سلطة النقد الفلسطينية

Economic Forecast Report, 2017

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Contents

1. Preface

Available data evidence shows that despite having attained levels around 3 percent per annum over the past few years, Palestine's economic growth rates continue to slacken. This slow-down can be attributed to several factors, most prominently: (1) the continuation of political uncertainty and impasse and the split between the two regions of the homeland; (2) the Israeli-imposed measures and obstacles and their adverse impact on investor confidence; (3) the weakness of the public sector, coupled with the inability of the private sector to act as an engine of economic growth; (4) Israel's unabated settlement activities and the stifling of economic activity in Area C in the West Bank (WB); and (5) the ongoing Israeli siege and blockade of the Gaza Strip (GS) alongside the closure of the Rafah Crossing, which adversely impact the trade exchange and overall economic activity in the Strip.

Despite reforms implemented during 2016 in many areas (such as strengthening the tax management process, enhancing dialogue with the Israeli side with respect to the size and regular flow of clearance revenues, and the Ministry of Finance adoption of a program to finance government arrears through the issue of short-term promissory notes), yet the overall economic situation and outlook during 2017 will continue to be governed by political and economic uncertainty.

2. Resent economic developments: 2014- 2015

During 2015, the Palestinian economy experienced some recovery after the downturn of 2014, with real GDP growing by about 3.5 percent compared with a contraction by 0.2 percent in 2014. The year 2015 witnessed several important political and economic changes, particularly during the first and last quarters of the year. In the first quarter, Israel suspended the transfer of clearance revenues to the Palestinian government. In the last quarter, the West Bank witnessed severe political and security developments, which culminated in a popular uprising in response to the unrelenting Israeli occupation of Palestine, the expanding settlement activity and the blocked political horizon. These events adversely affected WB's economic performance, causing growth to slow down to 2.5 percent in 2015 from 5.3 percent in 2014. Somewhat in contrast, Gaza experienced rapid economic growth (about 6.8 percent) in 2015 in the aftermath of the devastating Israeli war in 2014, in which the economy contracted by 15.1 percent.

At any rate, as a result of the economic upturn, real GDP per capita grew by 1 percent to USD 1,746 in 2015, in comparison with a contraction by 3.1 percent in 2014. However, the economic boost in 2015 did not have an appreciable positive impact on the Palestinian labor market, as the unemployment rate dropped only slightly (to 25.9 percent from 26.9 percent in 2014). In WB, the unemployment rate dropped to 17.3 percent from 17.7 percent in 2014. In GS, it had soared to a record level of 43.9 percent in 2014 in the aftermath of the war waged by Israel in that year. The unemployment rate resumed its decline, falling to 41.1 percent in 2015. Yet, this rate remains extremely high, given the slow pace of the reconstruction process in GS, and the continued siege on the Strip imposed since 2007.

In terms of spending as a percent of GDP, except for net exports, all components of real aggregate demand picked up during 2015, with final consumption increasing by about 4.2 percent (as opposed to 3.6 percent during 2014), as private and public consumption grew by 4.6 percent and 2.9 percent respectively, compared with an increase of 3.5 percent and 3.7 percent respectively in 2014. Likewise, total investment rose by around 18.3 percent compared with a decline by 13.9 percent in 2014, keeping investment in the Palestinian economy at a modest level. In contrast, net exports (exports minus imports) dropped by about 13.6 percent, compared with a drop by 1.4 percent in 2014. This decline was the result of exports growing by 7.9 percent, compared with a growth by 9.6 percent in 2014. In comparison, imports grew by about 5.2 percent, compared with a growth by 4.1 percent in 2014.

On a different note, prices grew more slowly during 2015, with the inflation rate dropping to 1.4 percent, compared with 1.7 percent during 2014. This drop in inflation reflected a drop in the cost of imports and a decline in the global prices, particularly for oil and food which together account for the largest weight in the Palestinian consumer basket.

