THE WORLD BANK

Impacts of the Conflict in the Middle East on the Palestinian Economy

December 2023 Update[1]

Synopsis

The current conflict in the Middle East has left large numbers of people dead and injured, ravaged vital infrastructure in the Gaza Strip, and cast a heavy shadow on economic activity in the West Bank. This war will have lasting effects on the impacted populations in Israel, Gaza and the West Bank far beyond what can be captured in numbers alone. Similarly, it will have a lasting impact on the Palestinian economy.

Declining incomes from job loss, dwindling trade, heightened restrictions, and salary cuts are dampening growth by affecting consumption levels. *The labor market impacts are – in short – making Palestinians poorer. Incomes suddenly dropped due to lack of employment, declining trade and private sector activity, increased restrictions on movement and temporary reductions in public salaries in the West Bank. Consequently, consumption – the only actual engine of the Palestinian economic rebound since the COVID 19 shock – is taking a deep hit.*

The current crisis exacerbates pre-existing structural weaknesses, and efforts by the international community to address them have had limited success*. The occupation, and related restrictions, have long affected both potential and actual growth and fiscal sustainability, as well as the lack of access to resources and the control over a large portion of the territory including Area C. This has imposed binding constraints to economic activity and development long ahead of the conflict. Inconsistent implementation of necessary reforms by the Palestinian Authority (PA) has contributed to further prevent the Palestinian economy from reaching its full potential. Over three decades, attempts by the international community to address these structural bottlenecks have proved to be insufficient as well.*

On the institutional and fiscal front, the PA faces monumental challenges to secure basic functions, reflecting the lack of fiscal resources. *Any prolonged absence or significantly lower volumes of clearance revenue transfers would severely jeopardize the social contract. The authorities would not be able to ensure the provision of public salaries or essential services. In this context, additional downward risks for fiscal sustainability are related to the potentially significant larger arrears from the PA to suppliers and civil servants, as the sole available option to maintain minimum liquidity. On the upside, the financial system appears relatively resilient, but risks are on the rise, considering the resort to forbearance as per the above.*

While poverty and vulnerability in Gaza are going to increase substantially, adverse welfare effects will be clearly felt across the West Bank, too. *Multidimensional poverty*[2] *is estimated to have skyrocketed in Gaza and could increase also in the West Bank. A national reduction in GDP of 3.7 percentage points in 2023 suggests that all the welfare gains made in the Palestinian territories since the end of the pandemic would be erased, and that poverty at the end of 2023 would reach slightly higher levels than in 2020, at the height of COVID-related economic restrictions, when it stood at 26.5 percent.*

Against this backdrop, the Palestinian territories would remain structurally dependent on aid. The latter, however, has been declining steadily, and significantly, over the last two decades. Absent a paradigm shift, the Palestinian territories are anticipated to remain prone to structural fiscal crises, relying on foreign aid as the only short-term palliative.

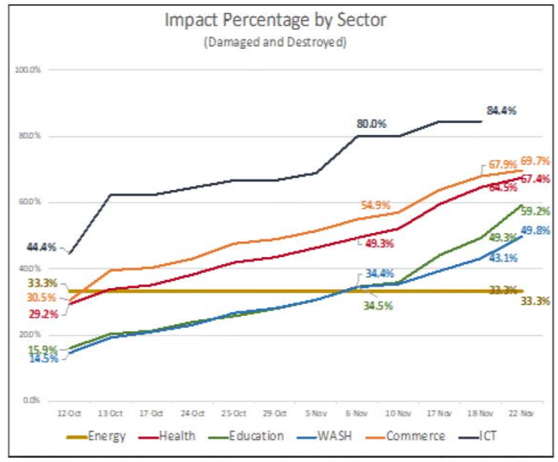
---

[1] This note was finalized at the end of November 2023.

