سلطة النقد الفلسطينية

Economic Forecasts Report 2019

Research and Monetary Policy Department

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CONTENTS

1) Preface

Slowdown in the performance of the Palestinian economy continued throughout recent years due to political and economic developments and changes, which had negative impact on key economic drivers and weakened economic activity. This happened at the same time while the private sector lagged behind its role of leverage boosting growth due to an obscure and fragile political and economic prospect. This has overshadowed macroeconomic indicators and economic growth.

The pressures on the macroeconomic indicators increased in 2018 leading to overall weakness in local demand and further slowdown in performance throughout the first three quarters of the year. The pressures were to do with several obstacles and challenges, some of which had been there for a long time, and some were new.

The most noticeable challenges that impeded growth in 2018 were (1) Increase in uncertainty and pessimism due to lack of economic and political prospects especially in light of the tension associated with moving the United States embassy to Jerusalem; (2) Noticeable drop in foreign grants to the Palestinian government leading to drop in government spending. This has been against the backdrop of the withholding of American aid and the United States' position towards funding the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA); (3) Land confiscation and settlement expansion in the West Bank and prohibiting utilization of available resources in Area C; (4) The continuation of closure of Gaza Strip, partial closure of commercial border crossings to Gaza, and political tensions in Gaza Strip; and (5) Continued internal schism and hindrance of the Palestinian reconciliation efforts.

The challenges are expected to overshadow the **economic prospects of 2019** especially if the political and economic situation continues to linger on causing more pressures on economic activity; otherwise, the partial or total decline in the impact of the challenges will lead to some kind of recovery in economic.

2) Global economy developments and prospects in 2019

Apparently, the global economic momentum started to stabilize and become moderate; thus, the global growth rate in 2018 stayed at the same level of 2017 at 3.7 percent[1]. However, the stability of the global economic momentum hid dissimilarities among countries' groups. In developed economies, the gap between the United States of America, Europe, and Japan increased due to different monetary and fiscal policies and slowdown in global trade and industrial production. Growth in developing and emerging economies; on the other hand, experience slowdown as a result of restricted financial situations, alteration in economic policies and global trade, and different capacity to respond to the new alterations and shocks. The United States had recently imposed customs tariff on several imports from China, Turkey, Mexico, and Canada. This was met by similar measures taken by these countries. If such measures continue, they are expected to cause sharp fluctuations in the global financial market, outflows of foreign investments, and weaken trade movement in emerging and developing economies of frailer economic basis. According to the IMF report, publish in October 2018, the balance of risks surrounding global growth heads towards negative developments due to uncertainty about monetary, fiscal, and trade policies. Therefore, IMF reduced its expectations of global economy growth in 2019 to 3.7 percent instead of 3.9 percent as published in the IMF report of April 2018. This is primarily attributable to growth reduction in developed economies to 2.1 percent instead of 2.2 percent, and in emerging and developing economies to 4.7 percent instead of 5.1 percent.

Growth rate for the main economies (2017-2019)

(percent)

	2017	2018	2019
World Economy	3.7	3.7	3.7
Developed economies	2.3	2.4	2.1
United states	2.2	2.9	2.5
Euro area	2.4	2.2	1.9
Japan	1.7	1.1	0.9
Developing economies	4.7	4.7	4.7

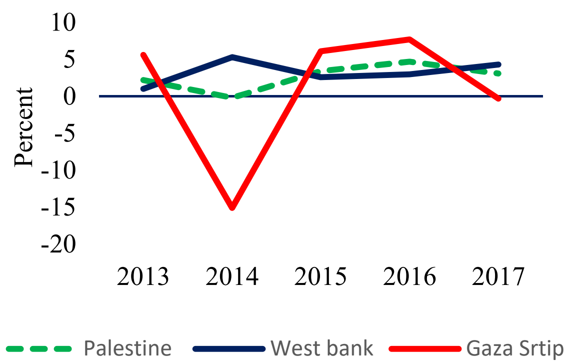
Source: World economic outlook, IMF, October 2018.