3. Growth projections for 2016

With the onset of 2016, signs of economic recovery became quite obvious. Following a brief slowdown in the final quarter of 2015, real GDP in 2016Q1 increased by about 0.8 percent on yearly basis. In the WB, which benefitted from relative political and economic stability, growth accelerated to 4.2 percent, as opposed to 1 percent in the previous quarter. Meanwhile, GS witnessed a modest slowdown during this quarter despite the continued influx of raw materials, with the growth rate reaching 21.1 percent, as opposed to 24.2 percent in the previous quarter.

Yet, despite the accelerated growth, the overall labor market statistics continued to weaken slightly. Unemployment in Palestine rose again to 26.6 percent as opposed to 25.8 percent in the previous quarter. This resulted from an increase in GS from 38.4 percent to 41.2 percent, as opposed to a decrease in the unemployment rate in the WB from 18.7 percent to 18.0 percent.

Similarly, the first quarter of 2016 witnessed tangible growth in government revenues, the sharp drop in foreign aid as compared with the corresponding quarter in 2015. This drop was concomitant with growth in government expenditures, albeit to a lesser extent, due to a sharp rise in the salary bill. The ultimate result was the realization of surpluses in both the current account balance and the overall balance after grants and aid, which showed serious deficits in the previous quarter.

However, recovery signs of the Palestinian economy were short-lived in light of declining investment and a slowdown in construction activity, particularly in GS, which bore the brunt of tighter Israeli imposed restrictions on the influx of raw materials during the second quarter. Consequently, growth rates retreated again during 2016Q2, with real GDP growing by about 3.9 percent on annual basis. This resulted from the economic slowdown to 3.3 percent in WB, and a more significant slowdown (to 5.8 percent) in GS. These developments negatively affected the labour market, as unemployment rates resumed their upward trend, rising to 26.9 percent, due to a rise to 18.3 percent in the WB, and to 41.7 percent in GS.

Similarly, the second quarter witnessed a pronounced drop in Palestinian government revenues due to shrinkage in both clearance transfers and foreign grants, (in comparison with the corresponding quarter), and an increase in expenditures due to an increase in non-salary expenditure. Eventually, a current account deficit and an overall deficit after grants emerged, succeeding significant surpluses in the first quarter.

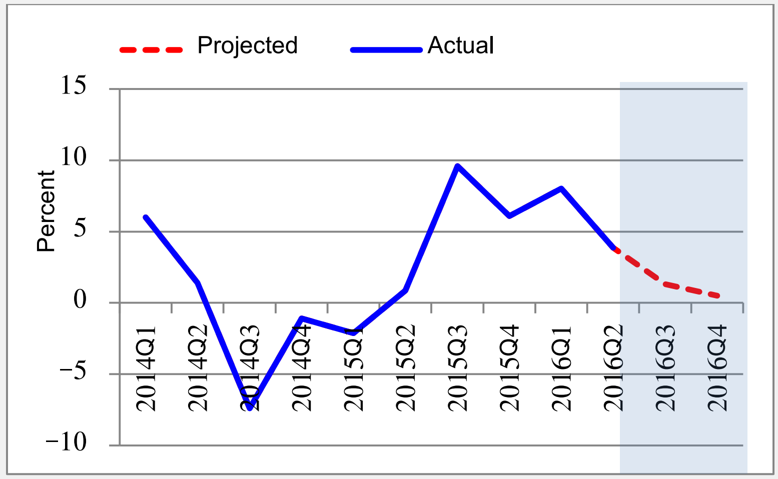
As for the second half of 2016, PMA projections indicate the continuation of the slowdown in Palestine's economic activity, with estimated annual growth rates of around 1.3 percent, and 0.5 percent in the third and fourth quarters, influenced primarily by the downturn in exports, the rise in unemployment, the drop in the number of Palestinian workers in Israel, and the expected deceleration of the Israeli economy.

