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Main reports

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In June 2014, total exports of goods from Palestine amounted to $74.5m (up by 4.8% from June 2013), while imports reached $460m (+18.2%). Trade deficit stood at $385.5m

Aggregated net profits of Palestinian listed companies reached $136.7m in the first half of 2014, up by 13.6% from H1 2013

World Bank and IMF Economic Assessments

The World Bank[1] and the IMF[2] issued reports assessing the current state of and prospects for the Palestinian economy. In a context of economic slowdown and rising unemployment, and in the aftermath of the recent Israeli military operation in Gaza, both organisations called for an immediate, comprehensive lifting of Israeli-imposed restrictions on the Palestinian economy and for increased international support and coordination for Gaza´s reconstruction. The IMF also warned about the increased fiscal risks faced by the Palestinian National Authority (PNA) following the war.

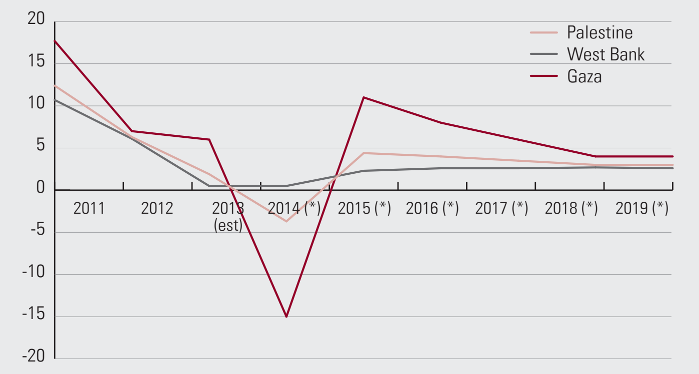
The IMF presented short and medium term GDP growth projections. Although a definitive, comprehensive assessment of the economic impact of the military operation in Gaza is not yet available, it is anticipated that destruction to infrastructure and productive assets across a wide range of economic sectors and decreased economic activity during the 51-day conflict will have a negative impact on growth – which was already slowing down prior to the latest round of violence. Following seven years of positive growth, between 2007 and 2013, an overall 3.7% GDP contraction is expected for 2014. In Gaza, the IMF anticipates a 15% drop in GDP by the end of the year. In the West Bank, although economic disruption during the war was less dramatic than in Gaza, there is a risk that declining household and business confidence could lead to decreased consumption and investment. As a result, the IMF expects annual growth of only 0.5% in the West Bank by the end of 2014.

For 2015 an 11% rebound in GDP growth in Gaza is expected, following major donor-funded reconstruction activities. The IMF anticipates that GDP levels in Gaza will return to the pre-war situation by 2016-2017, after which growth is expected to converge to around 4% (Figure 1). However, unless substantial progress is achieved regarding the political situation, the IMF anticipates that any positive effects of the reconstruction efforts will be short-lived. With growth in the West Bank expected to remain below 3% through to 2019, overall Palestinian growth is projected to reach 4.4% by the end of 2014 and 4% in 2015 - to stabilise at 3% in 2018-2019 (just above the yearly population growth rate). Weak growth would result in lower levels of income per capita and a further rise in unemployment, which was already at a high 26.3% in Q2 2014 (16% in the West Bank and 45% in Gaza).

Cash assistance and other emergency response measures in Gaza are likely to have immediate impact on retail trade and services. Construction and associated small industries would also rebound rapidly if building materials were allowed to enter Gaza smoothly to assist in rebuilding efforts. However, the World Bank highlights that a sustainable, "build back better" approach would require not only major international funding but also increased co-ordination between the PNA, the international community and support organisations; better and faster movement of people and goods; and strong Palestinian governance. In this respect lessons are to be learned from the 2008/2009 Israeli military operation in the Gaza Strip.

1 www.bit.ly/1poT34P
2 www.imf.org/external/country/WBG/RR/2014/091214.pdf

Figure 1: Growth Projections[3]



Source: IMF

According to the IMF, consumption-driven economic recovery in the aftermath of the 2008/2009 conflict, aided by cash assistance-support, proved to be unsustainable. With no real change on the ground, the continuing of Israeli restrictions not only hampered reconstruction efforts (mostly through the limited passage of construction materials) but also limited industrial development and job creation by hindering exports and investment. Addressing the major pre-existing constraints on the Palestinian economy, including restrictions on movement and access, is therefore a pre-requisite for any medium to long-term development strategy.

