The Portland Trust

PALESTINIAN ECONOMIC BULLETIN

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Main reports

In Q2 2014 Palestinian quarterly GDP was 3.9% higher than in Q2 2013. In the West Bank it increased by 8% year-on-year, while in Gaza it was 7.2% lower

UNCTAD issued a report estimating the amount of fiscal revenue leakages suffered by Palestine as a result of the clearance system emerging from the Paris Protocol

In Q2 2014 the current account deficit reached 16.6% of quarterly GDP at current prices, the highest quarterly level since Q4 2012

In Q2 2014 Palestine's International Investment Position (defined as external assets minus foreign liabilities) stood at $980m, marking a 27% decline from Q1 2014

The Palestine Exchange signed a custody agreement with Cairo Amman Bank

Gaza Reconstruction

On 12 October, Palestinian President Mahmoud Abbas and the governments of Egypt and Norway hosted an international donor conference in Cairo to discuss the challenges facing Gaza's reconstruction.[1] The total cost of relief, recovery and reconstruction following the 51-day Israeli military operation launched in Gaza on 8 July is estimated at $4bn (an amount equivalent to around 35% of Palestinian GDP and about three times the estimated cost after the 2008 war). The conference, attended by representatives of EU and Arab League countries, the World Bank, the IMF, various UN agencies and different Arab and Islamic organisations, secured a total of $5.4bn in pledges from international donors. Around half of this sum is expected to be directly allocated to Gaza, with the rest going to support other funding needs of the Palestinian National Authority (PNA).[2] Funding for much needed early recovery and reconstruction works is expected to include major contributions from Qatar ($1bn), the EU ($568m), the US ($212m), the UAE ($200m) and Turkey ($200m).[3] Discussions during the conference also focused on the need to strengthen the Palestinian government's ability to assume its responsibilities in the rehabilitation of Gaza, as well as the necessary mechanisms to enable the import and export of goods and materials to and from Gaza (by building on existing efforts by the UN).

Prior to the conference, the Palestinian government's Higher Inter-Ministerial Committee for Gaza Recovery and Reconstruction presented an impact assessment of the latest operation and a comprehensive strategy for the implementation of recovery measures.[4] The governmental plan, developed with assistance from a broad range of stakeholders (including Palestinian line ministries, the local private sector and different international organisations), is aimed at transitioning from urgent relief efforts to longer-term development needs, across four areas: social protection, infrastructure, economic development and governance and institution building. While short-term efforts will focus on ensuring rapid improvements to the lives of the thousands of affected citizens, the government's long-term vision for Gaza *"…is one of sustainability and self-sufficiency, where Gaza is an integral driver of a growing Palestinian economy, united with the West Bank and opened up to the rest of the world."*

The PNA plan is structured around three phases (Table 1): an urgent relief phase including rapid and short-term interventions ($414m); an early recovery phase involving interventions of up to 12 months ($1.2bn); and a reconstruction and development phase, expected to be implemented over the longer term ($2.4bn).

The social sector chapter of the plan is aimed at combatting poverty, vulnerability and food insecurity in Gaza, which increased sharply as a result of extensive

1 www.mfa.gov.eg/gazaconference/default_en.html
2 www.bbc.com/news/world-middle-east-29586636
3 The funds committed by the US government specifically for Gaza's reconstruction come on top of the amount already pledged, bringing the total U.S. contribution to $414 million. Prior to the conference, the government of Saudi Arabia pledged extra $500m in support for reconstruction (www.reut.rs/1tlgazC ; www.cnn.it/1zjbmTP)
4 www.bit.ly/1Dk42py

damage and internal displacement of civilians during the conflict. Thousands of households have seen their source of income severely affected and can no longer subsist without external assistance. Urgent repairs are needed to ensure the continued provision of health services and education in schools and universities. Total funding needs for the social sector are estimated at around $700m and include social protection and social safety programmes (cash transfer schemes, health insurance coverage and food assistance); the provision of health and psychological support; reconstruction, repair and re-equipment of damaged facilities in the education sector; and the re-establishment of civil society, community-based and religious institutions.