[2] Multidimensional poverty covers income, access to education and basic infrastructure *inter alia*. For more info please see https://www.worldbank.org/en/topic/poverty/brief/multidimensional-poverty-measure

Assessment

Figure 1: Damages by Sector, Gaza



Source: WB staff preliminary Gaza damage assessment, using Synthetic Aperture Radar (SAR) imagery – as of 28 Nov 2023

Ahead of the current conflict, the Palestinian economy was already slowing, and Gaza was experiencing a deep contraction[3]. In the first half (H1) of 2023, growth in the Palestinian territories decelerated to 3.0 percent, year-on-year (y/y), largely due to the waning post-pandemic recovery. In Gaza, specifically, the economy contracted by 4.4 percent in H1 2023, on an annual basis, due to a large decline in the agricultural, forestry, and fishing sectors, reflecting the implementation by Israel of additional restrictions on the sale of Gazan products into the West Bank since August 2022.

The effects of the conflict on the Palestinian economy are consequential, based on preliminary estimates. The loss of life[4], speed and extent of damages to fixed assets and reduction in income flows across the Palestinian territories are unparalleled. As of the second half of November, roughly 60 percent of ICT infrastructure, 60 or more percent of health and education facilities, 70 percent of commerce-related infrastructure are damaged or destroyed in Gaza(see Figure 1). Similarly, nearly half of all primary, secondary, and tertiary roads are damaged or destroyed. More than half a million individuals are currently without a home as a result of the conflict[5].

Economic activity in Gaza has come to a near-complete standstill since the onset of the conflict, with all economic sectors affected. Based on preliminary estimates from the Palestinian Central Bureau of Statistics (PCBS), the Gaza Strip operated at 16 percent of its productive capacity in October 2023. This is consistent with the findings of an analysis based on nighttime lights (see figure 4), showing a drop of roughly 90 percent in the luminosity from the Strip. Approximately 85 percent of workers in the Gaza Strip have been out of work since the conflict started. The same is true for close to 200,000 workers from the West Bank who previously worked in Israel and the settlements. These workers constitute 20 percent of employed West Bankers but account for one third of overall demand. They have either lost their jobs or are no longer able to access them due to new restrictions implemented by Israel since the start of the conflict. Stricter restrictions on movement within the West Bank, coupled with a rapid surge in settler violence[6], affect approximately 67,000 workers who are no longer able to reach their places of work. Tourism in the West Bank has seen a significant decline, especially to places like Bethlehem and Jericho that usually experience a surge during the Christmas season. In terms of economic activities, the estimated deviation from pre-conflict forecasts for the Palestinian economy is close to 7 percentage points of GDP, for 2023. Prior to the conflict, the World Bank forecast 3.2 percent real GDP growth in 2023. That figure is now being revised to -3.7 percent. This is equivalent to approximately US$1.5 billion in nominal GDP lost (i.e., losses of income for households, profits for firms, and taxes for government) for 2023 alone.

---

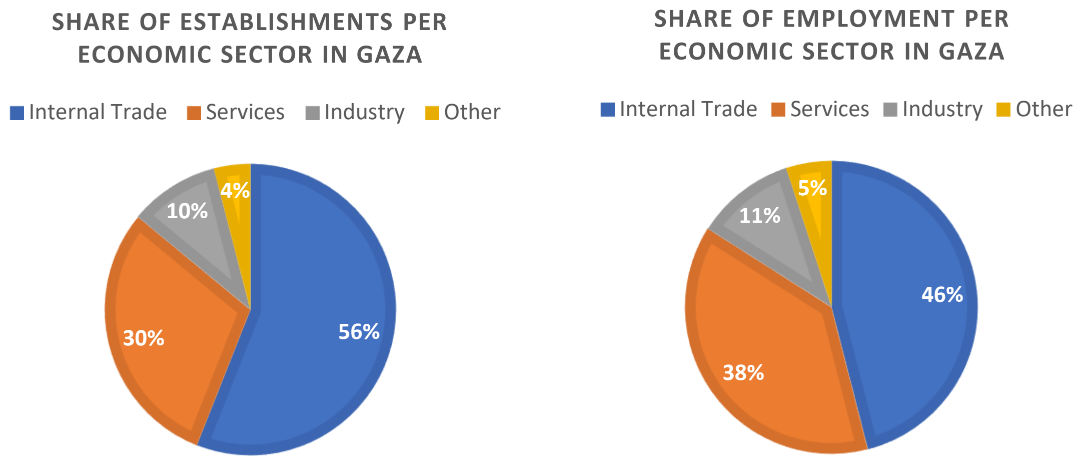
[3] See World Bank and IMF reports to the, September 2023 AHLC; WB link: https://www.worldbank.org/en/topic/poverty/brief/multidimensional-poverty-measure https://www.worldbank.org/en/country/westbankandgaza/publication/world-bank-economic-monitoring-report-to-the-ad-hoc-liaison-committee-september-2023

