سلطة النقد الفلسطينية

Economic Forecast Report, 2018

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1. Preface

The pattern of economic activity in Palestine is unusual. While economic activity and growth stimulators in conventional economies are largely related to internal economic variables and policies, the Palestinian economy operates in an environment rife with different internal and external risks and challenges, which significantly affect and change the economic situation. External challenges facing the Palestinian economy include the Israeli occupation and the multiple associated restrictions imposed over the years (internal and external closures), as well as restrictions on the freedom of movement of goods and people and access. The fluctuating flow of foreign grants has a direct impact on the performance of the Palestinian economy because they are considered an important source of revenue for the government.

Internal challenges include: (i) the difficulty of formulating a monetary policy in the absence of a local currency; (ii) the dependence of the existing multi-currency system on monetary policies adopted by issuing countries: the United States, Israel and Jordan; (iii) uncertainty and the associated fragile political and economic situation; and (iv) the weak role of the private sector as a growth driving force. These challenges are responsible for several shocks to the Palestinian economy, including significant fluctuations in trade, investments, economic activity and growth, given the limited freedom of movement and access of individuals to goods and capital.

In 2018, the economic situation will depend on several political and economic variables, namely: (i) the reconciliation process between the Palestinian Authority and Hamas, the two major political parties and its consequences on the government's fiscal situation (i.e. expenditure and revenue); (ii) ensuring a regular flow of clearance revenues from the Israeli side and a commitment to providing foreign grants to the Palestinian Authority; (iii) easing restrictions on trade and allowing the exploitation of local resources in Area (C); and (iv) an improved investment environment in order to encourage the private sector and allow it to increase its investment and carry out major infrastructure projects.

2. Recent economic developments: 2015- 2016

In 2016, the Palestinian economy experienced further relative recovery, especially during the first and third quarters of the year, as growth accelerated to record levels of 6.6 and 5.2 percent, respectively. In general, real GDP rose by 4.7 percent compared to 3.4 percent in 2015. A combination of political and economic conditions promoted growth in 2016, mainly a stable economic situation and regular domestic and clearing revenues, a regulated financial situation, some recovery in economic activity, improvement in aggregate demand, and the ongoing gradual restoration of the Gaza's production base, devastated by the Israeli war in summer 2014. Such conditions have boosted production and the growth rate. In Gaza Strip, growth increased by 7.7 percent compared to 6.1 percent the previous year, mainly supported by increased investment, while in the West Bank, economic activity expanded little. Growth rate reached 3.0 percent compared to 2.6 percent in 2015. This growth was achieved despite the negative repercussions of the political and security situations in the West Bank.

On the demand side (GDP by expenditure), real aggregate demand improved in 2016, albeit at a slower pace. On the one hand, final consumption increased by 2.8 percent as private consumption rose by 3.6 percent and public consumption by 0.1 percent. On the other hand, total investment growth reached 5.7 percent, at a time when net exports increased slightly (0.02 percent) compared to the previous year, exports of goods and services increased by 5.5 percent and imports by 1.8 percent.

On the supply side of GDP (Value added by economic activities), the performance of economic activity was somewhat inconsistent. The manufacturing and mining sectors grew significantly by 7.0 percent, compared with -5.7 percent in 2015: the construction sector also shot up (by 5.9 percent), compared with 3.7 percent in 2015. Financial and insurance activities grew by 12.6 percent compared with 5.3 percent; the public administration and the defense sector rose by 4.7 percent compared with 1.7 percent; and the services sector grew (5.5 percent) compared with 1.1 percent. In contrast, growth decreased by -11.0 percent in the agriculture compared with -7.2, and trade also fell by (-1.9 percent) compared with 6.8 percent in 2015.

As a result of these developments, real GDP per capita increased by 1.2 percent in 2016, compared with 0.4 percent. However, these developments did not affect the Palestinian labor market, as the unemployment rate rose to 26.9 percent, compared with 25.9 percent in 2015. In the West Bank, the unemployment rate increased to 18.2 percent compared with 17.3 percent, while reaching 41.7 percent in Gaza compared with 41.1 percent in 2015.

In terms of prices, data from the Palestinian Central Bureau of Statistics (PCBS) indicate a drop in inflation (to -0.2 percent) in 2016 compared with 1.4 percent in 2015. In the West Bank, the general price level dropped to -0.1 percent, compared with 1.3 percent, while in Gaza Strip, it dropped to -0.8 percent compared with 1.8 percent. The decrease in inflation is attributed to lower import costs and the drop in global prices of some commodities (especially oil and food) which constitute the largest share in the Palestinian consumer's basket.