To address current challenges in a sustainable manner, the IMF recommends that reconstruction activities focus on SMEs, manufacturing and agriculture activities in order to stimulate job creation and to develop stable economic foundations.

The reconstruction and development agenda in Gaza not only needs to go beyond immediate assistance but also has to include the Palestinian private sector at its core, as the central force for sustainable growth and job creation. Leveraging Palestinian businesses´ expertise and entrepreneurial spirit in key sectors including energy, water and solid waste management could help to provide a sustainable solution to some of the long-standing challenges affecting development in Gaza, and also to create much needed impact in the short term. Opportunities exist for private sector participation in projects through public-private partnerships and also through leveraging donor funded investment promotion mechanisms, including risk mitigation funds. The role of local banks and Palestinian Diaspora investors could also help drive job creation, an immediate priority.

Finally, as donors´ focus shifts to Gaza, it is also crucial to boost economic momentum in the West Bank. With an expected financial gap of $350m in the PNA´s budget by the end of 2014 (prior to accounting for expenditure on Gaza reconstruction), the IMF warned about increasing risks for Palestinian businesses should the PNA seek to bridge the gap by further accumulation of domestic arrears with the private sector and / or increased levels of debt with local banks.

3 2013 growth rate is estimated (official data unavailable). 2014-2019 (*) corresponds to IMF projections.

Delivering short term, private sector-driven impact in the Palestinian economy is an absolute priority for stability and development prospects in the medium to long term. Focusing on sustainable growth and job creation is therefore crucial, as weak growth, lower levels of GDP per capita and high unemployment (especially among youth) are correlated with a higher risk of conflict recurrence, a major obstacle to economic recovery and development in post-conflict areas.

Investment Climate Assessment

In September, the World Bank published a report assessing the investment climate in Palestine during 2013.[4] This comprehensive study followed the World Bank´s Investment Climate Assessment (ICA) methodology, which quantifies the main characteristics and evolution of a country´s investment climate for productivity and income growth using unified criteria, which allows for comparison between different countries and regions. The recently published report is an expanded update of a similar work undertaken by the World Bank in 2006. The 2013 ICA was based on a survey of almost 900 formal and informal enterprises operating in the West Bank, the Gaza Strip and East Jerusalem. Panel data was exploited to assess changes in the operating conditions of the sample of enterprises between 2006 and 2013.

Empirical results indicate that political instability remains the key obstacle to growth in the Palestinian economy – as reported by the vast majority of surveyed companies, formal or informal, across Palestine. According to the World Bank, "*few other aspects of the investment climate appear to be as binding in the light of this overwhelming constraint*". Restrictions on the movement of people and goods, limited access to economic space and resources and relative isolation from the global economy, among other factors, are said to have increased the cost of doing business in Palestine and created an "*uncertain environment in which it is difficult to predict future risks and returns*." As a consequence, the World Bank says, the Palestinian private sector is largely characterised by small firms operating in low productivity sub-sectors without a clear investment horizon. Competition is believed to be low given the existence of large barriers to entry for firms that are neither large enough to manoeuvre through the existing set of complex and changing regulations and restrictions, nor small enough to avoid them. Within this uncertain and fragmented economic environment, the World Bank argues, most Palestinian firms have relatively low capital intensity and have not shown significant growth in capital investment or employment between 2006 and 2013.

According to the study, restrictions and the years of political division between the West Bank and Gaza have resulted in fragmentation of the two areas into disconnected "micro-climates", where firms face significantly different operating conditions and constraints. Fragmentation is

4 www.bit.ly/1uTiqlK

said to have resulted in low competitive forces, which in turn has led to large disparities in productivity between Palestinian firms operating in the West Bank, Gaza or East Jerusalem (where, for example, firms have more than three times the value added per worker and are 16 times more capital intensive than in Gaza).

Other factors hampering the investment climate in Palestine, as characterised by the World Bank, include the lack of reliable basic services; restrictions on the economic use of land in the West Bank (especially in Area C); the lack of a unified legal and regulatory environment across the different Palestinian areas (due to which few firms attempt to operate in both the West Bank and in Gaza); the existence of a large informal economy (an estimated 100,000 informal units are competing with a similar number of small registered businesses in the same sub-sectors and markets) and a drop in innovative and business-upgrading activities among Palestinian firms (especially in Gaza).