Based on the aforementioned analysis, and on several other PMA-designed leading indicators of GDP projections (most importantly the Business Cycle Index-PMABCI, indices of the construction sector, the external sector and other Israeli-economy associated statistics), PMA forecasts a real growth rate of about 3.3 percent in 2016, compared to a growth of about 3.5 percent in 2015.

The slowdown in the projected growth during 2016 is attributed to the continued state of political uncertainty in view of the cessation of negotiations and the slow pace of the

GS reconstruction. In addition, deceleration of Israeli economic growth in 2016, according to Bank of Israel projections, cast a shadow over Palestinian economic growth since the two economies are closely linked, particularly in the areas of trade and employment. This slowdown has contributed to exacerbate the stagnation in GDP per capita levels and push up unemployment rates.

Figure 1: Real economic growth, 2014-2016



4. PMA growth forecasts for 2017

a. Growth forecasts

PMA economic forecasts included primarily predictions with respect to developments of key Palestinian macro-economic variables during 2017 under the baseline scenario[1]. These predictions were coupled with two other sets of forecasts (optimistic and pessimistic scenarios) based on a risk assessment of different shocks of varying likelihood expected to impact on economic performance positively or negatively, compared to the baseline assumptions. It is noteworthy that all the above-mentioned forecasts are sensitive to any revisions of previous years' actual data published by official data-producing agencies, most importantly the Palestinian Central Bureau of Statistics and the Ministry of Finance.

[1] These forecasts 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 pma.ps

Basic forecasts for Palestinian economic performance during 2017 were founded on a set of basic assumptions (baseline scenario) and their associated implications for economic conditions. These assumptions were:

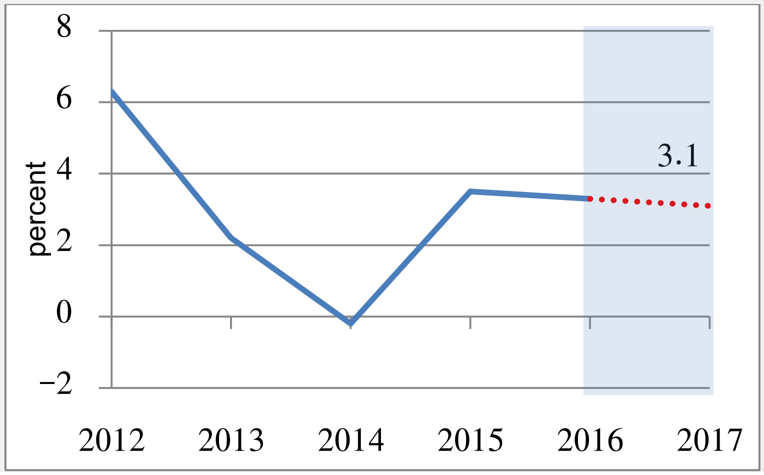
- No significant change will occur in the political or security conditions, particularly concerning the restrictions imposed at crossings on freedom of movement of people and trade. Meanwhile, the increase in the number of Palestinian workers in Israel will stand around previous-year levels, with the pattern of GS reconstruction process remaining essentially unchanged from 2016 to 2017.
- The government will continue to follow a fiscal austerity policy and implement current-expenditure rationing, while growth in government revenues and expenditures remains relatively unchanged from previous-year levels.
- Foreign grants extended by donor countries to the government's treasury will continue to decline, totalling about USD 0.5 billion during 2017.
- Private sector transfers from abroad will exceed USD 1 billion during 2017.
- Credit facilities granted to the private sector by banks operating in Palestine will rise by 15 percent, as compared to 2016.
- Cost of imports (inflation rate and exchange rate with trading partners) will rise by 2.8 percent, (based on forecasts of international institutions, primarily the IMF and World Bank).
- The weighted real GDP growth rate of Palestine's main trading partners will increase to 3 percent, (based on Bank of Israel forecasts).