[4] Euro-Med Human Rights Monitor, https://euromedmonitor.org/en/article/5903/Number-of-Gazan-children-killed-in-under-a-month-is-10-times-higher-than-that-of-Ukrainian-children-killed-in-entire-first-year-of-Russia%E2%80%99s-ongoing-war ;

[5] World Bank staff analysis based on IPSOS data.

[6] https://www.reuters.com/world/us-impose-visa-bans-soon-israeli-extremist-settlers-west-bank-violence-2023-12-01/

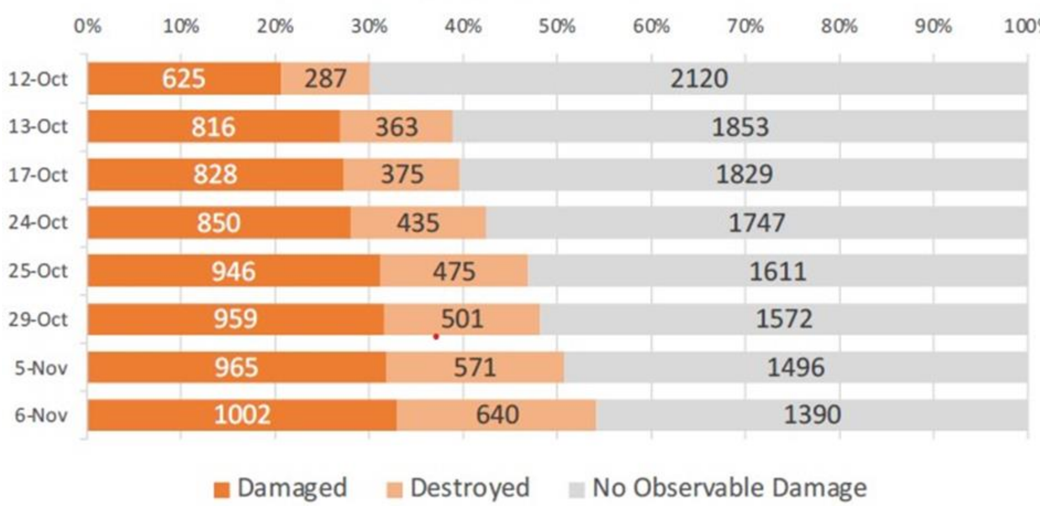
Figure 2: Snapshot on Private Sector activity and Employment sectoral breakdown[7] (2023 data, pre-conflict)



Source: PCBS

The conflict has disrupted private sector activity in Gaza, while severely adverse impacts are also observed in the West Bank. Satellite imagery[8] from November 15, 2023, suggests that more than 54 percent of businesses located in close vicinity to areas of fighting in Gaza have been impaired: out of over 3,000 known business facilities in these areas. Production in Gaza is estimated to have shrunk by 84 percent in the month of October 2023, compared to pre-conflict months. An estimated 147,000 formal jobs in Gaza have been lost with most of Gaza's 56,000 formal business establishments suspending operations. The only operative flour mill in Gaza is currently non-functional due to intermittent access to electricity and all bakeries in Gaza have either been damaged or have closed, contributing to food shortages reported in Northern Gaza and Khan Yunis. Business activity in the West Bank has also slowed down, affected by increased Israeli restrictions on access and movement of people and goods, decline in trade with Israel as well as by settler violence, and military activity[9].