(1) IMF estimates.

3) Diagnosis of the Palestinian economy during (2016-2017)

Economic activity experienced relative slowdown at the end of 2017. The signs of improvement and recovery of 2016 did not last; hence, slowdown overshadowed again the economy due to being subject to opposing currents that weakened the forces that supported the economic activity and negatively influenced the process of production. These opposing currents included mainly drop in international grants, drop in the size of private and public final consumption, and increased reliance on imported goods and services. Hence, overall real growth of Palestinian economy dropped to 3.1 percent compared to 4.7 percent in 2016. The accelerated growth in the West Bank (4.3 percent compared to 3.0 percent in 2016) failed to maintain the same level of 2016 especially that Gaza Strip economy suffered a downturn of 0.3 percent compared to a 7.7 percent growth during the same period. Performance of the components of aggregate demand (spending to GDP) varied. Growth in final consumption declined by approximately 1.2 percent as private consumption dropped at a rate of 1.5 percent and the consumption at non-profit organizations declined by 6.9 percent. Alternatively, government consumption experienced marginal improvement at 0.9 percent. Overall investment rose by 10 percent compared to previous year, due to investment in construction picked up at 2.9 percent, change in inventory experienced noticeable improvement, while investment in non-construction dropped by approximately 1.4 percent. Foreign trade indices experienced positive developments as exports grew by 12.4 percent; this was accompanied by slight drop of 0.8 percent in imports, leading to improved trade balance (drop in trade deficit) at a rate of 6.9 percent. The variation in the aggregate demand components was more obvious in Gaza Strip especially with respect to government consumption and the size of imports. The developments in the West Bank were more consistent with their general trend at the Palestinian

Growth rates in Palestinian Economy (2013-2017)



level. Exports and investment were the key drivers of growth in the West Bank; exports grew by 7.8 percent and capital formation grew by approximately 6.1 percent, in addition to an increased in government spending by 3.5 percent. On the other hand, private consumption declined by approximately 1.9 percent and imports dropped by an average of 2.3 percent. Private and public consumption and trade deficit were behind the decline in growth in Gaza Strip. Public consumption dropped by 3.3 percent; this drop was accompanied by drop in private consumption by approximately 0.3 percent. Additionally, trade deficit increased by 9.0 percent in light of growth in exports by 14.9 percent and growth in imports by approximately 9.7 percent.

A state of slowing down overwhelmed most of economic activities on the supply side (product/ value added) including, a sharp slowdown in transport and warehousing activities at 2.2 percent compared to 18.9 percent in 2016; industry to 2.2 percent compared to 5.0 percent; construction to 6.3 percent compared to 13.0 percent; financial and insurance activities to 7.1 percent compared to 19.1 percent; and services to 3.1 percent compared to 3.4 percent. A number of sectors also experienced noticeable decline in their performance such as the public administration and defense, which dropped to approximately 2.6 percent compared to growth of approximately 4.5 percent, information and telecommunication to 5.7 percent compared to growth of approximately 5.1 percent. On the other hand, the pace of decline in agriculture sector retreated to 5.7 percent in comparison with 8.1 percent in 2016 while trade and retail sale activity experienced the only improvement by growing to 8.7 percent compared to a drop of approximately 0.5 percent in 2016.

Obviously, this growth rate was not sufficient to mitigate the number of unemployed persons or maintain their previous rate; hence, unemployment rate in Palestine climbed to 28.4 percent compared to 26.9 percent in 2016, as unemployment rate in Gaza soared to approximately 43.9 percent from 41.7 percent in 2016, with a marginal drop in the West Bank to 17.9 percent from 18.2 percent in 2016.

