Palestinian National Authority

Ministry of Finance

Fiscal Developments & Macroeconomic Performance: Third Quarter Report 2012

Macro-Fiscal Unit

15/11/2012

Section 1: Palestinian Territory Macroeconomic Performance in 2012:

GDP: According to preliminary estimates published by PCBS[1], Palestinian Territory*[2] real GDP increased by 7.7% during Q2 2012 compared to Q2 2011, and it showed an increase of 9% compared to Q1 2012. GDP grew in the first half of 2012 by 6.7% over the first half of 2011.

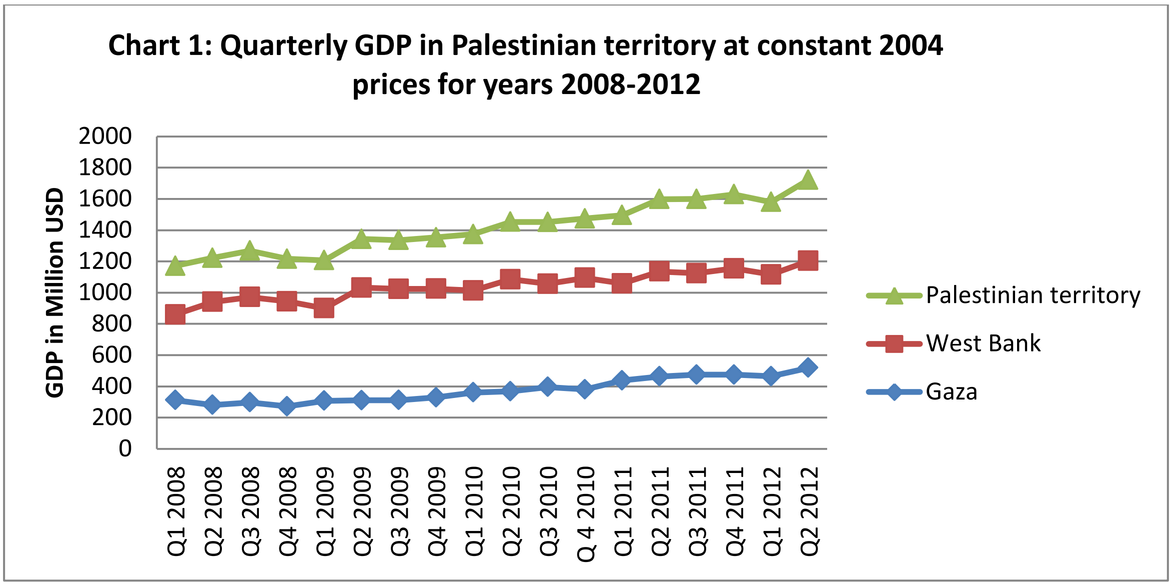
Real GDP in West Bank was USD 1,203 million in Q2 2012 growing by 6% over Q2 2011, and increasing by 7.8% over Q1 2012. West Bank GDP witnessed an increase of 5.7% in the first half of 2012 over the same period of 2011. GDP in Gaza reached USD 519 million in Q2 2012, growing by 12% over Q2 2011, and increasing by 12% over Q1 2012 (Table 1A). GDP in Gaza during the first half of 2012 increased by 9% over the first half of 2011. The pickup in growth in Gaza during the second quarter of 2012 can be mainly attributed to a major increase in construction and services by 54% and 20% respectively. The construction sector contributes to around 19% of total growth in Gaza, while services contribute to about one third of total growth. The increase in constructions reflects recovery following the relaxing of Israeli import restrictions on construction materials for donor supervised projects since 2010, in addition to increasing imports of construction material from Egypt through the tunnels. However, the significant decrease of 41% in the agriculture and fishing sector continues because of the Israeli ban on agricultural exports to Israel and the movement of products to West Bank, and the constant harassment of fishermen within their 3 km fishing limits off the Gaza Coast. Following the attack on Egyptian troops in the Sinai in September, tunnel trade has been reduced to 10% of what it was during the first half of the year as a result of a crackdown by the Egyptian government. The sharp reduction in fuel imports also resulted in much longer power cuts which paralyzed the economy, particularly the manufacturing sector. Therefore, prospects for Gaza economic activity during the rest of this year may be subdued. Overall, economic growth in the Palestinian territory will continue to be restrained by Israeli restrictions, a shortfall in donor aid, deterioration in Gaza's economic activity and uncertainty caused by the PA's fiscal crisis.