On the other hand, the study concluded that most of the positive factors identified in the 2006 ICA remain true today. These include the low incidence of petty corruption in business activities, with only 7% of surveyed firms reporting having experienced a request for a bribe from an official (a large departure from other comparator countries in the region where such payments are cited much more frequently). Further, labour productivity of Palestinian firms is on par with comparator countries, an impressive achievement under the current circumstances. Unit labour costs are also competitive within the region. Labour productivity is indeed higher than in Egypt, Tunisia and Yemen in recent years. This is believed to be the result of a combination of relatively high technical efficiency, low capital intensity firms operating in relatively low-productivity sub-sectors. This indicates great potential for achieving productivity gains by increasing capital investment in Palestinian firms and promoting a shift towards higher productivity sub-sectors.

At the same time, although export performance is still poor and dependence on Israel as an export destination continues to dominate, the percentage of goods exported to the Israeli market is in decline. According to the study this indicates a promising trend towards diversification of export destinations, products and sales channels (especially in relatively high-value sectors such as pharmaceuticals, furniture, agribusiness, IT services and call centres). The World Bank also points out the emergence of a technology-based entrepreneurship eco-system in Palestine as an encouraging development.

Finally, the report highlights that over recent years a number of equity investors (often following a specific mandate and partnering with foreign investors or finance facilitators) have managed to increasingly attract foreign investment into Palestine. In this respect, The World Bank recognises that the launching of the ´Beyond Aid´ initiative by the Palestinian private sector and of the 'Initiative for the Palestinian Economy' put forward by the Office of the Quartet Representative could support this trend.

The World Bank considers that policy directions in the medium to long term can only be formulated assuming the achievement of a final peace agreement. Consequently, short-term policy recommendations focus on means to mitigate the effects of political instability and work towards improving those specific aspects of the investment and business climate that can be advanced under the current circumstances (even if marginally). Some of the World Bank´s key recommendations will require political will and broad coordination between the PNA, the international community and others (including the Government of Israel). These include the adoption of measures to improve access to resources and markets; promote greater integration between the economies of the West Bank and Gaza; mitigate political risks; improve business regulation; enhance the role of the private sector and invest in innovation, technology and skills development.

Hotel Activities

In Q2 2014 207,083 guests spent the equivalent of 493,104 guest nights in 113 hotels in the West Bank (85) and East Jerusalem (28).[5] Most hotel guests came from EU countries (36%) and the US and Canada (11%). Hotels employed 3,010 workers during the same period, a quarter of whom were females.

The second quarter of 2014 showed remarkable performance by Palestinian hotels, which attracted 35% more guests than in Q2 2013 (Table 1). The number of guest nights increased by 31% over the same period, while room occupancy reached 30.6% (up by 4.4 percentage points from Q2 2013).

Table 1: Hotel Activities Main Indicators (West Bank and East Jerusalem)

	Q2 2013	Q1 2014	Q2 2014
Number of hotels	107	120	120
Number of rooms	5,936	6,674	6,621
Number of beds	13,545	14,780	14,675
Number of hotel workers	2,793	3,035	3,010
Number of guests	153,085	149,526	207,083
Number of guests nights	376,848	361,711	493,104
Room occupancy (%)	26.2	23.0	30.6

Source: PCBS

However, in the aftermath of the recent military operation in Gaza, a general contraction in hotel activities could be expected for the remainder of the year (with the impact of the conflict possibly going beyond the end of 2014), as cancellations of travel plans by international visitors usually occur following unrest in the region. If prolonged, such effects can result in lay-offs of workers, deterioration of marketing channels and capability losses in the sector.

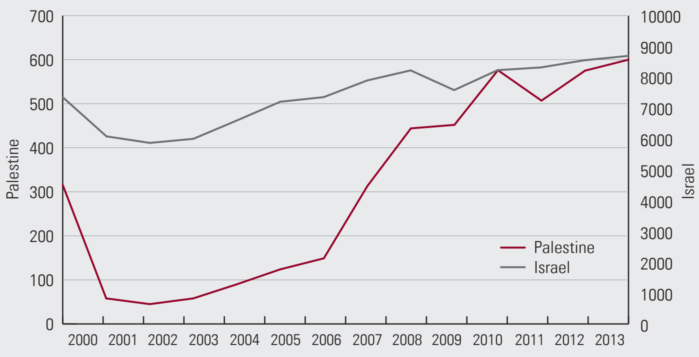
Following the 2008/2009 Israeli military operation in Gaza, the number of guests in Palestinian hotels in Q1 2009 dropped by 20% from Q1 2008 and by more than 40% from the previous quarter.[6] In Israel, where hotel activities are equally affected by conflict episodes, the number of hotel

5 www.bit.ly/1r8hU3n
6 PCBS. The Hotel Activities in the West Bank, quarterly data 2007-2013.

guests dropped by almost 25% between Q4 2008 and Q1 2009.