The slowdown in growth rate and increase in unemployment rate mean that the living standards of Palestinian citizens will not get any better. In fact, these developments are expected to negatively affect the average income per capita, especially in Gaza Strip where unemployment rates hit record levels as a result of big drop in economic activity. The slowdown in growth and accompanying drop in public and private consumption had an impact on prices level, which slightly grew. Inflation; hence, hit approximately 0.2 percent compared to price downturn of 0.2 percent in 2016. The West Bank registered marginal price downturn close to zero (-0.01 percent compared to -0.8 percent in 2016). Gaza Strip; in contrast, registered very slight inflation (0.1 percent compared to -0.8 percent in 2016). Inflation rates in Palestine are largely prone to changes in costs of imports and global prices of some basic goods especially oil and food, which constitute the largest weights in the Palestinian consumption basket.

4) Growth estimates of 2018

Palestinian economy grew sluggishly in 2018, which was a continuation of the economic slowdown of 2017. This reflected weak performance of economic activities and retreat in the levels of private and public consumption, increase in unemployment rate, slowdown in wages growth, and drawback in the pace of private sector spending and investment in light of uncertain political prospects.

Growth rate experienced slowdown in the first quarter of 2018 on annual basis to hit 2.0 percent against the backdrop of weak performance of many economic activities. The sluggish activities of industry, trade, public administration, and defense as well as the sluggish growth of final consumption and gross capital formation chipped in with frustrating growth rate. Moreover, differences between the West Bank and Gaza Strip deepened as the West Bank registered growth rate of 5.2 percent on annual basis while Gaza Strip downturn increased to 8.8 percent.

Economic activity deteriorated even further in the second quarter leading to drawback in growth to hit 1.3 percent on annual basis as a result of sharp drop in consumption, especially government consumption and slowdown in investment growth and increase in trade deficit. It was also affected by drawback in growth in the West Bank to register 0.6 percent and sharp downturn in Gaza Strip in the second quarter to hit 8.5 percent.

However, the sharp drop in growth was reduced in the third quarter to 0.5 percent due to relative improvement in economic activity in the West Bank at 1.2 percent and relaxed pace of retreat in Gaza Strip to 6.5 percent. This performance was boosted by some improvement in government spending and increase in exports and growth in private investments.

According to the PMA's estimates, it is expected that some improvement will occur to growth in the fourth quarter of 2018 to hit approximately 2.1 percent; however the rates will not be sufficient to largely influence annual growth rate. The baseline scenario shows slowdown in annual growth rate at 0.6 percent compared to 3.1 percent in 2017. The estimates are based on multi leading indicators used in estimating the GDP; most importantly, Palestine Monetary Authority Business Cycle Index (PMABCI), construction and foreign sectors indicators, and some other indicators linked to Israeli economy.

Gaza Strip Economy: Challenges and Prospects

Gaza Strip underwent significant economic, political, and security developments in 2018 that directly affected economic activity and growth; especially in light of a number of measures that largely impacted the living conditions and humanitarian and economic conditions in 2017. Among the measures were 30 percent to 50 percent cuts of Gaza Strip civil servants' salaries and imposing forced retirement on thousands of them in accordance with Law 17 of 2017 published on July 22, 2017 concerning early retirement of civil servants. The measures went on in 2018 and the cuts rate increased making most of Gaza Strip civil servants earn 50 percent of their salaries. The crisis of power cut in Gaza Strip for long hours also exacerbated to reach 16 hours a day. This had direct impact on economic activity and production. A state of pessimism prevailed and large retreat in purchase power and a state of recession hit most economic sectors.

Consequently, economic activity continued to retreat as of the third quarter of 2017; GDP experienced a downturn of 2.9 percent in the fourth quarter of 2017 and a 6.1 percent in the second quarter of 2018. Per capita share in GDP at constant prices dropped by 9 percent in the second quarter of 2018 to reach approximately USD 410 compared to $974 for the West Bank. The sharp retreat in growth and income continued to hit the third quarter of 2018 as the deteriorated conditions and failed internal reconciliation efforts continued as well as the political uncertainty and negative consequences of the attack on Gaza Strip in the final quarter of 2018.