Table 1: Gaza Damages and Reconstruction Requirements (by area, USD millions)

Area \ Phase	Relief	Early recovery	Reconstruction	Total
Social sector	245	215	241	701
Infrastructure	169	332	1,410	1,911
Economic development	0	481	754	1,235
Governance and institutions	0	157	26	183
Total	**414**	**1,185**	**2,431**	**4,030**

Source: PNA

The infrastructure sector, which was already at a critical state prior to the latest operation, was seriously affected during the war. The supply of water, power and sanitation services was largely disrupted and remains a major challenge. Less than 30% of the total electricity demand is being currently met and, as up to 30% of water and sewage networks remain damaged and only 50% of wastewater is being treated, around 450,000 people do not have access to municipal water. At the same time, around 60,000 housing units have been totally destroyed or partially damaged. The government estimates that $1.9bn will be required to finance the temporary provision of services and extensive rehabilitation and reconstruction works. In the short term, the government plan prioritises the removal of rubble and explosive remnants of war. In the energy sector, additional supplies are needed to complement production from the now repaired Gaza Power Plant. The government expects to improve access to potable water through the rehabilitation of destroyed and damaged infrastructure and equipment, the development of small-scale desalination units and the distribution of pumps, generators and chlorine. Expenditure in infrastructure recovery is expected to be greatest in housing, including the provision of temporary solutions for displaced families. The effective implementation of response measures in infrastructure development will require a broad lifting of Israeli restrictions on the passage of construction materials and other critical inputs.

The economic development component of the government's plan is aimed at restoring productive capabilities in Gaza, which were greatly affected by extensive damage to factories, agricultural holdings and other productive assets. Local businesses also suffered indirect losses due to the extended closure of crossings and an almost complete cessation of economic activity during the conflict. As a result, unemployment in Gaza is expected to rise even further (from an already high 45.1% in Q2 2014). At the same time, potential disruptions in the chain of payments could impose challenges in the banking sector should companies and individuals default on their debts. The government estimates total needs for economic development at $1.2bn. Its recovery plan includes a set of measures to rebuild the private sector and increase employment, including economic stimulus and cash-for-work programmes aimed at restoring productivity in agriculture, fishing, industry, manufacturing, trade and services. Rapid recovery in food and construction activities is also deemed critical. Interventions are also expected to include investment in the development of a highly skilled workforce, new technologies and equipment. Early response in support of agriculture and fishing will include assistance to farmers whose land and infrastructure were affected, support to producers who lost livestock and aid to fishermen to repair or replace damaged boats and equipment. In the industrial sector, all firms are expected to report damage as part of an assessment to determine eligibility and scope for assistance. Early recovery will be based on the distribution of compensation for production losses, followed by interventions under the Industrial Repair Programme. Complementary measures will include the disbursement of cash grants to MSMEs and the empowerment of the credit market.

Governance and institution building efforts, budgeted at around $180m are at the core of the government plan as a way of ensuring national ownership of the reconstruction agenda. Under the central authority of the national consensus government, local government institutions are expected to be empowered to assume their role as direct service providers.

On top of the $4bn bill for Gaza's reconstruction, the PNA is calling on international donors to sustain budgetary support during 2014-2017. An estimated $4.5bn is required over the next three years, including $580m committed but yet not disbursed for 2014. The government considers that without these funds neither the proper functioning of the national consensus government nor recovery and reconstruction in Gaza will be possible.

Assistants to the Cairo conference agreed that beyond the overall funding needs, successful implementation of the reconstruction plan in Gaza will require not only a strong governmental presence on the ground but also the achievement of a sustainable truce on the ground. In this sense, Egyptian President Abdel Fattah el-Sisi said that all parties should work towards turning reconstruction efforts "*…into a real starting point to achieve a peace that secures stability and flourishing, and renders the dream of coexistence a reality.*"[5]

5 www.bit.ly/1z4yTaU

National Accounts

In Q2 2014 country-level quarterly GDP increased by 5.1% in real terms from the previous quarter, and was 3.9% higher than in Q2 2013.[6] Real GDP in the West Bank ($1,493m) increased by 6.3% and 8% from Q1 2014 and Q2 2013 respectively. The year-on-year increase was mostly explained by high growth in wholesale and retail activities (+24%) and services (+14%). In contrast, real GDP in Gaza in Q2 2014 was 7.2% lower than in Q2 2013 – signalling a sharp slowdown even prior to the latest Israeli military operation. The contraction in Gaza was the result of a severe drop of almost 73% in the value added by construction activities. While construction represented 18.3% of GDP in the Gaza Strip in Q2 2013, the sector's share in the economy dropped to merely 5.3% in Q2 2014, following the tightening of long-standing restrictions to the import of construction materials into Gaza.

