percent in the previous quarter to 1.8 percent in 2014Q3. In the EA, inflation declined from 0.6 percent to 0.4 percent between quarter 2

Figure 3: Inflation rates in Palestine and other World regions



and quarter 3 of 2014. It is worth mentioning that the EA inflation rate has continued to fall below the target (2 percent) since the end of 2010.

In EDC, inflation receded slightly from 5.5 percent in 2014Q2 to 5.4 percent in 2014Q3. In the MENA region, which suffers from some of the highest inflation rates in the world, inflation reached 8.1 percent during 2014Q3, the same level as in the previous quarter.

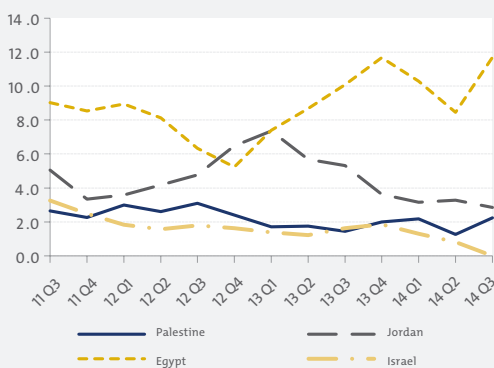
Figure (4) compares the average annual inflation rate in Palestine with its neighboring countries (Jordan, Egypt, and Israel). It shows that the movement of inflation rates in Palestine is highly consistent with those in Israel. In 2014Q3, Palestine's inflation rate increased to 2.3 percent compared with 1.3 percent in the previous quarter.

Inflation in Jordan declined to 2.8 percent during 2014Q3 compared with 3.3 percent in 2014Q2. The inflation rate in Egypt increased to 11.7 percent in 2014Q3 compared with 8.5 percent in the previous quarter.

Inflation in Israel registered a zero increase in 2014Q3 compared with 0.8 percent in 2014Q2. This rate is lower than the target level (1-3 percent) set by the Bank of Israel.

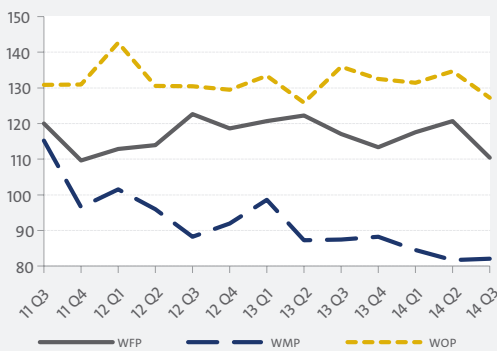
As mentioned above, the change in global, regional, and local inflation rates is mainly due to the change in commodity prices worldwide. Figure (5) shows that world food price (WFP) declined by 8.4

Figure 4: Inflation rates in Palestine, Jordan, Egypt, and Israel



Sources: IFS and PCBS.

Figure 5: Indices of primary commodity prices, 2010=100



Source: IFS

percent in 2014Q3 compared with the previous quarter and by 5.6 percent compared with the corresponding quarter of 2013.

World oil price (WOP) declined by 5.6 percent in 2014Q3 compared with the previous quarter and by 6.4 percent compared with the corresponding quarter of 2013.

World metal price (WMP), for the first time since the beginning of 2014, increased compared with the previous quarter (0.5 percent) but declined by 6.2 percent compared with 2013Q3.

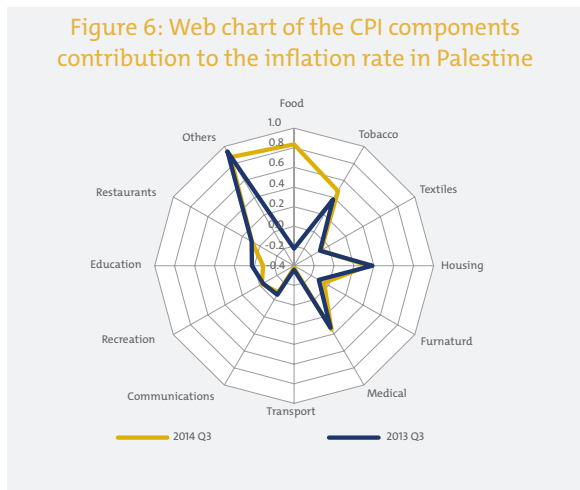
As for the quarter-on-quarter inflation rate, Palestine experienced an inflation of 1.9 percent in 2014Q3 compared with a deflation of 1.3 percent in 2014Q2. This inflation came as a result of the rise in prices in all regions in Palestine. In GS, prices increased by 3.9 percent. They also rose in the WB by 0.8 percent and in Jerusalem by 0.3 percent.

Data show that the main driver of the recent inflation trend in Palestine is the increase in alcoholic beverages and tobacco prices, which increased by 5.6 percent in 2014Q3 compared with the previous quarter.