The unprecedented high rate of unemployment; especially among youths and university graduates, is among the most dangerous problems in Gaza Strip. This is due to the strict closure that has been imposed for more than ten years. Unemployment sharply rose in the third quarter of 2018 to reach 54.9 percent compared to 48.2 percent 2017 according to the findings of the 2017 Census; hence, the number of unemployed people registered 295,700 in the third quarter of 2018. Poverty rates in Gaza Strip were also high reaching 53 percent of the population in 2017, according to monthly consumption patterns, compared to approximately 13.9 percent in the West Bank. Alternatively, poverty rate in Gaza Strip, according to household monthly income, is 67.6 percent of the population compared to 24 percent in the West Bank.

Despite the sharp deterioration in the basic macroeconomic indicators during the first three quarters of 2018, the fourth quarter experienced significant political and security changes that directly impacted the economic activity. Among these changes were the continuation of the efforts of Egypt, Qatar, and the United Nations to solve Gaza problem and reduce human suffering. These efforts can be summarized in the following:

1. Rafah border crossing continued to be open for commuters and goods, including strategic goods such as cooking gas from Egypt, oil, construction material (cement, iron, and gravel) tobacco, and a number of other consumer goods. This was relative change in the trends of importing from Israel through the Karem Abu Salem border crossing to importing from Egypt through Rafah border crossing. This also meant that there would be drop in imported goods over which clearance revenues were collected; therefore, clearance revenues, which the Palestinian government collected, would drop as a result if this change in trade route.
2. The emergency Qatari grant of USD 150 million (given over six months at USD 25 million a month) to pay for the salaries of Gaza civil servants and for diesel for the electricity generating company to ensure that it ran again and supplied at least eight hours of power a day. The Qatari grant was also used to give humanitarian aid to 50,000 impoverished families at USD 100 each and finance temporary employment program creating 10,000 temporary jobs including 5,000 for university graduates to reduce unemployment among them. The wage paid to an undergraduate was NIS 1,000 and NIS 900 was paid to a diploma holder. The grant also covered creating 5,000 jobs for unemployed people at NIS 900 wage per person. The Qatari grant; therefore, contributed to boost spending and demand at the market.
3. Enlarged fishing areas and continuation of opening Erez border crossing and continuation of power supply from Israel also contributed to reducing the impact of the deteriorating economic situation in Gaza Strip.

This is expected to lead to economic recovery in the fourth quarter of 2018 compared to the rather gloomy growth in the first three quarters of 2018, which will lead to relative improvement in the Palestinian macroeconomic indicators of 2018 and improve further in 2019 if the humanitarian aid were to continue.

5) PMA's forecasts for 2019

a) Growth forecasts

The forecasts of PMA for the economic performance include the most important developments to key variables of the Palestinian economy in 2019 (baseline scenario)[2], risk analysis of potential shocks of different degrees (optimist scenario, pessimist scenario) that are expected to have positive and negative impacts on the economic situation. However, the sensitivity of the findings to changes in actual data of previous years at their official sources; mainly the Palestinian Central Bureau of Statistics and the Ministry of Finance and Planning, is taken into consideration. Key forecasts of Palestinian economy performance in 2019 are based on a number of main hypotheses[3] (baseline scenario) and their effects on the economic status, including,

- Continuation in the drop of grants to Treasury. They are assumed to drop to USD 500 million in 2019; hence, government spending is expected to drop by 4.0 percent compared to 2018.
- Increase in current transfers from abroad to the private sector at the rate of 2.0 percent.
- Increase in the number of Palestinian workers in Israel at the rate of 5.0 percent.
- Increase in loans granted to the private sector by 13 percent over 2018.
- Increase in the rate of import cost (inflation rate and exchange rate among trading partners) by 1.4 percent based on the expected inflation rate in Israel.
- Real growth of the Israeli economy by 3.6 percent in 2019 according to Bank of Israel estimates.