Further deterioration is expected during the second half of the year, due to the negative impact of the latest war in Gaza. With country-level GDP expected to decline by up to 4% by the end of 2014 (IMF[7]), real GDP in Palestine would reach around $3,300m in the second half of 2014, a 13% drop from H2 2013. Real GDP in H2 2014 would fall by almost 9% in the West Bank from H1 2013, and by as much as 24% in Gaza.[8]

The available estimates, together with evidence from recovery attempts in the aftermath of the 2008/2009 conflict, suggest that in the absence of fast, effective reconstruction in Gaza (in turn dependent on a broad easing of restrictions and the timely disbursement of donor funds), there would be severe humanitarian and economic consequences, including record levels of unemployment and further deterioration of household income.

UNCTAD Report

The United Nations Conference on Trade and Development (UNCTAD) has recently issued a report estimating the amount of (customs) fiscal revenue leakages suffered by Palestine as a result of the clearance system emerging from the Paris Protocol (PP).[9] The PP, signed in 1994, formalised the economic relations between the PNA and the Government of Israel in the framework of a customs union based on the Israeli customs and trade system, including taxation. According to UNCTAD, by making Palestine dependent on Israeli customs tariff rates and procedures, the Protocol has prevented the PNA from developing its own financial, trade and taxation policies.

The recent work by UNCTAD focuses on two main sources of fiscal leakage. One derives from the VAT collection system within the framework of the existing customs union between Israel and Palestine (as outlined in the PP), while the second is related to fiscal leakage from indirect imports. The transfer of VAT revenues which Israel collects on behalf of the PNA is conditional on the presentation of clearance bills as proof of transaction. According to UNCTAD, this mechanism results in various shortcomings, including tax evasion due to the non-submission of bills to the Palestinian tax authorities and the unregistered movement of goods between the Israeli and Palestinian markets. Indirect imports, consisting of the entry of non-Israeli products to the Palestinian market as if they were actually produced in Israel, also prevent the PNA from receiving the corresponding tax revenues on those operations. In this case customs duties are paid to the Israeli treasury upon import into Israel, with the products being re-exported to Palestine duty free as they are treated as if they were produced in Israel. According to UNCTAD, Palestinian traders typically resort to indirect importing due to commercial interests, restrictions and obstacles affecting direct importing, and administrative obstacles, among other reasons.

UNCTAD estimated the total annual average fiscal leakage resulting from customs duties evasion and direct and indirect importing for the years 2010-2011 at $306m. This is equivalent to 17% of total tax revenues collected by the PNA in one year and to around 3.6% of annual GDP. UNCTAD utilised statistically recorded values of exports and imports between Palestine and Israel to perform the calculations.

On top of direct costs, UNCTAD calculated indirect costs by modelling alternative uses of the foregone fiscal resources under alternative scenarios. Departing from a baseline situation including fiscal leakage, it is estimated that using the 17% of leaked tax revenues to increase public transfers could boost GDP by $205m (in 2004 prices) and create up to 3,300 additional jobs. Alternatively, using the resources for the promotion of exports could result in a GDP increase of almost $280m and create as many as 9,200 jobs (1.1% absolute increase in employment).

Finally, the UNCTAD report includes a series of recommendations to prevent fiscal leakage, including greater transparency and more effective exchange of information between the Israeli and Palestinian tax authorities for the calculation of clearance revenues.

Balance of Payments Q2 2014

In Q2 2014 the deficit in the current account reached $614.6m (or 16.6% of quarterly GDP at current prices)[10], the highest quarterly level since Q4 2012.[11] This marked an increase of almost 50% from the previous quarter and of 3.2% from Q2 2013. The significant variation from Q1 2014 was fully explained by an increase in the deficit of the trade balance of goods.