3. Growth projections for 2017

Initial projections for 2017 indicated that economic recovery would continue. However, since the Palestinian economic situation is affected by the political situation as well as internal and external shocks, signs of a relative slowdown in economic activity have emerged again this year. Based on available data and information, it seems that negative risks will prevail and a relative slowdown in comparison with last year will be in order in 2017.

The latest data released from the PCBS indicates that economic activity is decelerating (first half of the current year compared with the corresponding half of the previous year). This can be attributed to the drop in aggregate demand, the deteriorating performance of the agricultural and trade sectors, and the slowdown in the construction and manufacturing sectors in the first half of the year. In the first half, growth was much less than expected (at 0.9 percent) compared with 5.0 percent in the first half of 2016. Final consumption dropped by (-2.6 percent), and fixed capital formation decreased by -2.2 percent while net exports declined by 6.4 percent during the same period. PMA projections for the second half of the year indicate that the Palestinian economy's growth rate will reach 4.8 percent. Annually, overall economic activity in 2017 is expected to slow down compared with last year.

The baseline scenario indicates a growth of 2.9 percent compared with 4.7 percent in 2016. These estimates were based on several leading indicators, most importantly the Palestine Monetary Authority Business Cycle Index (PMABCI), construction and external sector indicators, and indicators related to the Israeli economy.

4. PMA growth forecasts for 2018

A. Growth forecasts

The PMA forecast main macro-economic variables in 2018 (baseline scenario[1]) and analyzed the risks of different shocks which were likely to occur to varying degrees (optimist and pessimistic scenarios). These shocks were likely to have positive and negative impacts on economic performance. All of the above mentioned forecasts are sensitive to revisions of actual data for previous years published by official data-producing agencies, mainly the PCBS and the Ministry of Finance.

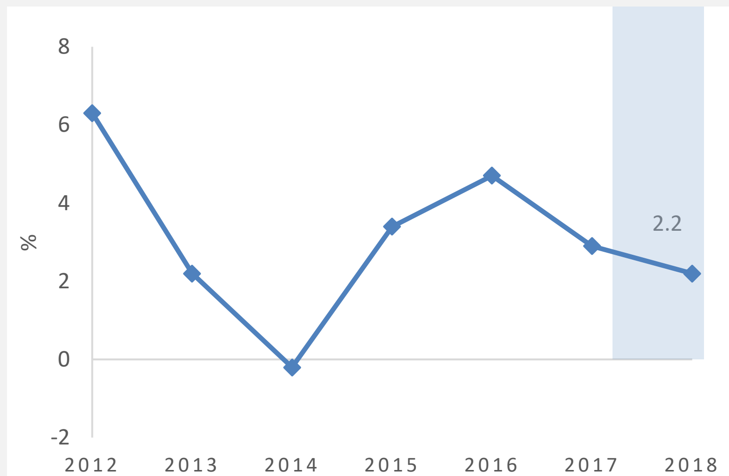
The basic forecasts for the performance of the Palestinian economy during 2018 were founded on a set of basic assumptions (baseline scenario) and their associated implications on economic conditions. These assumptions were:

- The political and security situations will remain unchanged with no significant development, particularly regarding restrictions imposed at border crossings on the freedom of movement of people and goods and access. Meanwhile, the increase in the number of Palestinian workers in Israel will average around previous-year levels, and the slow pace of the reconstruction process in Gaza Strip will remain essentially unchanged (i.e. the same 2017 levels).
- The government will continue to follow a fiscal austerity policy and implement current-expenditure rationing, while growth in government revenues and expenditures will remain relatively unchanged at previous-year levels.
- Foreign grants extended by donor countries to the government's treasury will continue to decline, reaching almost USD 600 million during 2018.
- Private sector transfers from abroad will exceed USD 1 billion during 2018.
- Credit facilities granted to the private sector by banks operating in Palestine will rise by 18 percent compared with 2017.
- The cost of import (inflation rate and exchange rate with trading partners) will rise by 1.5 percent.
- The weighted real GDP growth rate of Palestine's main trading partners will increase by 3 percent.

[1] The forecasts for Palestinian economic key variables were based on economic models developed by the PMA, most importantly the Reduced Form Equation, to predict GDP on quarterly basis. In line 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 www.pma.ps.