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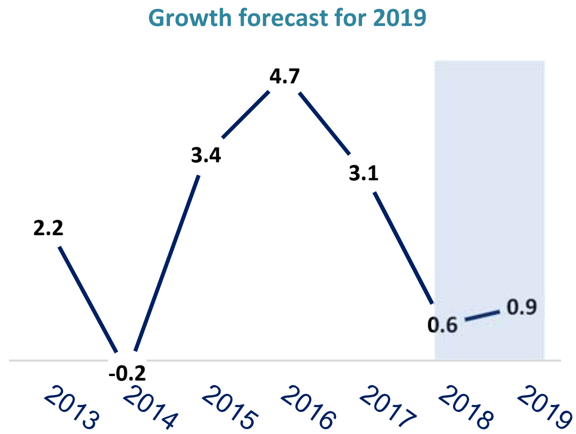
(2) The forecasts are based on economy models, which PMA had developed, including most importantly Reduced Form Model to forecast GDP on quarterly basis. Structural model also used in parallel to forecast key macroeconomic indicators (GDP components, labor, and wages). For more information about the forms, please review working papers posted on PMA website www.pma.ps

(3) Some of the hypotheses are based on statistical estimates (mean and weighted average) and others are based on available data and information

According to the hypotheses, the forecasts of the PMA indicate that real GDP expected to grow in 2019 by 0.9 percent compared to 0.6 percent in 2018. Average per capita income is expected to drop by 0.4 percent compared to 1.1 percent in 2018. Private sector value added is also expected to grow by 1.2 percent; however, public sector valued added is expected to drop by 0.1 percent. Forecasts also show slow retreat in total consumption to 0.1 percent compared to 1.3 percent in 2018 and increase in its contribution to GDP to 111.4 percent compared to 111.1 percent in 2018[4]. On the other hand, growth pace accelerates in investment activity to 2.2 percent compared to 1.6 percent in 2018 to constitute 23.1 percent of the GDP compared to 22.8 percent in 2018.



Forecasts of trade sector show slowdown in growth of exports to 2.4 percent compared to 7.9 percent in 2018 and accelerated growth of imports to 2.6 percent compared to 0.8 percent in the same period. This will exacerbate the trade deficit by 2.7 percent compared to 3.1 percent improvement in 2018 to constitute approximately 34.5 percent of the GDP forecast for 2019 compared 33.9 percent in 2018. This scenario will have negative impact on the labor market where unemployment rate will climb to 31.3 percent compared to 31.0 percent in 2018.

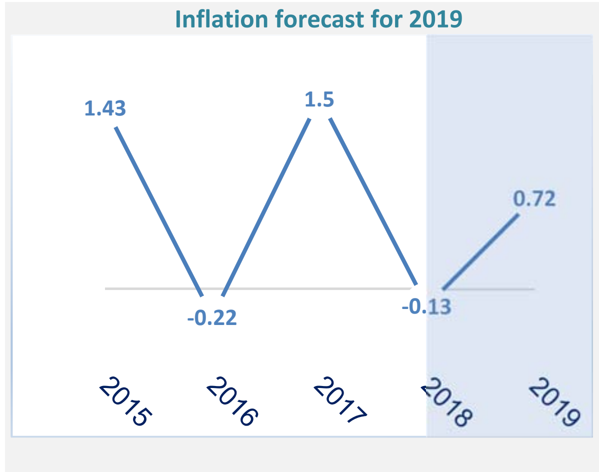
b) *Inflation forecasts*

The forecasts of PMA[5] indicate that prices will grow again in 2019; however, slightly at 0.7 percent compared to limited downturn at 0.1 percent in 2018. These forecasts come against the backdrop of expectations of slight acceleration of the cost of imports and global food prices that considered the key determinants of

(4) The figures and rates of 2018 are estimates and subject to change.