On an annual basis, medical care prices and alcoholic beverages and tobacco prices showed the highest inflation rate with an increase of 9.0 percent each in 2014Q3 compared with 2013Q3. Miscellaneous or other goods and services prices came in the second place, with an 8.7 percent increase. Restaurants and cafes services prices increased by 4.5 percent. Housing services prices increased by 3.8 percent, and finally food and soft drinks prices increased by 2.4 percent between 2013Q3 and 2014Q3.

On the other hand, prices declined for transportation by 2.8 percent, for communications by 2.6 percent, for education by 2.4 percent, for textiles by 1.5 percent, for cultural goods by 1.4 percent, and for furniture by 1.0 percent in 2014Q3 compared with the corresponding quarter of 2013.

Figure (6) shows the contribution of the different broad CPI components to the inflation

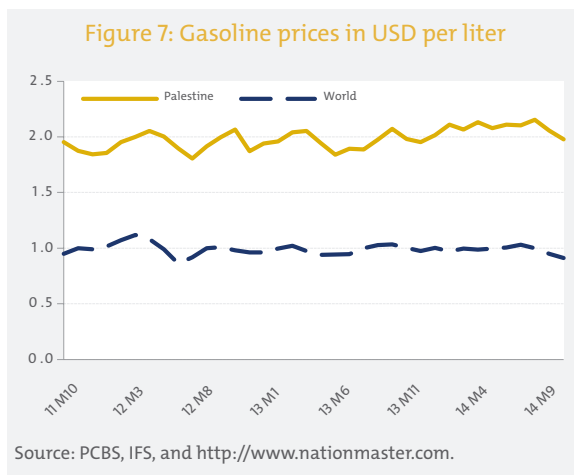


rate in the third quarter of 2014 compared with 2013Q3. The web chart indicates, for the second successive quarter, that miscellaneous goods and services price index made the highest contribution to inflation rate, while transportation price index recorded the lowest contribution.

Although miscellaneous goods and services price index had the highest contribution to inflation in 2014Q3, it declined to 0.87 percentage point from 0.94 percentage point during 2013Q3. The contribution of transportation price index was -0.38 percentage point during 2014Q3 compared with -0.36 percentage point during 2013Q3. The contribution of food and soft drinks, medical care, and cultural prices to inflation increased between 2013Q3 and 2014Q3. The contribution of all other categories declined between the same two periods.

Commodity prices in Palestine hit much higher levels than in the world market. Looking closer at prices, the retail price of gasoline in Palestine is among the highest in the world. One liter of gasoline costs 7.3 NIS (\approx USD 2.1), which is more than double the world average price, USD 1.0 during 2014Q3.

Figure (7) shows that fuel prices in Palestine and the world are highly correlated. Gasoline prices in Palestine increased by 2.8 percent in 2014Q3 compared with 2013Q3, while the world's average price of gasoline declined by 6.5 percent. However, comparing with the previous quarter, gasoline prices didn't change in Palestine, while they declined by 5.6 percent in the world.



The case is the same with other commodity prices like wheat, rice, and sugar. The prices of these commodities in Palestine are higher than the world prices. During 2014Q3, wheat prices in Palestine were around 2.8 times the world prices, rice prices were around 3.3 times the world prices, while sugar prices were around 1.4 times the world prices.

Also important are some non-imported commodities like fresh chicken and beef meat. Local prices of these commodities are not sensitive to global trends but are still much

higher than world prices due to the high cost of production and the absence of effective price monitoring. Fresh chicken meat prices in Palestine were around 1.9 times the world price and beef meat prices were more than 2.5 times the world prices during 2014Q3.

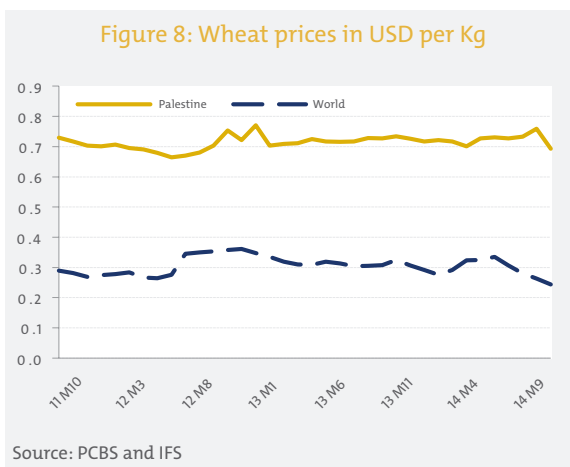


Table 1: Prices of selected commodities in Palestine NIS

per unit^[3]