Based on these assumptions, PMA forecasts indicate an expected 2.2 percent growth in real GDP in 2018, compared to an estimated 2.9 percent growth in 2017[2]. This slowdown in growth is expected to be reflected in real per capital income (real GDP per capita) which slightly increased (by 0.3 percent) compared with 0.4 percent in 2017 (reaching USD 2,943). Growth in real GDP in 2018 is expected to remain the same as in previous years, primarily driven by growing private consumption (which is financed by increasing banking facilities) and accumulated arrears as well as the rise in total investments.

Figure 1: Growth forecasts, 2018



The private-sector value added is expected to grow by 1.9% during 2018, raising he sector's contribution to real GDP at factor costs to 78.4 percent. Public-sector value added is expected to grow by 1.7 percent pushing the sector's contribution to real GDP down to around 21.6 percent. Additionally, PMA forecasts point to an expected 2.5 percent increase in total consumption spending during 2018 (2.4 percent for private consumption and 3.0 percent for public consumption), increasing its contribution to real GDP to 118.8 percent in 2018 (consequently, imports will increase). Conversely, total investment spending is expected to increase slightly (by about 0.7 percent) to constitute 20.5 percent of GDP.

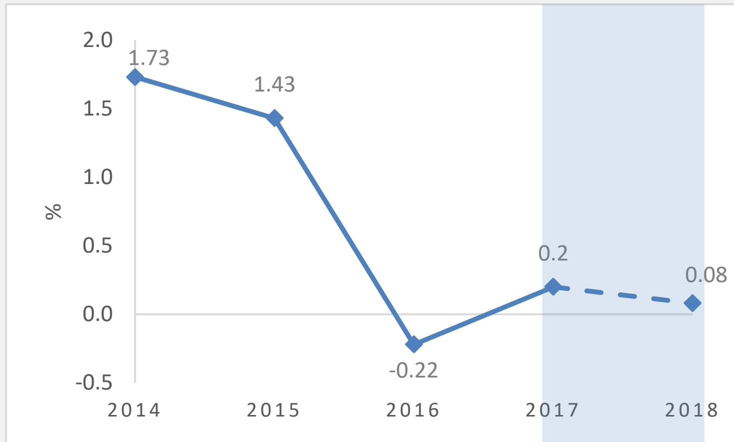
As for the Palestinian external sector, forecasts indicate that exports will decline by -0.2 percent, and imports (whose increase is mainly associated with an increase in consumption) will rise by 1.7 percent. Consequently, it is expected that these changes in exports and imports will exacerbate the trade balance deficit by about 2.5 percent to constitute 40.7 percent of the real GDP predicted for 2018. It is expected that this growth will not have a significant impact on job creation and employment. Instead, unemployment rates in Palestine will continue to rise, reaching about 29.3 percent of the labor force in 2018.

[2] According to PMA projections which are similar to IMF forecasts and are estimated at 3 percent in the latest report published in September 2017.

B. Inflation forecasts

PMA forecasts[3] indicate that the pace of price growth will continue to slow down in 2018. As a result, inflation is expected not to exceed 0.1 percent, on average, similar to the 0.2 percent rate of 2017. These forecasts come at a time when growth in the cost of imports and global food prices (which are the main determinants of inflation in Palestine) are expected to slow down. cost of imports will grow by 1.9 percent while global food prices are expected to grow at a slower pace (1.3 percent) in 2018.

Figure 2: Inflation forecasts, 2018



5. Risk analysis (shocks)

Apart from potential statistical or methodological errors, uncertainty associated with many disparate factors continues to prevail. This is particularly the case because the Palestinian economy operates in a high-risk environment, both internally and externally. These risks are responsible for numerous possible shocks which impact the economic performance, mainly by influencing consumption, trade and investment. The impact and consequences of such shocks will affect several key economic indicators.

A positive shock to the Palestinian economy (the optimistic scenario, reconciliation scenario) presumes serious progress in the political track, an improving security situation, peace talks, and reconciliation between the two major Palestinian political parties. It also presumes an accelerated reconstruction of Gaza Strip, the launch of major projects and the introduction of measures to stimulate the economy, lifting the siege and ending the closure of Gaza, easing restrictions on the movement of people and goods in general, and an increase in the number of Palestinians workers in Israel. In addition, it entails a rise in

[3] To prepare the inflation forecasts, the inflation forecasting model was used. It 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 published on the PMA's official website www.pma.ps.