(5) Inflation forecasting model takes into account the impact of both exogenous and endogenous factors on inflation in Palestine by implementing the "co-integration analysis" and "autoregressive distributed lag (ARDL)" methods. For more information on this model, please check working papers posted on the PMA's official website www.pma.ps

inflation in Palestine. It is expected that the first would grow by approximately 1.1 percent, while the second would grow at a slightly higher pace of 2.8 percent in 2019.



6) Risk analysis (shocks)

Apart from potential statistical errors that may result from using mathematical models in the forecast process, these expectations remain subject to potential shocks that may occur at different degrees especially that the Palestinian economy operates in a high-risky environment, both internally and externally. These risks are responsible for numerous possible shocks which my impact the economic performance, mainly by influencing consumption trends, investment and trade. New shocks are experienced every year whether political or security shocks or economic shocks (foreign grants and/ or clearance revenue) and their serious impact of the Palestinian economy.

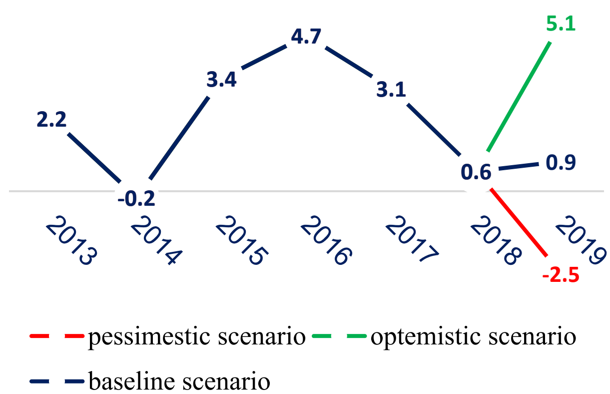
A hypothesized positive shock to the economy (optimist scenario) that include serious improvement in the political, security situation, and reconciliation; implementation of development projects that would stimulate the economy; lifting the closure of Gaza Strip (totally or partial); increase the number of Palestinian laborers in Israel; increase in the pace of flow of donors’ grants in budget support and development expenditure; and increase in private sector transfers that exceed annual rates.

This scenario, according to PMA forecasts, means that the Palestinian economy would grow by 5.1 percent and per capita income would increase by 2.9 percent. Private sector value added would grow by 6.8 percent and public sector value added would grow by 5.1 percent. Total consumption would grow by 5.0 percent (3.8 percent for private and 9.5 percent for public consumption), while gross investment would grow by 9.2 percent and its contribution to GDP would reach 23.7 percent.

This scenario also ensue 8.6 percent growth in exports while imports would grow by 8.0 percent leading to deterioration in trade balance where deficit would rise to 7.6 percent thus constituting 34.7 percent of the real GDP in 2019. This scenario also expected to have positive impact on the labor market by reducing unemployment rate to 29.5 percent of the total labor force.

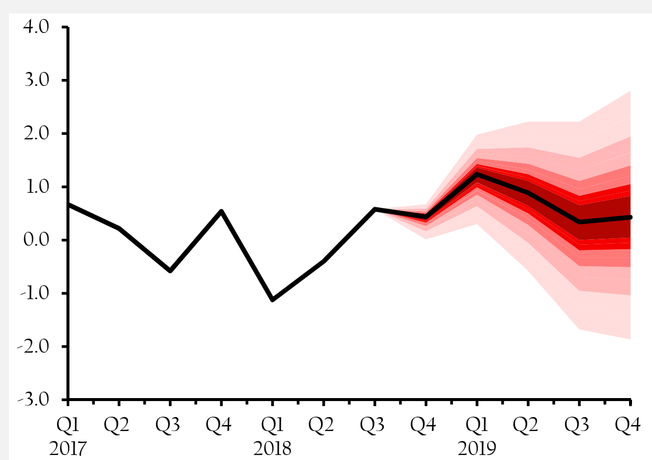
However, the economy may also be subject to negative shock (pessimist scenario) that may entail more deterioration of political and security situation, more Israeli attacks on Gaza Strip, sharp drop in the size of grants in treasury support, Israel withholds clearance revenue, and drop in the number of Palestinian workers in Israel.