Hotel activities in Israel and Palestine follow close trends (Figure 2). These have been greatly affected during times of conflict since 2000, including a massive drop in the number of hotel guests in both Palestine and Israel following the Second Intifada.

Figure 2: Total number of (domestic and foreign) hotel guests (thousands), Palestine and Israel, 2000-2013



Source: PCBS and CBS (Israel)

While recent monthly data is not available for Palestine, in Israel the number of incoming visitors during July and August 2014 dropped by 26% and 36% from the corresponding months of the previous year, respectively.[7] This could anticipate activity drops of a similar magnitude in Palestine.

Foreign Trade in Goods June 2014

In June 2014, total exports of goods from Palestine amounted to $74.5m, while imports reached $460m.[8] Trade deficit, at $385.5m, experienced a slight increase from the previous month (0.7%), as exports decreased by 2.4% and imports increased by 0.2%. From June 2013, exports and imports increased by 4.8% and 18.2%, respectively. Trade performance in June 2014 followed a trend verified for the whole second quarter of the year.

In June 2014, Israel accounted for 87% of Palestinian exports and 62% of imports, following a long-standing dependency situation. In 2013, Israel accounted for 87% of Palestinian exports, followed by Jordan (6.1%), the US (1.1%) and Saudi Arabia (0.9%). In that same year, 71.5% of Palestinian imports came from Israel, followed by Turkey (5.6%), China (4.6%), Germany (2.4%) and Jordan (1.8%).[9] At the same time Israeli imports from Palestine accounted for merely 0.8% of the total, while exports to Palestine were 5.6% of total exports from Israel.[10]

In 2013, Palestine's major exports came from stone and marble ($171m, or 19% of total exports), vegetable products ($137m; 15.3%), base metals ($102m; 11.3%), agro-food processing ($88.4m; 9.81%) and plastics ($76.5m; 8.5%).[11] Imports were dominated by mineral products ($1,772m, 34% of the total), food products ($556m; 10.8%) and vegetables ($492m; 9.5%).

August Trading

In August the Al-Quds index increased by 3.2% from the previous month, reaching 521.5 points on the last day of trading. A total of 8.6m shares worth $15.9m were traded in 21 sessions. This marks an increase of 157% in the number and of more than 120% in the value of traded shares from July 2014, and a sharp decrease of 60% and 48%, respectively, from August 2013. Market capitalisation reached $3.2bn.

In related news, PEX announced that aggregated net profits of listed companies reached $136.7m in the first half of 2014, up by 13.6% from H1 2013.[12] 34 out of 49 listed companies achieved joint net profits of $148.4m (+8.5% from H1 2013), while 12 firms registered total losses of $11.8m (-28.4% from H1 2013). Palestine Telecommunications (PALTEL) achieved the greatest profits after tax ($48m), followed by Bank of Palestine ($19m) and PADICO Holding ($15m).

Finally, on 1 September the first traded Palestinian bond was listed in the debt instrument sector following a listing agreement between PEX and Palestine Commercial Bank. The bond is now traded under the symbol PCB01. Palestine Commercial Bank issued 10,000 mandatory convertible bonds with a face value of $1,000 each.[13] The bond maturity is 5 years with a semi-annual coupon of 6.5%.[14]

7 www.cbs.gov.il/reader/newhodaot/hodaa_template.html?hodaa=201428242
8 www.pcbs.gov.ps/portals/_pcbs/PressRelease/Press_En_RegExTrd062014E.pdf
9 www.pcbs.gov.ps/Portals/_PCBS/Downloads/book2070.pdf
10 www.cbs.gov.il/hodaot2014n/09_14_155t3.pdf
11 www.pcbs.gov.ps/Portals/_PCBS/Downloads/book2070.pdf
12 www.pex.ps/PSEWebSite/NEWS/280820143.docx
13 The bonds will be converted into stocks upon maturity in 2019 as per the issuance prospectus
14 www.pex.ps/PSEWebSite/NEWS/english_01092014.docx

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