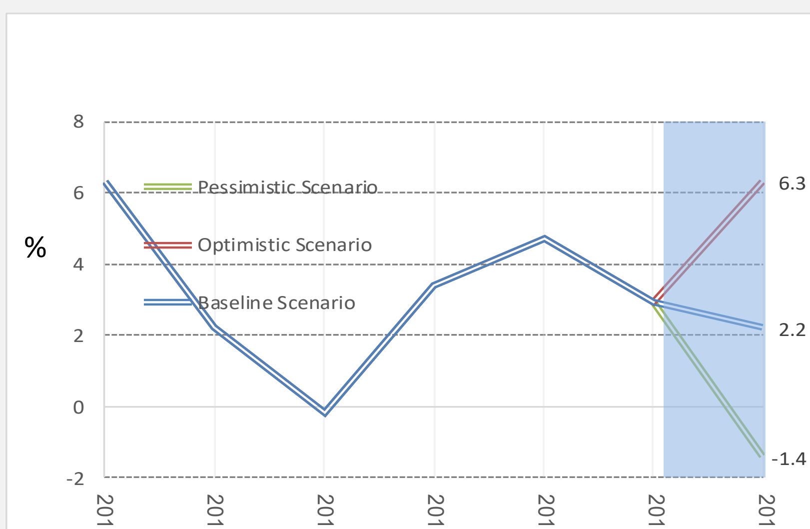
donor grants to support the budget and development spending, as well as a rise in private sector transfers from abroad, which will exceed annual rates.

In light of this, PMA forecasts a 6.3 percent economic growth, due to an expected 20 percent growth in Gaza, bringing real GDP in the Palestinian Territory to USD 14,515 million, increased GDP per capita by 3.1 percent to USD 3,030. The private sector value-added is expected to grow by 9.5 percent, increasing its contribution to GDP at factor costs to 78.7 percent. The public-sector contribution is expected to grow by 9.5 percent, lowering its contribution to GDP to 21.3 percent. Under this scenario, unemployment rates are also expected to improve, dropping to around 27.1 percent of total labor force, compared with 28.4 percent in 2017.

Under such a scenario, total consumption spending is expected to grow by around 5.8 percent (4 percent for private consumption and 12 percent for public consumption), driving its contribution to GDP down to 117.8 percent. Likewise, total investment spending is expected to grow by around 17 percent, increasing its contribution to GDP to about 22.9 percent. Similarly, forecasts indicate a 9.4 percent growth in exports, as opposed to a 10.1 percent growth in imports, leading to an increase in the trade balance deficit by about 10.4 percent. Subsequently, the deficit is expected to grow to around 40.7 percent of predicted real GDP for 2018.

In contrast, under the pessimistic scenario, the economy remains susceptible to negative shocks. A negative shock scenario assumes a sharp deterioration in the political and security situation, a decrease in the number of Palestinian workers in Israel, a 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

Figure 3: Potential risks to growth, 2018

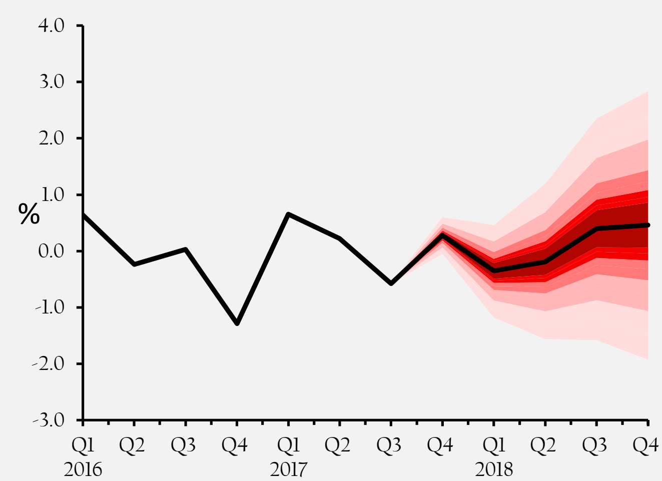


expenditures, and a cessation of Gaza reconstruction process. In case the economy was exposed to a similar shock, PMA predicts a further deterioration of economic conditions. The Palestinian economy would contract by -1.4 percent (figure 3) and real GDP will drop to around USD 13,463 million. It is also expected that the decline in growth will adversely affect real per capita income, causing a 3.6 percent drop to about USD 2,830. Moreover, under this scenario, private-sector value-added is expected to decline (by 3.2 percent) in 2018, decreasing its contribution to GDP at factor costs to 78.1 percent. Similarly, public-sector value added is expected to decline by -1.9 percent, and its contribution to GDP at factor costs is expected to reach 21.9 percent. Such a scenario would have tangible adverse impacts on unemployment, increasing it to 32.4 percent of total labor force. As a result, total consumption spending under this scenario is expected to fall by around -0.6 percent (-0.3 percent for private consumption, and -1.4 percent for public consumption). This drop is expected to bring the contribution of total consumption to GDP to around 119.4 percent.