Based on these assumptions, PMA forecasts a real growth during 2017 by 3.1 percent, to around USD 8,221 million, compared with 3.3 percent during 2016[2]. This growth is expected to raise real per capita income (real GDP per capita) by 0.8 percent to USD

[2] According to PMA projections and IMF forecasts in its latest report published August 2016

1,776, compared to a rise of about 1.0 percent in 2016. As was the case in 2016, real GDP growth during 2017 will be primarily underpinned by an increase in private consumption financed by further expansion in bank credit and the swelling of arrears. Real GDP growth will be additionally favorably affected by the upturn in total investment, particularly relating to the reconstruction process in GS, its slow pace, notwithstanding.

Figure 2: Growth forecasts, 2017



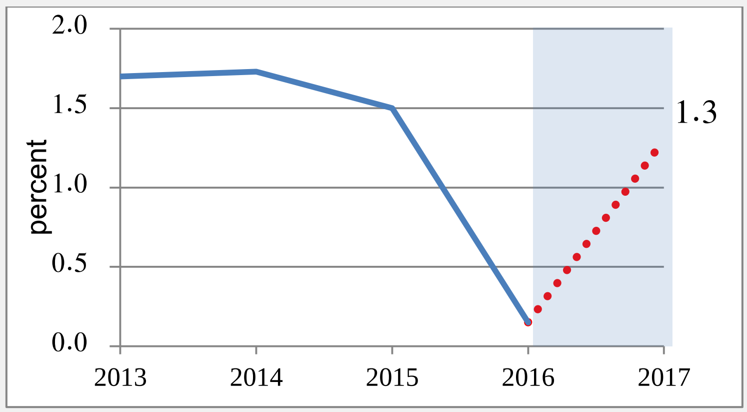
Likewise, the private-sector value added is expected to grow by 3.2 percent during 2017, raising the sector’s contribution to real GDP at factor costs to around 79 percent, as opposed to an expected growth of public-sector value added by only 2 percent, pushing the sector’s contribution to real GDP down to around 21 percent. Additionally, PMA forecasts point to an expected upturn in total consumption spending by 4.1 percent during 2017 (of which 3.7 percent is for private consumption and 5.7 percent for public consumption), pushing its contribution to real GDP up to 119.5 percent. Conversely, total investment spending is expected to increase slightly by about 0.8 percent, to constitute 20.9 percent of GDP during the same year.

As for the Palestinian external sector, predictions point to an expected growth in exports by 2.2 percent as opposed to a growth in imports by 3.6 percent, mainly associated with an increase in consumption. Subsequently, it is expected that these changes in exports and imports will exacerbate the trade balance deficit by about 4.4 percent to constitute 40.4 percent of the real GDP predicted for 2017. It is worth to mention that because the predicted growth in real GDP is not high enough and historically shown to be a strong stimulator to employment, It is expected that this growth will not have a significant impact on job creations and employment. Instead, it is expected that unemployment rates in Palestine will continue to climb, reaching about 27.6 percent of labour force in 2017.

b. Inflation forecasts

PMA forecasts[3] indicate that prices will grow at an escalating pace during 2017. Over the year, inflation is expected to reach an average of 1.3 percent, marking an increase of about 0.2 percent over previous year's average. These forecasts are based on predictions of an increase in the cost of imports by about 1.8 percent, coupled by a smaller increase (about 1.3 percent) in global food prices.

Figure 3: Inflation forecasts, 2017



5. Risk analysis (shocks)

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

[3] 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.

In this context, PMA forecasts for 2017 remain subject to several potential shocks of varying likelihoods, both positive and negative. The impact and consequences of such shocks will reflect on several key economic indicators.