	2013		2014		
	Q3	Q4	Q1	Q2	Q3
Wheat	155.5	153.6	149.6	151.5	153.6
Bread	3.8	3.8	3.8	3.9	3.9
Rice	103.8	103.5	109.6	127.4	125.4
Beef meat	50.5	50.1	47.7	47.4	48.0
Chicken meat	18.3	16.0	16.7	15.4	16.4
Powder Milk (Nido)	94.8	95.5	95.3	94.8	96.7
Yogurt (local)	4.8	4.8	4.8	4.7	5.0
Chicken Eggs	16.6	17.4	17.8	15.1	17.1
Tomatoes	2.2	3.8	3.1	2.4	4.2
Sugar	174.2	172.8	141.2	146.4	146.2
Gas	64.1	68.7	73.0	69.6	71.0
Diesel	6.3	6.4	6.7	6.6	6.6
Gasoline 95	7.1	7.0	7.4	7.3	7.3

Source: PCBS

[3] Unit for Wheat: 60 Kg sack; Bread: 1 Kg; Rice: 25 Kg sack; Chicken and Beef meet: 1 Kg, Powder Milk: 2.5 Kg can; Yogurt: 500 g can; 2 Kg box; Tomatoes: 1 Kg; Sugar: 50 Kg sack; Gas: 12 Kg cylinder, Diesel and Gasoline: 1 Liter.

Aggregate demand

Table (2) shows that real GDP in Palestine reached USD 1,973.8 million in 2014Q2, increasing by 3.9 percent compared with 2013Q2 and by 5.1 percent compared with 2014Q1. The year-on-year increase in real GDP is mainly attributed to the increase in private and government consumption.

Table 2: Aggregate demand at constant prices (2004=100)

(USD million)

	2013			2014	
	Q2	Q3	Q4	Q1	Q2
Private consumption	1,694.8	1,684.5	1,678.6	1,713.5	1,785.5
Government expenditure	479.5	516.2	462.2	495.9	576.2
Investment	457.7	398.8	424.3	356.8	401.1
Exports	340.5	318.4	365.2	344.5	359.2
Imports	1,070.2	1,037.9	1,002.4	1,020.0	1,138.0
GDP	1,899.6	1,893.1	1,897.0	1,878.5	1973.8

Source: PCBS.

Private consumption increased by 5.4 percent in 2014Q2 compared with the corresponding quarter of 2013, and increased by 4.2 percent compared with the previous quarter. On the other hand, government expenditure increased by 20.2 percent in 2014Q2 compared with 2013Q2 and by 16.2 percent compared with 2014Q1.

Investment, on the other hand, declined by 12.4 percent compared with 2013Q2, but increased by the same percent compared with the previous quarter. Exports increased by 5.5 percent in 2014Q2 compared with 2013Q2 and by 4.3 percent compared with 2014Q1. Imports also increased by 6.3 percent in 2014Q2 compared with 2013Q2 and by 11.6 percent compared with 2014Q1.

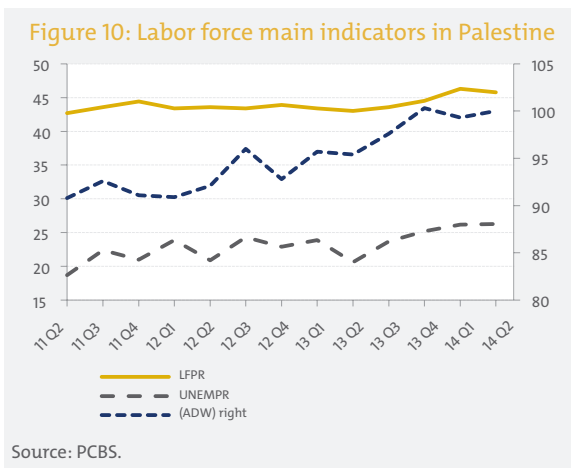
Labor force and wages

Labor force participation rate declined in Palestine during the second quarter of 2014 and reached 45.8 percent of the total number of persons aged 15 years and

over^[4] compared with 46.3 percent in the previous quarter, but was still higher than the respective quarter of 2013 (43.0 percent).

Unemployment increased to 26.3 percent in 2014Q2 compared with 26.2 percent in the previous quarter and 23.9 percent in 2013Q2. Looking at the geographical pattern of unemployment, the WB shows lower unemployment rates than GS, i.e., 16.0 percent in the WB, compared to 45.1 percent in GS in 2014Q2. It is worth mentioning that the unemployment rate in WB declined compared with the previous quarter (18.2 percent), while increasing in GS (40.8 percent).

Average daily wages in Palestine increased slightly in 2014Q2 compared with previous quarter. ADW reached NIS 100.0^[5] in 2014Q2 compared with NIS 99.3 in 2014Q1. When comparing the ADW based on work location, a big gap emerges between those who work in Palestine and those who work in Israel and settlements. ADW for those who work in Palestine reached NIS 81.9, versus NIS 184.3 for those who work in Israel and settlements^[6]. On the other hand, ADW in WB reached NIS 90.7 while in GS it reached NIS 61.4 in 2014Q2.