Figure 3: Damages to the Business Sector on Selected Days (expressed as a percentage of buildings)



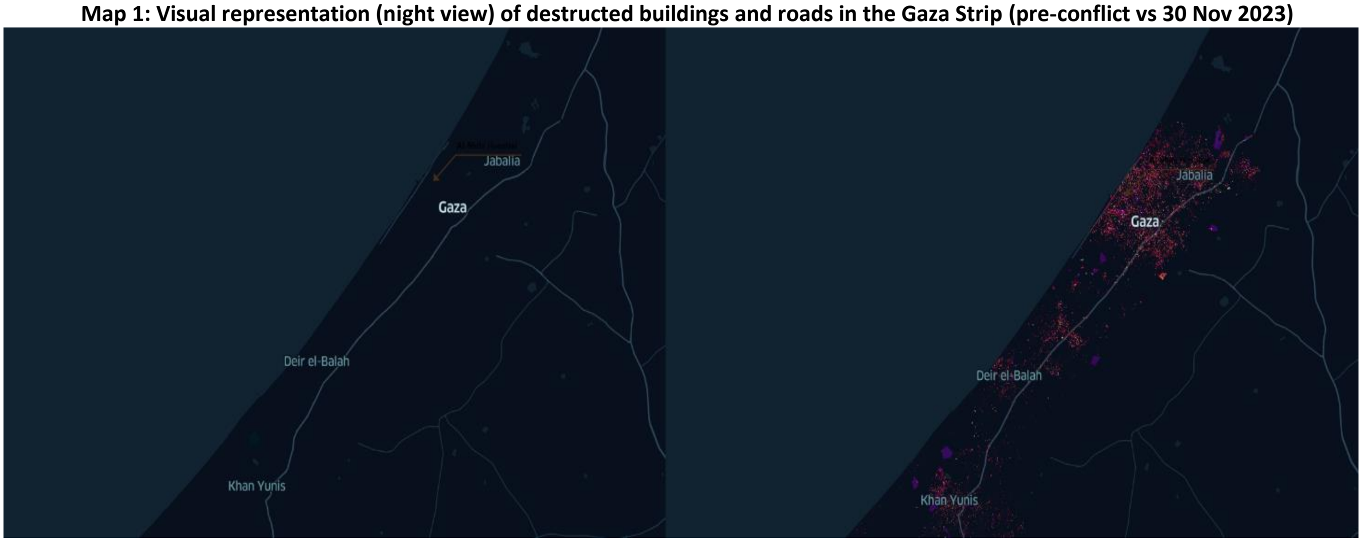
Source: The World Bank's preliminary Gaza damage assessment, using IPSOS data

[7] "Internal trade" refers to wholesale and retail sale domestic activities.
[8] Based on November 15, 2023, data.
[9] https://www.cnn.com/2023/11/11/middleeast/west-bank-restrictions-violence-intl-cmd/index.html

Poverty was already severe in Gaza before the war. Unofficial estimates show that almost 60 percent of Gazans were already poor[10] on the eve of the conflict, with 8 out of every 10 Gazans already dependent on aid. Since more than one third of the population is younger than 15, a large number of those suffering from dire socioeconomic conditions are children. Even before the start of the current conflict, unemployment in Gaza stood at 45 percent, with youth unemployment at almost 60 percent[11].

Massive internal displacement, destruction of homes, assets and productive capacity, along with a deep recession have pushed even more Gazans below the poverty line and deepened poverty for those already vulnerable. Multidimensional poverty[12] in Gaza has also skyrocketed due to the hostilities that has seen the discontinuation of school access for children, as well as the difficulties related to accessing health and other basic services. The overwhelming majority of Gazans are estimated to be living in multidimensional[13] poverty. The mitigating impacts of social protection programs are hindered by the Palestinian Authority's severely constrained fiscal space. The projected overall economic slowdown in the last quarter of 2023 will also impact poverty in the West Bank. A national reduction in GDP of 3.7 percentage points suggests that all the welfare gains made in the Palestinian territories since the end of the pandemic will be erased. Poverty at the end of 2023 would reach slightly higher levels than in 2020, at the height of COVID-related restrictions, when it stood at 26.5 percent.

Map 1: Visual representation (night view) of destructed buildings and roads in the Gaza Strip (pre-conflict vs 30 Nov 2023)



Source: World Bank staff, based on SAR imagery, powered by MapBox

In Gaza, prices increased on average by 12 percent in October 2023[14], reflecting pent-up demand for products that are increasingly difficult to find on the local markets. Massive shortages of basic products have severely limited the capacity of hundreds of thousands of households to purchase them, regardless of whether they can afford them. Shrinking supply and rising prices are having substantial adverse impacts on household welfare. Food prices increased on average by 10 percent month-on-month. Bottled water prices spiked by 75 percent, and gasoline increased by close to 120 percent. In contrast, CPI in the West Bank increased marginally by 0.1 percent.