6 www.bit.ly/1w8VUHV
7 www.imf.org/external/country/WBG/RR/2014/091214.pdf
8 Own calculations using PCBS and IMF data
9 www.unctad.org/en/PublicationsLibrary/gdsapp2013d1_en.pdf

10 www.pcbs.gov.ps/portals/_pcbs/PressRelease/Press_En_BOPQ22014E.pdf
11 www.bit.ly/1tbtvQf

At the same time, the surplus in the capital and financial account rose by 27.3% from the previous quarter but was 30% lower than in Q2 2013. This decline resulted from simultaneous drops in the net capital and net financial accounts.

Table2: Balance of Payments, Q2 2013, Q1 2014 and Q2 2014

Item	Q2 2013 (USD millions)	Q1 2014 (USD millions)	Q2 2014 (USD millions)	Change (%) (Q1 2014-Q2 2014)	Change (%) (Q2 2013-Q2 2014)
Current Account	**-595.7**	**-418.5**	**-614.6**	**46.9**	**3.2**
Trade Balance of Goods	-1,226.9	-1,293.1	-1,540.7	19.1	25.6
Trade Balance of Services	-99.8	-94.8	-88.1	-7.1	-11.7
Income Balance	310.5	411.2	401.9	-2.3	29.4
Balance of Current Transfers	420.5	558.2	612.3	9.7	45.6
Capital and Financial Account	**646.8**	**355.4**	**452.6**	**27.3**	**-30**
Net Capital Account	144.2	80	80.3	0.4	-44.3
Net Financial Account	587.7	275.4	372.3	35.2	-36.7

Source: PCBS and PMA

International Investment Position

Following a medium-term trend, in Q2 2014 the stock of investments of Palestinian residents outside Palestine (total external assets) exceeded investments in Palestine by non-residents (total foreign liabilities). Palestine's international investment position (defined as external assets minus foreign liabilities) stood at $980m in the second quarter of the year, marking a 27% decline from Q1 2014.[12] The observed change was the result of a $443m decrease in external assets being only partially offset by a $82m drop in foreign liabilities. The drop in the stock of Palestinian investments followed a $167m decrease in foreign direct investments and a drop of $228m in portfolio investments.

Entrepreneurship

On 18 September, the Palestinian start-up accelerator Arabreneur held its third angel pitching event in Ramallah, partnering for the first time with Seedstars, an emerging-markets start-up competition.[13] A total of 12 Palestinian start-ups, including three companies from Gaza, presented their ideas to an audience of over 60 international investors and entrepreneurs, Palestinian business leaders and representatives from the PNA and foreign governments.

Three start-ups were chosen to receive mentoring and support from Seedstars: Edunation (a social education platform), MyMic (an application to convert smart phones into microphones for conferences, developed in Gaza) and AidBits (a monitoring and evaluation platform for non-profit organisations). AidBits was also awarded an invitation to represent Palestine in the Seedstars global competition in Geneva in February 2015, where start-ups from around the world will compete to receive up to $0.5m in investment.

Trading News

In September the Al-Quds index decreased by 2% from the previous month, reaching 511.14 points on the last day of trading. A total of 21.5m shares worth $31.8m were traded in 22 sessions. This marked an increase of 151% in the number of traded shares and of 100% in the value of traded shares from August 2014. Market capitalisation decreased over the month by 1.5%, reaching $3.2bn.

In related news, PEX announced that it has signed a custody agreement with Cairo Amman Bank.[14] The agreement allows the bank to keep custody of stock certificates and other assets for international and local investors (including mutual funds, individuals, corporate clients and others), acting as an agent and exercising legal authority over the financial assets of another individual or company for safekeeping – and thus minimising the risk of financial assets theft or loss. The custody service includes maintaining securities under the bank's custody, organising and keeping customers' registries, receiving the value of sold securities and payment for purchased ones and sending periodic reports to customers. Following the agreement, Cairo Amman Bank will be the second custodian bank active on PEX, joining HSBC Middle East, which has been PEX's sole custodian bank since 1999.

12 www.pcbs.gov.ps/portals/_pcbs/PressRelease/Press_En_IIPExtDtStatQ22014E.pdf
13 www.arabreneur.com/?p=1984
14 www.pex.ps/PSEWebSite/NEWS/300920143.docx

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