Exchange rates

Figure (11) shows the nominal and real effective exchange rates (NEER and REER) in Palestine^[7]. The discrepancy between the NEER and REER indicates that changes in

[4] The total number of persons aged 15 years and over in Palestine reached 2,726,600 in 2014Q2.

[5] This value includes the ADW of the Palestinian workers in Israel and settlements.

[6] An analytical study was conducted to explore the relation between aggregate demand, unemployment rate, and wages on the one hand, and inflation on the other, but the results showed no statistically significant relationship between these variables and inflation in Palestine. These results prove that inflation in Palestine is imported and influenced by external factors more than by internal conditions.

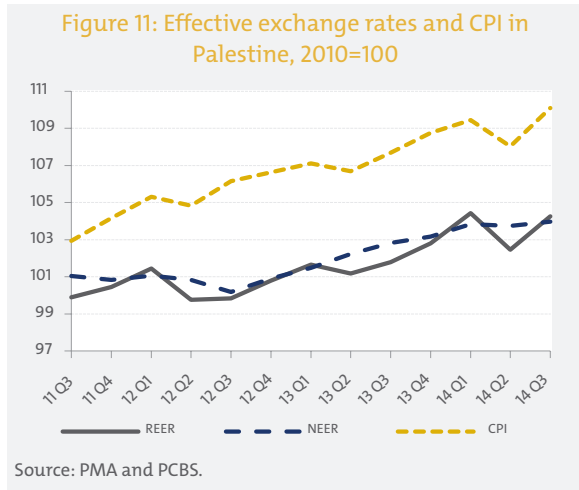
[7] The NEER provides a weighted average of a country's nominal bilateral exchange rates, indexed on a chosen base year; The REER corrects the NEER for relative price developments.

inflation in Palestine relative to its trading partners contributed to the appreciation of the real exchange rate during this period. The appreciation of the NEER indicates that the NIS appreciated against Palestine's trading partners' currencies, and the appreciation of the REER indicates that Palestine lost competitiveness against its trading partners^[8].

Data show that the NEER increased by 1.1 percent in 2014Q3, compared with 2013Q3, which indicates that the NIS depreciated against Palestine trading partners' currencies. The REER increased by 2.4 percent in 2014Q3, compared

with the 2013Q3, which indicates that Palestine lost some competitiveness against its trading partners. On the other hand, cost of imports (CIM) declined by 0.2 percent during the same comparative period.

It is worth mentioning that Palestinian foreign trade is substantially affected by restrictions and other obstacles imposed by the Israeli occupation, and its effects on trade is much stronger than the effect of changes in NEER and REER.



[8] NIS is the currency used in the calculation of the CPI and thus NEER and REER.

Recent Financial Developments

Interest Rates

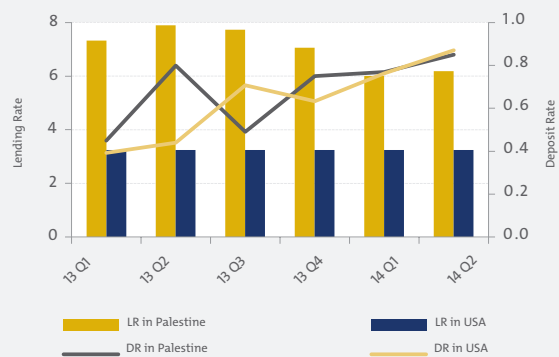
The volatile and vulnerable economic and political conditions in Palestine have direct influence on interest rate levels. On one hand, lending rates, except for the JD, in Palestine are significantly higher compared to the same rates in the issuing countries. On the other hand, deposit rates, except for the NIS, are lower than the rate in countries of origin of respective currencies. Thus, lending rates on the NIS and the USD currencies circulating in Palestine are more than double their counterparts in the countries of origin. On the contrary, the lending rate on the JD in Palestine was lower than in Jordan.

The lending rate on the USD has increased by around 17 basis point, reaching 6.18 percent during 2014Q2. IMF data indicate that lending rate on USD in the US was relatively stable at 3.25 percent during the same period.

Lending rate on the NIS in Palestine has decreased, for the third consecutive quarter, to 11.05 percent in 2014Q2. Notwithstanding, NIS interest rate in Palestine amounts to around threefold its counterpart in Israel, which recorded an average of 3.92 percent during the same period.

It is worth mentioning that the weak economic performance in Israel forced Bank of Israel to cut the interest rate to a historical low rate during the second quarter of 2014. This partially led to a decline in the lending rate on the NIS in Palestine, for the third consecutive quarter. Despite this decline, the NIS lending rate is still relatively high in Palestine. This is mainly due to the intensive use of the NIS in daily transactions, which increases the demand for it. Add to this the high cost of transferring the NIS between Israeli corresponding banks and banks operating in Palestine, due to obstacles imposed by the Israeli side.