---

[10] WB staff estimates based on money metric poverty at the national poverty line

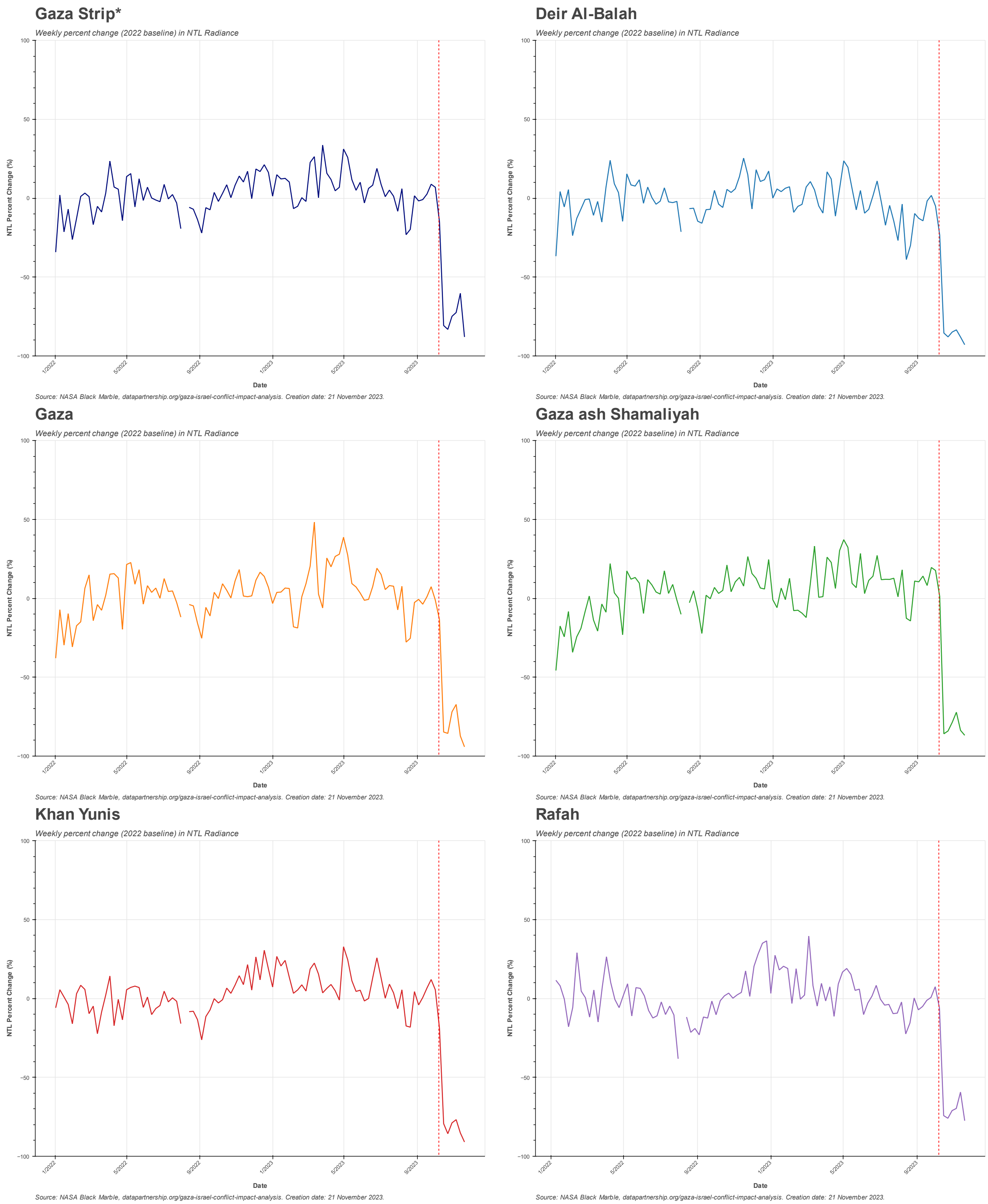
[11] Labor Force Survey, September 2023

[12] The latest official measure of multidimensional poverty, estimated by World Bank staff, dates back to 2017, when it stood at 45 percent.