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

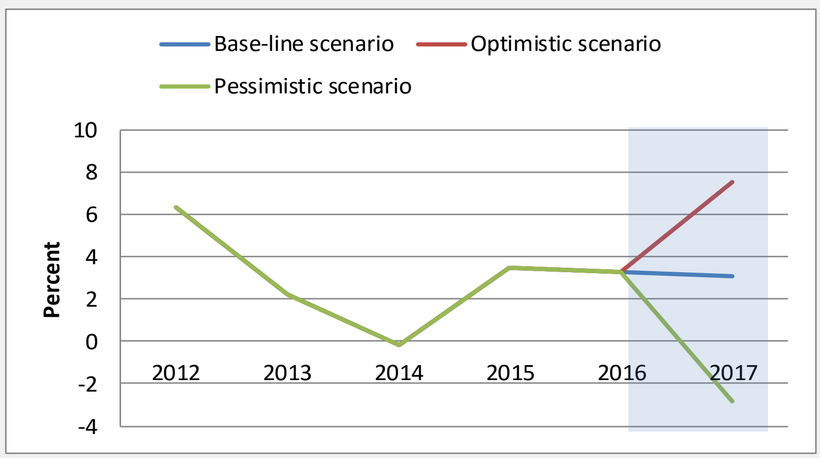
Under such assumptions, PMA forecasts economic growth by 7.5 percent, and an increase in GDP per capita by 5.1 percent to USD 1,852. The private sector value-added is expected to grow by 7.8 percent, increasing its contribution to GDP at factor costs to 79.3 percent, while the public-sector contribution is expected to grow by 6.4 percent, lowering its contribution to GDP to 20.7 percent. Under this scenario, unemployment rates are also expected to improve, dropping to around 25.5 percent of total labor force.

Under such a scenario, total consumption spending is expected to grow by around 7.7 percent (5.5 percent for private consumption and 15.7 percent for public consumption), driving its contribution to GDP down to 118.6 percent. Likewise, total investment spending is expected to grow by around 11.3 percent, to contributing to GDP by about 22.3 percent. Similarly, forecasts indicate a growth by about 13.7 percent in exports, as opposed to a growth by about 11.4 percent in imports, resulting in an increase in the trade balance deficit by about 10.2 percent. Subsequently, the deficit of predicted real GDP for 2017 is predicted to grow to around 40.9 percent.

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

In the event, PMA predicts further deterioration of economic conditions, with the Palestinian economy contracting by 2.8 percent (figure 4) with a subsequent decline of real GDP to around USD 7,751 million.

Figure 4: Growth potential risks, 2017



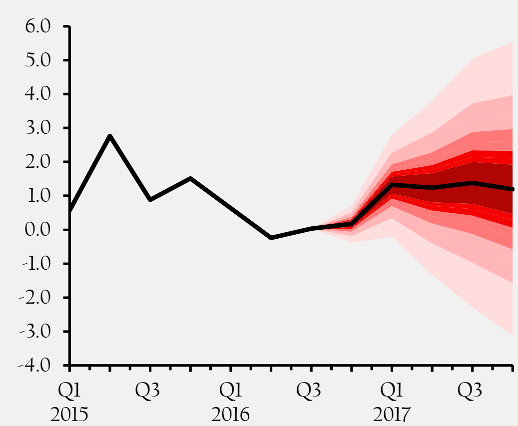
It is also expected that the decline in growth will adversely affect real GDP per capita, causing a drop by 4.9 percent to about USD 1,675. Moreover under this scenario, private-sector value-added is predicted to decline by 5.1 percent, pushing its contribution to GDP at factor costs up to 78.1 percent. Similarly, it is expected that public-sector value added will decline by 1.2 percent, while its contribution rises to 21.9 percent. Such a scenario is expected to have a tangible adverse impact on unemployment, bringing it up to 31.2 percent of total labor force.

As a result, total consumption spending under this scenario is expected to fall back by around 1.2 percent (a drop of 1.7 percent for private consumption, and a rise of 0.7 percent for public consumption). This drop is expected to bring the contribution of total consumption to GDP to around 120.3 percent. Additionally, gross investment spending is expected to recede by around -13.3 percent, bringing its contribution to GDP down to around 19.1 percent.