Figure 12: Lending and deposit rates of USD



Source: PMA and IMF.

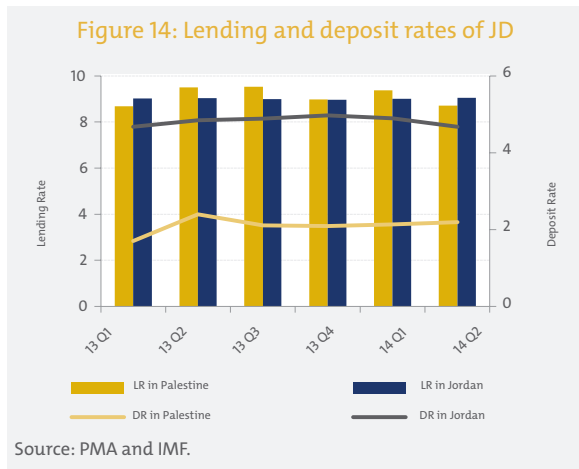
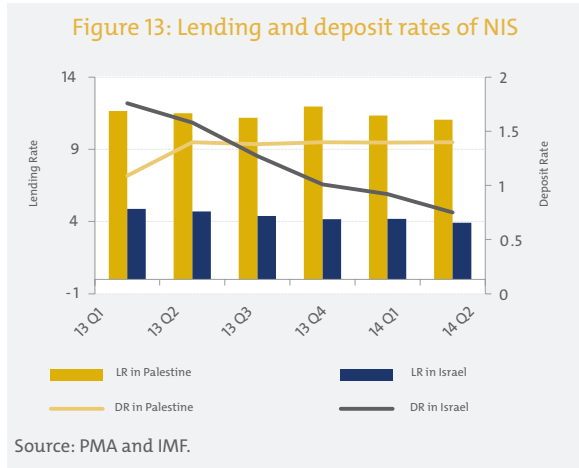
The lending rate on JD loans in Palestine has declined by around 67 basis points, reaching 8.71 percent during 2014Q2.

The deposit rate increased for both the JD and USD, while it remained unchanged for the NIS deposits in Palestine during 2014Q2. Hence, despite the decline of deposit rate in Israel to around 0.75 percent during 2014Q2, the deposit rate on NIS in Palestine remained unchanged at 1.4 percent, for the third consecutive quarter.

On the other hand, deposit rate on the USD in Palestine increased during 2014Q2 to 0.85 percent compared with 0.87 percent in the US^[9]. However, the low deposit rate on the USD, and on the NIS might be attributed to official efforts of both the US Fed and the Bank of Israel to preserve the economic competitiveness of their goods and services in the global markets.

The deposit rate on the JD in Palestine increased to reach 2.19 percent during 2014Q2, but remained less than its counterpart in Jordan (4.68 percent) during the same period. This might be attributed to the efforts of the central bank of Jordan to preserve the JD value.

The overall result reveals that the margin between the lending and deposit rates is remarkably higher and more volatile in Palestine than the margin in the currency issuing countries. It is about double the margin between lending and deposit rates in Jordan and the US, and

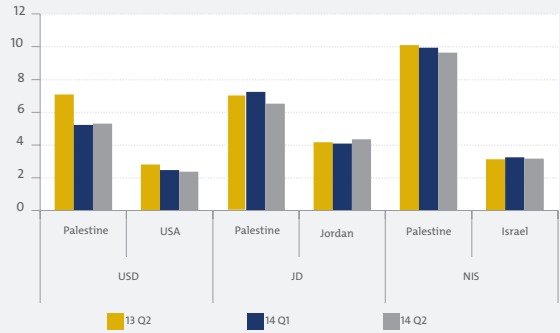


[9] Interest rates on government securities, and government bonds in the short-term, were used as a proxy for the deposit rate in USA.

about triple the margin in Israel.

As for real interest rates^[10], data indicate that real lending rates are always positive and high. On the other hand, real deposit rates on JD and NIS turned positive in the second quarter of 2014 for the first time since 2007. During 2014Q2, real deposit rate on NIS and on JD reached 0.15 percent and 0.93 percent respectively, however it was about -0.40 percent on USD during the same period. The real lending rates in Palestine during 2014Q2 reached about 4.92 percent on USD, 7.46 percent on JD, and 9.79 percent on NIS.

Figure 15: Margins between lending and deposit rates in Palestine compared with issuing countries

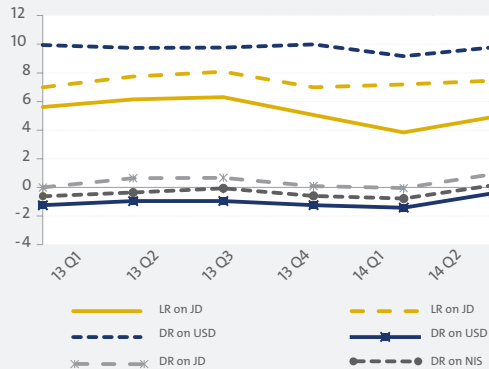


Source: PMA and IMF.

