# West Bank/Gaza's Economic Prospects and Challenges[1]

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**The economy of the West Bank and Gaza (WBG) functions within two disparate contexts, each of which presents a unique set of constraints**. Political and security dynamics are the most important factor influencing the performance of the economy in WBG. The Palestinian Legislative Council—the equivalent of the parliament—has been unable to function since 2007 due to the incarceration of many of its members in Israel as well as intractable political divergences between Fatah and Hamas. The West Bank enjoys a more favorable economic climate than Gaza, as it has fewer restrictions on movement and access and enjoys a greater degree of donor support. The international community regards Fatah as the legitimate Palestinian Authority (PA) and has consequently provided it with large amounts of donor assistance. Donors, as well as Israel, continue to favor the PA and give it primacy in regional negotiations. Compounding this is the fact that as of July 2010, there was still no agreement between Fatah and Hamas, which have controlled the West Bank and Gaza respectively since Hamas was elected in 2006 and militarily defeated Fatah forces in Gaza. However, according to the Economist Intelligence Unit (EIU), Hamas has recently been more flexible with respect to meeting certain requirements of the Quartet (the EU, the UN, Russia and the US), by accepting the principle of a Palestinian state in the territories under Israeli control since 1967. This is a small step towards full inclusion in peace talks with Israel, since the Quartet refuses to deal with Hamas until it renounces violence, recognizes Israel and recognizes as legitimate all Israel-PLO accords.

**Economic growth in the West Bank has been rapid in 2009 and the first quarter of 2010**. In 2009, the WBG economy recorded an estimated rate of growth of 6.8%. Real GDP growth in January–March 2010 is estimated at 2.9% quarter on quarter and 12.5% year on year, as the economy performed well in all sectors. The fastest growing sectors year on year were hotels and restaurants (113.5%), health and social work (26.9%), financial intermediation (21.6%), agriculture (20.1%) and construction (18.8%), with growth occurring almost exclusively in the West Bank. The public sector in the West Bank, supported by donor assistance, constitutes the main driver of growth. In 2009, high inflows of donor assistance, Israel's easing of movement and access restrictions and increased control over the security situation by the PA in the West Bank have been beneficial. However, economic restrictions still form a significant barrier to manufacturing, trade and the movement of labor, both externally and internally.

**Economic performance in Gaza has been poor**. Gaza's economy did not perform well in 2009 due to restrictions on trade, movement and access resulting from the Israeli blockade and ban on exports. These economic constraints, as well as fighting between Hamas and Israel in December

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2008 and January 2009, severely constrained private sector activity. A timid 1% GDP growth rate was recorded in 2009 due to reconstruction activity and the reopening of 30% of industrial establishments (with raw material inputs being smuggled in through tunnels). The Gazan economy stays afloat thanks to public sector employment, humanitarian assistance and UN-funded job creation programs. Reconstruction is expected to continue, eased by fewer restrictions on imports of building materials with the condition that some be used for UN-sponsored reconstruction projects. The international community has remained largely silent about the blockade, although there has been some condemnation of Israel by the EU, especially after the Israeli assault on the Gaza aid flotilla in May 2010. The Quartet and Israel seek to pressure and isolate Hamas until it moderates its stance on Israel or eventually loses legitimacy and control.

**Growth in WBG in the short- to medium- term will largely depend on the extent of restrictions imposed**. GDP growth rates of 7% and 8% are regarded as achievable in 2010 and 2011 respectively by the IMF, if stronger measures are taken to ease the blockade on Gaza and Israel accelerates the lifting of restrictions on internal and external access and movement in the West Bank. An estimated 500 Israeli obstacles to internal movement remain in place and Israel retains control over Area C, which includes 60% of the West Bank. Although the pace at which sanctions have been lifted so far has been slow and substantial obstacles to change remain,[2] the direct peace talks between the Palestinian leadership and the Israeli government that began in Washington, DC on September 2 could inject some momentum into the easing of restrictions.

**Donor assistance plays an essential role in limiting the PA's budget shortfalls, but the EU is growing impatient with the pace of reconciliation**. Donor funding makes up a large proportion of the PA's budget. In 2009, external assistance reduced the PA's budget deficit by approximately 80% (from US$407 million to US$68 million). During the first quarter of 2010, donor assistance covered only 68% of the US$306 million budget deficit, prompting the PA to borrow US$120 million domestically. In addition, donor commitments have been affected by changes in pledges by the EU, whose members expressed disappointment at the slow pace of progress on peace talks; EU pledges were reduced from €219 million (US$285 million) in 2009 to €158 million in 2010. A meeting in Paris in July, however, drew donors' attention to the PA's continuing financing requirements.