In the external sector, forecasts point to a decline in exports by around 13.8 percent, as opposed to a decline in imports by around 7.2 percent. These results are expected to aggravate Palestine's trade deficit to around 39.5 percent of the predicted real GDP for 2017, as opposed to 40.7 percent in 2016.

Inflation risks primarily hinge on changes to global prices (particularly of food and fuel), in addition to changes in inflation rates in Palestine's trading partners, in particular Israel. Such forecasts also depend on potential internal shocks that may affect domestic demand in Palestine. Figure (5) illustrates potential risks affecting inflation forecasts in Palestine in 2017. It is worth mentioning that the range of likely results is a broad one, as apparent in figure (4) and figure (5), which obviously is a reflection of the degree of uncertainty of predictions due to the potential risk factors highlighted earlier. These figures demonstrate the expected growth and inflation rates by order of likelihood of occurrence. For example in figure (5), the darker the shades, the higher the possibility of arriving at the expected inflation rate, and vice versa.

Figure (5): Potential risks to inflation, 2017



Appendix: PMA forecasts, 2017

	2013	2014	2015	2016	Forecasts 2017		
		Actual		Projection*	Baseline Scenario	Optimistic Scenario	Pessimistic Scenario
				Annual percent change (%)			
Real GDP	2.2	−0.2	3.5	3.3	3.1	7.5	−2.8
Real GDP per capita	−0.8	−3.1	0.5	0.9	0.8	5.1	−4.9
Private sector value added	1.8	−3.5	1.7	5.4	3.2	7.8	−5.1
Public sector value added	5.3	2.9	0.3	3.3	2.0	6.4	−1.2
Unemployment rate	**23.4**	**26.9**	**25.9**	27.3	**27.6**	**25.5**	**31.2**
Inflation rate	**1.7**	**1.7**	**1.4**	0.2	**1.3**	--	--
Total final consumption	**−3.5**	**3.6**	**4.2**	2.7	**4.1**	**7.7**	**−1.2**
Public	−1.6	3.7	2.9	3.8	5.7	15.7	0.7
Private**	−4.0	3.5	4.6	2.2	3.7	5.5	−1.7
Total investment	**4.2**	**−13.9**	**18.3**	2.5	**0.8**	**11.3**	**−13.3**
Net export of goods and services ***	**−11.6**	**1.4**	**13.6**	1.3	**4.4**	**10.2**	**−3.8**
Total exports	3.3	9.6	13.7	1.2	2.2	13.7	−13.8
Total imports	−7.2	4.1	13.6	1.3	3.6	11.4	−7.2
				As percent of real GDP (%)			
Total final consumption	**113.9**	**118.2**	**119.0**	**118.3**	**119.5**	**118.6**	**120.3**
Public	26.2	27.2	27.1	27.2	27.9	29.3	28.2
Private	87.7	90.9	91.9	91.1	91.6	89.3	92.1
Total Investment	**22.0**	**19.0**	**21.7**	**21.5**	**20.9**	**22.3**	**19.1**
Net export of goods and services	**−36.5**	**−37.1**	**−40.7**	**−39.9**	**−40.4**	**−40.9**	**−39.5**
Total Exports	17.8	19.6	21.5	21.1	20.9	22.3	18.7
Total Imports	54.3	56.6	62.2	61.0	61.3	63.2	58.2
Net error and omissions	**0.6**	**−0.1**	**0**	**0**	**0**	**0**	**0**
Memorandum Items							
Real GDP (USD million)	7,477.0	7,463.4	7,721.7	7,974	8,221	8,572	7,751
Real GDP per capita (USD)	1,793.3	1737.4	1746	1762	1776	1852	1675
USD/NIS exchange rate	3.61	3.58	3.88	3.84	3.85	--	--

* Projections of PMA research team

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

***Negative sign denotes decrease in trade balance deficit