[13] https://www.ochaopt.org/content/hostilities-gaza-strip-and-israel-reported-impact-day-58

[14] Month on month

Figure 4: Weekly percent change (2022 baseline) in Nighttime Light Radiance for selected areas of the Gaza Strip



Risks to fiscal sustainability are elevated. Overlapping shocks are expected to widen the fiscal gap significantly, resulting in a financing gap of US$580m, or 3.2 percent of GDP, in 2023. Total Government[15] revenues (excluding grants) are expected to contract by 13 percent compared to pre-conflict estimates for 2023, primarily due to a combination of: the lack of clearance revenues (assumed to continue throughout Q4 2023) and plummeting domestic revenues amid sluggish economic activity. As a consequence, the PA has delayed the payment of October salaries to ease the pressure from the revenue shortfall. Assuming that the PA would eventually find a way to pay 80 percent of committed salaries in the fourth quarter of 2023, the fiscal deficit (before grants) would reach US$ 887m in 2023. Since aid is projected at US$308m, the resulting financing gap would be US$580m (or 3.2 percent of GDP) in 2023, compared to a pre-conflict baseline of US$78m (0.5 percent of GDP).

The depth and urgency of the fiscal crisis are heightened by the penury of financing options. The PA continues to operate in a context marked by the absence of traditional economic policy tools, either of fiscal or monetary nature, largely as a result of the Israeli occupation and the stalled peace process. Constraints on the capacity to borrow domestically or externally, coupled with the absence of any sizeable reserves, leaves international aid or resorting to additional arears as the only avenues for the PA to finance fiscal gaps. As such, the PA is expected to accumulate additional arrears to the private sector and the public pension fund in the coming months, with the projected stock of arrears rising by 2 percentage points (compared to the pre-conflict forecast), to 37 percent of GDP by the end of 2023.

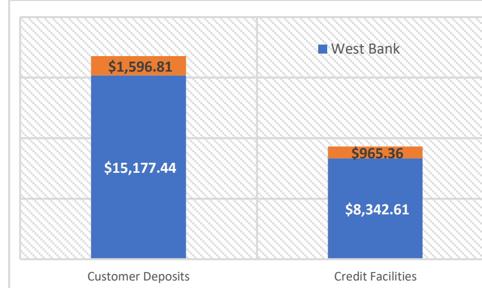
Resulting extreme fiscal austerity measures are anticipated to further limit growth. As mentioned earlier, the Palestinian Ministry of Finance resorted to drastic and unprecedented measures, including postponing the payment of public salaries for the month of October 2023. Should the absence of clearance revenues extend to Q1 2024, a continuation of severe fiscal tightening will likely be necessary. Assuming that the PA resorts to partial payment of public sector salaries[16] during that period alongside a reduction[17] in expenditure on goods and services compared to the baseline, GDP is expected to contract by 6.8 percentage points and the fiscal deficit (including grants) would widen to 4.3 percent of GDP[18]. It is also worth highlighting that clearance revenues are anticipated to naturally diminish over time due to structural reasons, as trade and economic activities remain subdued.

The banking sector remains resilient, though risks are on the rise. The Palestinian banking system is well capitalized, adhering to the Capital Adequacy Requirements set by the banking sector regulator, the Palestine Monetary Authority (PMA), under Basel III standards. In responding to the current crisis, PMA has prioritized two main aspects of their financial stability mandate: (i) ensuring that banks can support the economy, and (ii) avoiding the accumulation of excessive risks that could end up jeopardizing financial stability, with – in turn – potential risks also for the real sector. Digital financial services have also proved to be an effective way to channel financial support, cash, and credit immediately to affected economic agents such as households, corporates, and micro small and medium enterprises. Broadly speaking, Palestinian banks appear to be risk-averse and profitable, due in part to low funding costs. While the official non-performing loan (NPL) ratio was low at 4.1 percent as of Q2 2023, both NPLs and classified loans are projected to increase following the expiration of the Gaza loan moratorium, announced by the PMA as an initial policy response to the recent crisis. Additionally, the PA's growing reliance on arrears could potentially disrupt the flow of liquidity to suppliers, leading to an increase in the NPL ratio. In recent weeks, the percentage of returned checks has increased to 17 percent, while the pre-conflict average tended to hover around 7-8 percent a month, likely reflecting the increasing amount of public and private sector employees not getting paid.