Additionally, gross investment spending is expected to decline by around -6.1 percent, bringing its contribution to GDP down to around 19.8 percent. In the external sector, forecasts point to a decline in exports by around -3.7 percent and a decline in imports by around -2.1 percent. These results are expected to aggravate Palestine's trade deficit by -1.4 percent or 39.2 percent of the expected real GDP for 2018.

However, Inflation risks primarily hinge on changes to global prices (particularly prices of food and fuel), in addition to changes in inflation rates in Palestine's trading partners, particularly Israel. Such forecasts also depend on potential internal shocks that may affect domestic demand in Palestine. Figure (4) illustrates potential risks affecting inflation forecasts in Palestine in 2018. It is worth mentioning that there are many possible results, as figure (3) and figure (4) indicate. This obviously proves that predictions are uncertain due to the potential risk factors highlighted earlier. These figures demonstrate expected growth and inflation rates by probability of occurrence. For example, in figure (5), the darker the shades, the higher the possibility of achieving the expected inflation rate, and vice versa.

Figure 4: Potential risks to inflation, 2018



Appendix: PMA forecasts, 2018

	2014	2015	2016	2017	Forecasts 2018		
		Actual		Projection*	Baseline Scenario	Optimistic Scenario	Pessimistic Scenario
Annual percent change (%)							
Real GDP	-0.2	3.4	4.7	2.9	2.2	6.3	-1.4
Real GDP per capita	-3.1	0.4	2.1	0.4	0.3	3.1	-3.6
Private sector value added	-3.6	1.8	3.9	2.8	1.9	9.5	-3.2
Public sector value added	2.8	0.4	5.1	2.5	1.7	7.4	-1.9
Unemployment rate	**26.9**	**25.9**	**26.9**	28.4	**29.3**	**27.1**	**32.4**
Inflation rate	**1.7**	**1.4**	**-0.2**	0.2	**0.1**	--	--
Total final consumption	**3.6**	**6.1**	**2.9**	3.1	**2.5**	**5.8**	**-0.6**
Public	3.7	5.8	1.8	2.9	3.0	12.0	-1.4
Private**	3.5	6.2	3.3	3.2	2.4	4.0	-0.3
Total investment	**-13.9**	**9.5**	**4.8**	1.2	**0.7**	**17.0**	**-6.1**
Net export of goods and services ***	**1.4**	**13.1**	**-0.6**	3.5	**2.5**	**10.4**	**-1.4**
Total exports	9.6	2.6	1.9	-1.4	-0.2	9.4	-3.7
Total imports	4.1	9.5	0.2	2.0	1.7	10.1	-2.1
As percent of real GDP (%)							
Total final consumption	**117.2**	**120.2**	**118.2**	**118.4**	**118.8**	**117.8**	**119.4**
Public	26.5	27.1	26.3	26.3	26.5	27.7	26.3
Private	90.7	93.1	91.9	92.1	92.3	90.1	93.1
Total Investment	**19.9**	**21.1**	**21.1**	**20.8**	**20.5**	**22.9**	**19.8**
Net export of goods and services	**-37.5**	**-41.1**	**39.0-**	**-39.2**	**-39.3**	**-40.7**	**-39.2**
Total Exports	18.6	18.5	18.0	17.2	16.8	17.7	16.8
Total Imports	56.1	59.6	57.0	56.4	56.1	58.4	56.0
Net error and omissions	**0.4**	**-0.2**	**-0.3**	**0**	**0**	**0**	**0**
Memorandum Items							
Real GDP (USD million)****	12,253	12,673	13,270	13,655	13,955	14,515	13,463
Real GDP per capita (USD)	2,852	2,864	2,923	2,935	2,943	3,030	2,830
USD/NIS exchange rate	3.58	3.88	3.84	3.5	3.5	--	--

* PMA's research team projections.

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

***Negative sign denotes decrease in trade balance deficit.

**** Base year 2015.