Overall, one can notice the following:

- Real deposit rates on JD and NIS increased during 2014Q2 to become positive. This implies that the real value or the purchasing power of JD and NIS deposits has improved during 2014Q2. On the other hand, the purchasing power of USD deposits continued to decrease.
- Real lending rates are always positive, implying that the real value of banks' lending is increasing overtime, when purchasing power is taken into consideration.
- Finally, real deposit rates are convergent, while real lending rates are divergent.

Figure 16: Real lending and deposit rates in Palestine by currency



Source: PMA and PCBS

[10] Fisher's equation; $(1 + \text{real interest rate}) = (1 + \text{nominal interest rate}) / (1 + \text{expected inflation rate})$.

Stock market

The Palestinian stock market has witnessed a set of developments that enhanced its performance during the third quarter of 2014, especially due to the increase in capital of some of the listed companies in PEX, such as The National Bank, which raised its capital by about USD 25 million during September 2014. Such developments increased Al-Quds index by about 1.7 percent in 2014Q3 compared with the previous quarter, and 8.6 percent compared with 2013Q3, reaching 511.1 points.

The performance of all sectors has improved during 2014Q3 compared with the previous and corresponding quarters, except for the services sector which remained unchanged compared with the previous quarter.

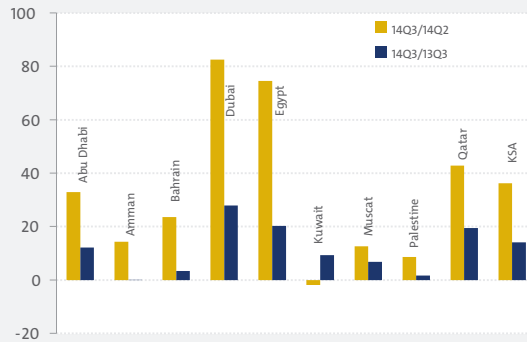
The increase in sectors' indices ranged between 1.4 percent as in the banking sector, to 5.5 percent as in the investment sector.

Table 3: Palestine stock exchange index (Al-Quds index)

	2013		2014		
	Q3	Q4	Q1	Q2	Q3
Banking	109.4	119.4	122.8	117.5	119.2
Industry	65.4	66.8	69.3	66.9	68.4
Insurance	44.6	44.5	46.2	44.9	45.7
Investment	20.7	23.9	30.5	26.7	28.2
Service	46.9	50.4	50.6	47.3	47.3
Al-Quds	470.7	541.5	548.4	502.8	511.1

Source: www.pex.ps

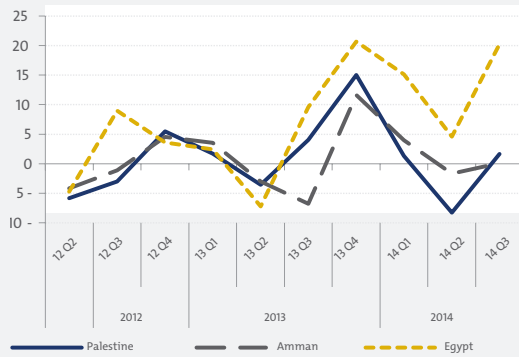
Figure 17: Stock markets performance, some selected Arab markets



Source: <http://www.gulfbase.com> - <http://www.ase.com.jo> - <http://www.egx.com.eg>

The performance of the stock markets of some selected Arab countries varied during 2014Q3 compared with 2014Q2. Bahrain's stock exchange had the least percentage increment (0.1 percent), whereas Dubai Financial Market witnessed the highest increment (27.9 percent). Furthermore, and except for the Kuwait Stock Exchange, all of the stock markets of the selected countries have made profits on the basis of annual comparison.

Figure 18: Stock markets performance in Palestine, Amman, and Egypt during 2012Q2 – 2014Q3



Source: <http://www.ase.com.jo>; <http://www.egx.com.eg>

Data revealed that Palestinian stock market is significantly affected by both the Amman and Egypt stock markets. The effects of other Arab stock markets were tested and turned out to be insignificant. Figure (18) shows the quarter on quarter growth rate of the general index.

Model Based Inflation Forecast

Inflation model and estimation technique

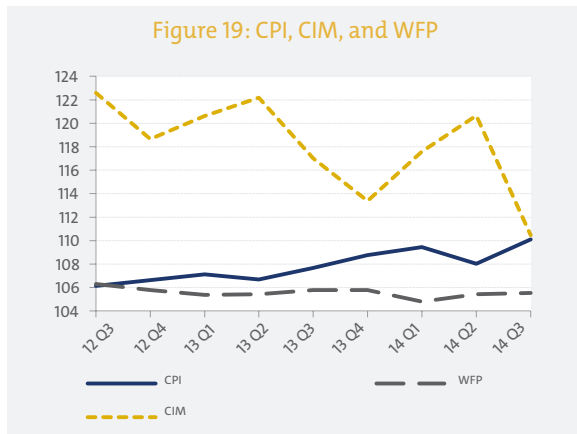
Analysis shows that the CPI in Palestine is co-integrated with (i) the CIM, which is a weighted average cost of imports, expressed in NIS, and calculated regularly by the PMA, and (ii) the world food price index. The importance of WFP is related to the high weight food occupies in the CPI basket in Palestine^[11].