Potential risks to growth rate, 2019



Forecasts show that if this scenario takes place, real GDP will drop by 2.5 percent leading to drop in per capita income by 0.9 percent. Private and public sectors value added will drop by 2.9 percent and 1.6 percent, respectively. Total consumption will also drop by 1.6 percent (1.6 percent for private and 1.7 percent for public consumption), and gross investment will drop by 5.5 percent. This scenario also entails 6.7 percent and 3.6 percent drop in exports and imports, respectively, leading to improved trade balance with 1.6 percent, thus constituting 34.2 percent of the GDP forecast for 2019. This scenario also expected to have negative impact on unemployment rate, which would rise to 32.3 percent.

Potential risks to inflation rate, 2019



However, Inflation risks in Palestine primarily linked to the changes that occur to global prices; especially oil and food, in addition to changes in inflation rate among Palestine trade partners, Israel in particular. There are also internal shocks that may impact size of local demand. The figure shows that the scope of these risks of 2019 is wide, which reflects the degree of uncertainty of the forecasts; the darker the color in the figure is, the inflation rate is more likely to materialize and vice versa.

Appendix: PMA forecasts, 2019

	2015	2016	2017	2018	Forecasts 2019		
		Actual		Projection*	Baseline Scenario	Optimistic Scenario	Pessimistic Scenario
Annual percent change (%)							
Real GDP	3.4	4.7	3.1	0.6	0.9	5.1	-2.5
Real GDP per capita	--	--	--	-1.1	0.4	2.9	-0.9
Private sector value added	1.8	3.9	2.7	-0.3	1.2	6.8	-2.9
Public sector value added	0.4	5.1	18.2	-1.3	-0.1	5.1	-1.6
Unemployment rate	**25.9**	**26.9**	**28.4**	31.0	**31.3**	**29.5**	**32.3**
Inflation rate	**1.43**	**-0.22**	**0.21**	-0.13	**0.72**	**--**	**--**
Total final consumption	**6.1**	**2.9**	**-1.2**	-1.3	**-0.1**	**5.0**	**-1.6**
Public	5.8	1.8	0.9	-5.8	0.5	9.5	-1.7
Private**	6.2	3.3	-1.8	0.1	1.4	3.8	-1.6
Total investment	**9.5**	**4.8**	**10.0**	1.6	**2.2**	**9.2**	**-5.5**
Net export of goods and services * **	**13.1**	**-0.6**	**-6.9**	-3.1	**2.7**	**7.6**	**-1.6**
Total exports	2.6	1.9	12.4	7.9	2.4	8.6	-6.7
Total imports	9.5	0.2	-0.8	0.8	2.6	8.0	-3.6
As percent of real GDP (%)							
Total final consumption	**120.2**	**118.2**	**113.2**	**111.1**	**111.4**	**111.0**	**112.1**
Public	27.1	26.3	25.7	24.1	24.0	25.1	24.3
Private	93.2	91.9	87.5	87.0	87.4	85.9	87.8
Total Investment	**21.1**	**21.1**	**22.6**	**22.8**	**23.1**	**23.7**	**22.1**
Net export of goods and services	**41.1**	**39.0**	**35.2**	**33.9**	**34.5**	**34.7**	**34.2**
Total Exports	18.5	18.0	19.6	21.0	21.3	21.7	20.1
Total Imports	59.6	56.9	54.8	54.9	55.8	56.4	54.3
Memorandum Items							
Real GDP (USD million)****	12673	13270	13686	13766	13891	14468	13422
Real GDP per capita (USD)	2864	2923	3072	3039	3051	3127	3012
USD/NIS exchange rate	3.88	3.84	3.6	3.6	3.7	3.7	3.7

* PMA's research team projections.
** Includes non-profit institutions serving households (NPISH).
***Negative sign denotes decrease in trade deficit.
**** Base year 2015.