**The PA's public finances have improved and prospects for further progress seem good**. The PA has been making progress along the fiscal roadmap outlined in the Palestinian Reform and Development Plan (PRDP) (2008-2010), which is scheduled to be extended and aims to achieve fiscal sustainability through efficient spending. In the first quarter of 2010, net revenue increased by 7% over the previous quarter and by 48% year on year, owing to a widening of the tax base,

[2] Such obstacles include the uncertainty over whether the freeze on settlement construction in the West Bank will continue after September 26th, disagreements over who will control East Jerusalem under a two-state solution, the control of Gaza by Hamas and the recent shooting attacks on Israeli settlers by Hamas.

improvements in revenue collection and the introduction of new customs controls. In the first quarter of 2010, expenditures and net lending decreased by 9% year on year and 7% year on year, respectively, due to the end of emergency aid needs in Gaza and to a reduction in non-wage expenditures. The wage bill, however, increased by 9% year on year in the first quarter of 2010. Major expenditure-reducing measures in 2010 and 2011 are expected to focus on lowering spending on public wages by limiting recruitment and restructuring pay scales, as well as on phasing out utility subsidies. However, should reconciliation between Fatah and Hamas occur, the PA would have to assume full responsibility for public sector expenditures (salaries and services) in Gaza, which would raise its expenditure bill.

**The PA has made efforts to raise the quality of governance**. PRDP goals also include increasing transparency and accountability, implementing institutional and structural reforms and promoting a larger role for the private sector in the economy. Reforms and institution-building initiatives have been implemented and considered by the IMF to be in line with the PRDP. For example, the Palestine Monetary Authority (PMA)—whose medium-term aim is to become a full-fledged central bank—has been designing supervisory rules and prudential regulations in line with international practice, monitoring their implementation in the West Bank and Gaza, improving legal frameworks in the financial system, and introducing electronic payment systems and a credit-scoring system. Another example of capacity building has been the rolling out of new computerized accounting systems from the Ministry of Finance to line ministries, which has raised the quality of budget execution.

**These reforms (many implemented with technical assistance from donors) and sound budget management have raised the confidence of the private sector in the economy**. The private sector has been encouraged by the budget and governance reforms implemented by the PA and the renewed presence of security forces in major West Bank cities. A broader recognition of an improved climate for business is demonstrated in the outcome of the second Palestine Investment Conference (PIC) that took place in June in Bethlehem, where a total amount of US$1 billion in investment was pledged. The investments, which included Palestinian, foreign and donor initiatives, comprised seven private-sector projects (for a total of US$848 million), US$120 million in donor programs for small and medium enterprises (mainly for access to finance), the inauguration of two Palestinian investment funds and a US$500 million affordable mortgage program (AMAL) led by the Palestinian Investment Fund (PIF). Lastly, plans for a US$300 million power plant in the West Bank—which imports 100% of its electricity from Israel—were also announced.

**The Palestine Monetary Authority (PMA) is aiming to strengthen the banking sector and has encouraged it to increase its lending to the domestic private sector**. In 2010, the PMA ordered banks to increase their minimum level of required capital from US$35 million to US$50 million, with the long-term goal of raising capital requirements to US$100 million. This, and the consequent expected merger of eight of the 19 local banks, is aimed at strengthening the banking sector and attracting Arab investors. In 2009, the PMA also required banks to lower the ratio of foreign investment to deposits from 65% to 55%. To encourage local banks to increase their lending to the private sector, it also made possible the verification of credit history through the creation of an online verification system. These measures seem to be working, as lending to the private sector was up by 34% (year on year) in the first quarter of 2010, and the loan-to-deposit ratio increased from 29% to 37% between October-December and the first quarter of 2010. Currently, businesses borrow 53% of all bank loans. On June 10th, the EU announced that it would extend its duty-free and quota-free access to Palestinian industrial exports to all Palestinian exports; this could provide further impetus to private sector development and job creation if restrictions on trade are lifted by Israel. The easing of the land blockade on Gaza in late June is expected to have the same beneficial impacts, although the restricted amount of allowed goods is unlikely to make a significant difference, especially given the extent of current reconstruction needs in Gaza.

**The poverty and social contexts remain dire, especially in Gaza**. GDP per capita in the West Bank and Gaza was US$1,229.47, US$1,566.15, and US$1,529.25 in 2007, 2008, and 2009 respectively. However, real GDP per capita in Gaza is currently about 45% below that in the West Bank, and has deteriorated by 40% from its 1999 level compared to the 10% decline in the West Bank. The CIA World Factbook's 2010 edition shows poverty headcounts of 70% in Gaza in 2009 and 46% in 2007 in the West Bank, although it does not say what poverty line was used. The IMF and World Bank cite 2008 estimates by the UN Relief and Works Agency using a poverty line of Israeli New Shequel (NIS) 2,363 in monthly expenditures per six-member household – approximately $3.14 in daily expenditures per person. These estimates show that 80% of households in Gaza and 45% of households in the West Bank lived in poverty in 2007. The World Bank, in a 2009 report, provided poverty rate estimates – based on a 2007 household survey – of 30% in Gaza and 19% in the West Bank. These numbers clearly show that poverty is higher in Gaza than in the West Bank, which inversely mirrors their respective levels of economic activity. Unemployment figures show a similar trend. The IMF estimates that in 2009, unemployment in the West Bank was approximately 18-20% and 39% in Gaza. Although the restrictions on movement and access make economic activity as well as social and public service delivery difficult in the West Bank, they are almost crippled in Gaza. Fuel scarcity due to the blockade has caused electricity and water shortages, forced hospitals to only operate in cases of emergency, and hindered the movement of schoolbooks and school equipment. The relaxation of the blockade has enabled Gazans to import food, sanitary, and consumer goods, and will likely reduce the prices of those items. However, the lack of private sector activity due to the blockade and the export ban means that consumption and income generation will likely remain very low in Gaza under the present circumstances.

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