Given the existence of a co-integrating vector between these variables and the CPI, the question arises as to how this long-run relationship is best estimated, and how to model the short-term dynamics that explain how fast shocks to this long-run relationship are corrected over time to bring the CPI back to its long-run equilibrium value.

In this respect, long-run and short-run relationships are estimated using three different approaches. The first is the Johansen's (1991, 1995) system-based reduced rank approach. The second is the ARDL test which is based on Pesaran, Shin (1999) and Pesaran, Shin, Smith (2001). The third is the semi-parametric Fully Modified OLS approach (FMOLS) of Phillips and Hansen (1990).

Baseline inflation forecast

The objective is to use the basic inflation model to generate a quantitative CPI outlook for the current and next years on a quarterly basis that is over the period 2014Q4 till 2015Q4. To that end, a baseline scenario for the exogenous variables CIM and WFP is needed. The CIM is basically the denominator of the REER index calculated by the PMA.



[11] For more details about inflation determinants in Palestine, see Palestine Monetary Authority (PMA), 2011. Inflation Report 2010: April.

The baseline scenario for the CIM was derived from the VECM. Thus CIM is assumed to increase by 0.03 percent in 2014 and by around 0.9 percent in 2015.

The most recent forecasts coming from the IMF estimate that food prices will decline in 2014 compared with 2013 and will continue declining in 2015. Accordingly, world food prices will decline by around 3.4 percent in 2014, and by around 7.0 percent in 2015.

The estimation of the basic inflation model, according to the three mentioned estimation techniques^[12], combined with the common baseline growth rates for the CIM, and the WFP as explained in table (4), result in an inflation forecast of 2.4 percent on average, for 2014Q4 as compared to 2013Q4.

Table 4: Inflation outlook of the three models

	Assumptions			Inflation Forecasts		
	CIM	WFP	VECM	ARDL	FMOLS	Aveg.
2013*	0.33	1.10	1.73	1.73	1.72	1.73
14Q1*	-0.53	-2.48	2.18	2.18	2.18	2.18
14Q2*	0.00	-1.30	1.26	1.26	1.26	1.26
14Q3*	-0.23	-5.60	2.25	2.25	2.25	2.25
14Q4	0.87	-4.20	2.24	2.10	2.77	2.37
2014	0.03	-3.36	1.99	1.95	2.12	2.02
15Q1	0.79	-7.80	2.17	2.25	2.14	2.19
15Q2	0.91	-11.32	2.18	1.97	2.38	2.18
15Q3	1.39	-4.81	1.20	1.10	1.22	1.17
15Q4	0.63	-3.70	1.62	1.48	1.50	1.53
2015	0.93	-7.03	1.79	1.70	1.81	1.76

* Actual data.

As is well known, the use of econometrically estimated models to forecast future inflation is subject to model and coefficient uncertainty. To reduce this specific uncertainty, the baseline CPI outlook for 2014 and 2015 is forecast as the simple average of the three models, which results in a forecast of 2.0 percent and 1.8 percent increase in CPI on average during 2014 and 2015 respectively.

The above-mentioned baseline forecasts took into account the Israeli attack on Gaza Strip, which led to an increase in prices in the Strip, and thus higher inflation. Without the war effect, inflation in Palestine would have been around 1.5 percent in 2014.

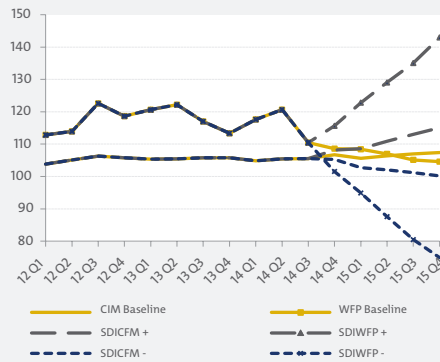
[12] VECM, ARDL, and the FMOLS.



The Balance of Inflation Risk

Apart from the abovementioned risks of model uncertainty, the CPI outlook also crucially depends on the assumptions concerning the course of the exogenous variables used in the model forecast, which exclusively refer to external conditions as implied by foreign inflation trends, bilateral exchange rates of the NIS and the world food market prices.