[15] Refers to the Palestinian Authority
[16] In this downward scenario, we assume a payment of 35 percent of committed salaries.
[17] We assume an 8 percent reduction in public spending on goods and services y-o-y.
[18] These figures refer to 2024.

The banking system's aggregate exposure to Gaza is small compared to that of the West Bank, in terms of both credit and deposits. For multiple reasons, which include Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) risks and operational risks, most of the 13 banks operating in the West Bank have minimized their exposure to Gaza. The PMA designated three out of the 13 licensed banks as Domestic Systemically Important Banks (D-SIBs). The destabilization of just one of the systemically important banks operating in the West Bank and Gaza, would lead to significant consequences for the economic system.

Figure 5: Geographic Distribution of Credit and Deposits (USD mil)



Source: World Bank staff based on PMA data

Early indicators point to damages to the banking sector being more acute than in previous conflicts. Banking sector damages and losses include physical assets, losses to cash in vaults/ATMs, and expected credit losses in Gaza and some West Bank loan portfolios. The PMA was able to confirm the total destruction of one branch and one regional office in Gaza, as well as partial damages to several other branches, including PMA's own office in Gaza. Only 15 ATMs (out of 91 in Gaza) are currently operational. Very limited financial services are accessed through POS/banking agents[19].

Absent a paradigm shift, the Palestinian territories risk remaining prone to structural fiscal crises, relying de facto on foreign aid as the only short-term alternative. The current context exacerbates pre-existing structural weaknesses, related to restrictions affecting both potential growth and fiscal sustainability, as well as the lack of access to resources and the control over a large portion of the territory like in Area C[20], which are all preconditions for continued dependence on grant assistance, including to cover basic public services. International aid over the last two decades has represented less and less, moving from close to 20 percent of GDP in the mid-to-late 2000s to representing less than two percent of GDP at present. Despite broad-based agreement on the irreplaceability of international financing, at least in the short-to-medium term, there are few-to-no signs of actual increases in aid flows. International financial assistance is crucial not only in the current emergency context; it is important to stress that – once the conflict ceases – pro-growth reforms and much-needed fiscal consolidation efforts will remain susceptible to external shocks. The implementation of these reforms will necessitate a gradual approach along with provisions to support those who may inevitably be disadvantaged by the introduction of the new rules. Therefore, success will strictly depend also on adequate and predictable budget support as an element to buffer short-term negative impacts.

Averting a dramatic recession, a poverty uptick, and an unparalleled hit to the economic fabric will require immediate action on the following:

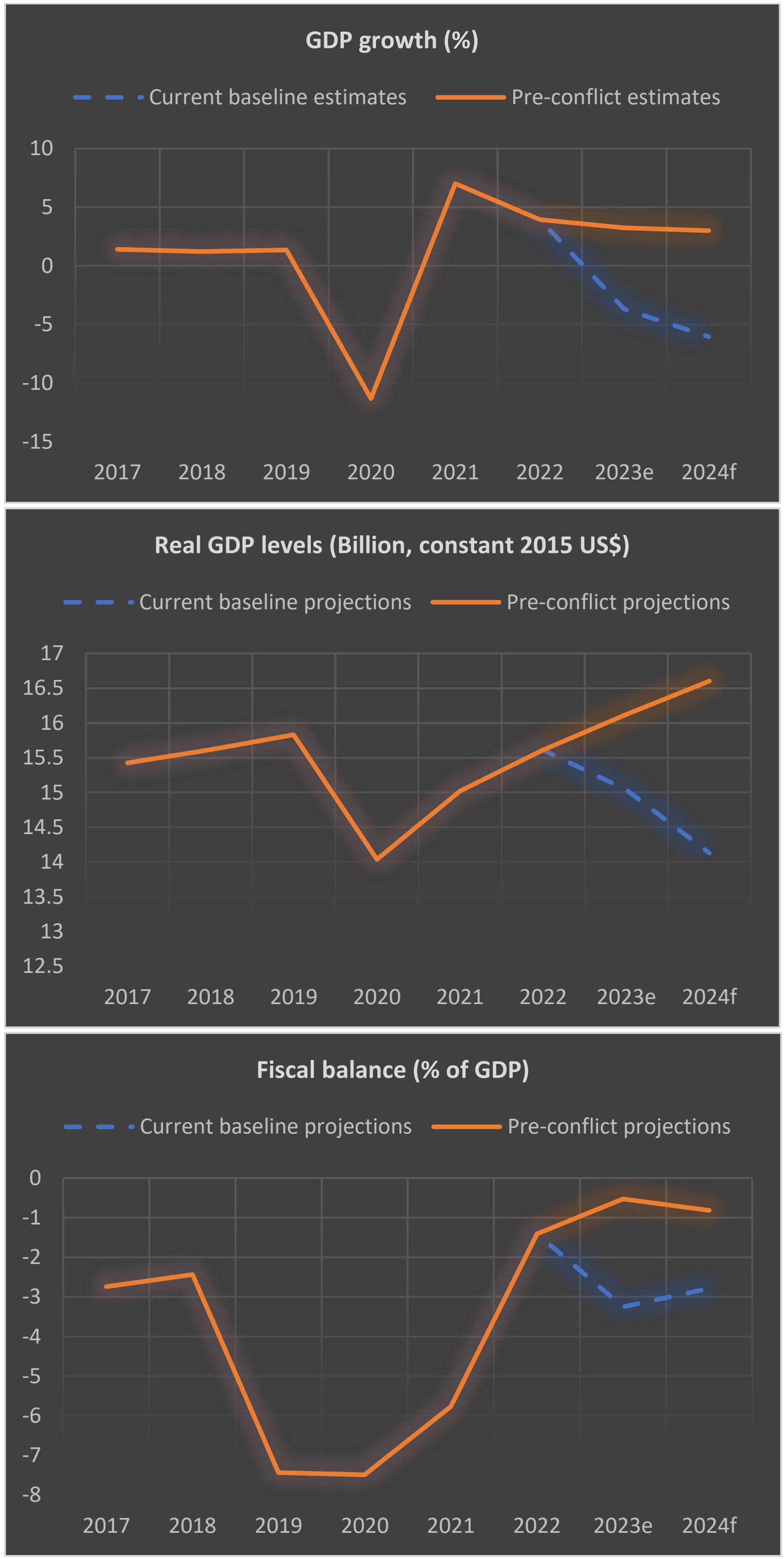
- **First**, the cessation of hostilities would pave the way for significant changes on the ground. Primarily, it would save lives, opening the opportunity for economic and social reconstruction;
- **Second**, reinstating Clearance Revenues transfers as soon as possible and reversing recent decisions to increase deductions;
- **Third**, facilitating trade and private sector activity in the West Bank and Gaza, to allow income generation;
- **Fourth**, urgently increasing financial support by the international community, during and after this crisis. With an estimated fiscal gap of US$580m in 2023, increasing humanitarian needs and – when the conflict ends – reconstruction needs, aid will need to continue to play a pivotal role in supporting the PA, especially in the short-to-medium term;
- **Finally**, undertaking renewed efforts towards policy reforms by the PA, including on fiscal sustainability.

---

[19] Source: WB staff based on information from PMA

[20] Area C covers roughly 61 percent of the West Bank, currently under Israeli civil and security control. The area is richly endowed with natural resources. Due to restrictions of movement, Palestinians have very limited access to economic opportunities in Area C, and the continued expansion of Israeli settlements over time has significantly reduced the amount of land available for use by the Palestinian private sector. Area C can be vital to the development of infrastructure networks. The area was committed in 1995 under the Oslo II Accord to be "gradually transferred to Palestinian jurisdiction". For more details see the Interim Agreement on the West Bank and the Gaza Strip, Washington, D.C., September 28, 1995, accessed here: https://www.gov.il/en/Departments/General/the-israeli-Palestinian-interim-agreement

Figure 6: Selected macro-fiscal graphs



Source: WB Staff, based on MFMod