Figure 20: Scenario assumptions for CIM and WFP

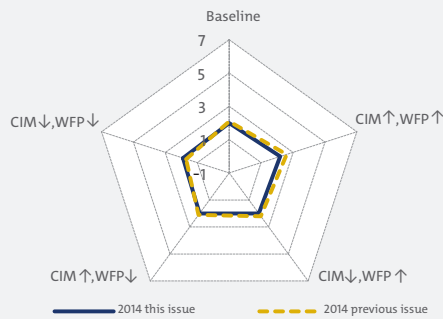


We evaluate the risks for the CPI outlook stemming from potential shocks in these external conditions, by setting up 4 alternative scenarios, resulting from all possible combinations of positive and negative one standard deviation shocks in the baseline growth rates of CIM and WFP.

These results demonstrate that taking a one Standard Deviation (1SD) shock may not fully reflect the implied risk. Because of the existence of excess kurtosis^[13], the probability distributions are leptokurtic, implying that the occurrence of extreme shocks has a probability that is higher than one would expect on basis of a normal distribution.

The results of these scenarios are mentioned in table (5). They indicate that, given the assumptions, the average inflation forecasts during 2014 range between 1.9 percent and

Figure 21: Web chart of the balance of Palestine's inflation risk



[13] Kurtosis measures the peakedness or flatness of the distribution of the series.

2.2 percent with 2.0 percent as the central baseline outlook. In 2015, the average inflation forecasts are expected to range between -2.2 percent and 5.7 percent with 1.8 percent as the central baseline outlook.

Table 5: Baseline and risk analysis of the CPI in Palestine for 2014 and 2015

(Percentage point)

Scenario	Shock	Implied annual growth rate CIM		Implied annual growth rate WFP		Implied inflation forecast	
		2014	2015	2014	2015	2014	2015
1	Baseline	0.0	0.9	-3.4	-7.0	2.0	1.8
2	+1SD CIM +1SD WFP	0.4	5.6	-1.9	14.1	2.2	5.7
3	+1SD CIM -1SD WFP	0.4	5.6	-4.9	-25.0	2.0	1.7
4	-1SD CIM +1SD WFP	-0.3	-3.5	-1.9	14.1	2.0	1.7
5	-1SD CIM -1SD WFP	-0.3	-3.5	-4.9	-25.0	1.9	-2.2

Figure (21) shows the risk analysis of inflation in Palestine during 2014 compared with the risk analysis predicted in the previous issue for 2014. As can be seen from the figure, scenarios 3 and 4 give close results to the baseline forecast. Scenarios 2 and 5 entail upside and downside outliers respectively. The figure shows that the risk declined compared with our risk analysis presented in the previous issue.

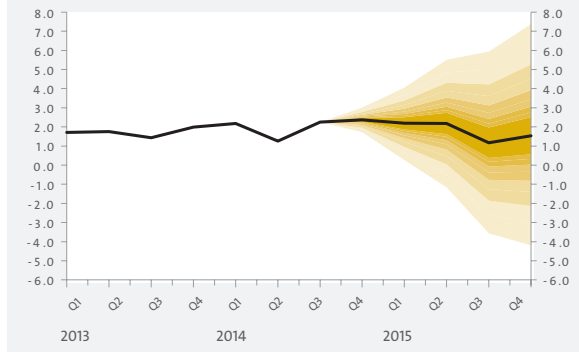
The upside risk to the inflation forecast is clearly related to a higher expected risk in world food prices, combined with a higher inflation in Palestine's main trading partners compared to what is assumed in the baseline. Conversely, inflation in Palestine may turn out to be considerably lower than predicted in the baseline in case world food prices, together with inflation in the main trading partners, turn out to be lower than expected.

Apart from model uncertainty and uncertainty related to external conditions, the inflation outlook for Palestine also hinges on potential specific shocks that may perturb the economic and political conditions in Palestine itself, which are independent of shocks occurring in the rest of the world. An example of such shocks was the last Israeli attack on Gaza Strip, which would lead to further rises in prices in the future.

Figure (22) shows the fan chart of the balance of Palestine's inflation risk during

2014Q4 – 2015Q4. This fan chart contains the quarterly profile of the baseline inflation forecast mentioned above. The risk parameters start from a standard deviation equal to 0.3 for the fourth quarter of 2014, which is based on the inflation volatility observed during the most recent years. It then rises up to 3.0 for the fourth quarter of 2015, reflecting the fact that uncertainty rises with the forecasting horizon.

Figure 22: Fan chart of the balance of Palestine inflation risk during 2014Q4 – 2015Q4



It should be mentioned that the range of the potential outcomes is fairly broad, reflecting the uncertainty of the forecast which is the consequence of all risk factors mentioned above, including the country specific ones (the Israeli attack on Gaza Strip). It should also be mentioned that the most likely outcomes for the predicted inflation are situated in the darkest shaded regions of the chart. The weaker the shading in the chart, the smaller the perceived probabilities of these potential outcomes.