Table 1A. Palestinian Territory Real GDP*(USD millions)

	Q2 2012 Real GDP (US)	Q2 12 over Q2 11 (%)	Q2 12 over Q1 12 (%)	First Half 2011	First Half 2012	H1 12 over H1 11 (%)
Palestinian Territory*	1722	7.7	9.0	3094.6	3302	6.7%
West Bank	1203	6.0	7.8	2193.3	2319	5.7%
Gaza	519	12.0	12.0	901.3	983	9.1%

***Base year 2004.**

[1] PCBS, Press Report, Preliminary Estimates of Quarterly National Accounts (Second Quarter 2012) Main Results
[2] Palestinian Territory*: exclude those parts of Jerusalem which were annexed by Israel in 1967



GDP per Capita: According to PCBS, Palestinian Territory* GDP per capita during Q2 2012 was USD 427, an increase of 4.6% over Q2 2011. GDP per capita in the first half of 2012 reached $822 in the Palestinian Territory, an increase of 3.7% over the first half of 2011. As for West Bank, GDP per capita in Q2 2012 was USD 502 increasing by 3.2% over Q2 2011. For the first half of 2012, GDP per capita in the West Bank was $971, an increase of 2.9% over the same period of 2011. While for Gaza GDP per capita was USD 317 during Q2 2012 increasing by 8.3% over Q2 2011. GDP per capita in Gaza for the first half amounted to $603, a 5.5% increase over the first half of 2011.

Table 1B. Palestinian Territory* GDP Per Capita (USD)

	Q2 2012 (US)	Q2 12 over Q2 11 (%)	Q2 12 over Q1 12 (%)	First Half 2011	First Half 2012	H1 12 over H1 11 (%)
Palestinian Territory*	427	4.6	8.1	793	822	3.7%
West Bank	502	3.2	7	944	971	2.9%
Gaza	317	8.3	10.8	572	603	5.5%

The overall Consumer Price Index in Palestinian Territory for September 2012 showed an increase of 1.42% compared to August 2012 and an increase of 4.06% compared to September 2011.[3]

The change in Consumer Price Index (CPI) for September 2012 is traced back to changes in prices of the following expenditure sub groups compared to the previous month: Fresh Vegetables (+15.49%), Eggs (+13.36%), Sugar (+8.25%), Gas (+4.41%), and Fuel for transportation (+2.52%).

The population of the Palestinian Territory at mid-2012 was about 4.29 million, 2.65 million in the West Bank and 1.64 million in Gaza. Of the females, 15 years and over, 7.4% were illiterate, which is more than three times higher than the rate for males (2.1%) in 2012.[4]

Unemployment rate during Q2 2012 reached 21% in WBG compared to 18.7% during Q2 2011 and 23.9% during Q1 2012.

[3] PCBS, "Palestinian Consumer Price Index in the Palestinian Territory", October 14, 2012
[4] PCBS, Press Release on the eve of the international population day, July 11, 2012

Unemployment in WB reached 17.1% during Q2 2012 compared to 15.4% during Q2 2011 and 20.1% during Q1 2012. There is a seasonal factor during the second quarter which reduces agricultural labor. In Gaza, unemployment reached 28.4% during Q2 2012 compared to 25.6% during Q2 2011 due to the deceleration of economic growth in Gaza which was substantially higher during the first half of 2011. A factor that contributes to high unemployment in the Palestinian Territory is the restriction on the number of Palestinian workers in Israel. The number of workers from the West Bank employed in Israel and Israeli settlements fell from 84,000 in 2011 to 80,000 by the end of June 2012. There have been no Gaza workers allowed into Israel since 2006. Reports by GoI state that the overall permit quota for Palestinian workers in Israel was recently raised by 10,250 permits. [5]However, even though the number of people from the West Bank allowed to work in Israel has been increasing, its share of total employment has remained around 12 percent since 2002 compared to 21 percent in 2000.

Table 2. Labor Force participation during Q2 2012

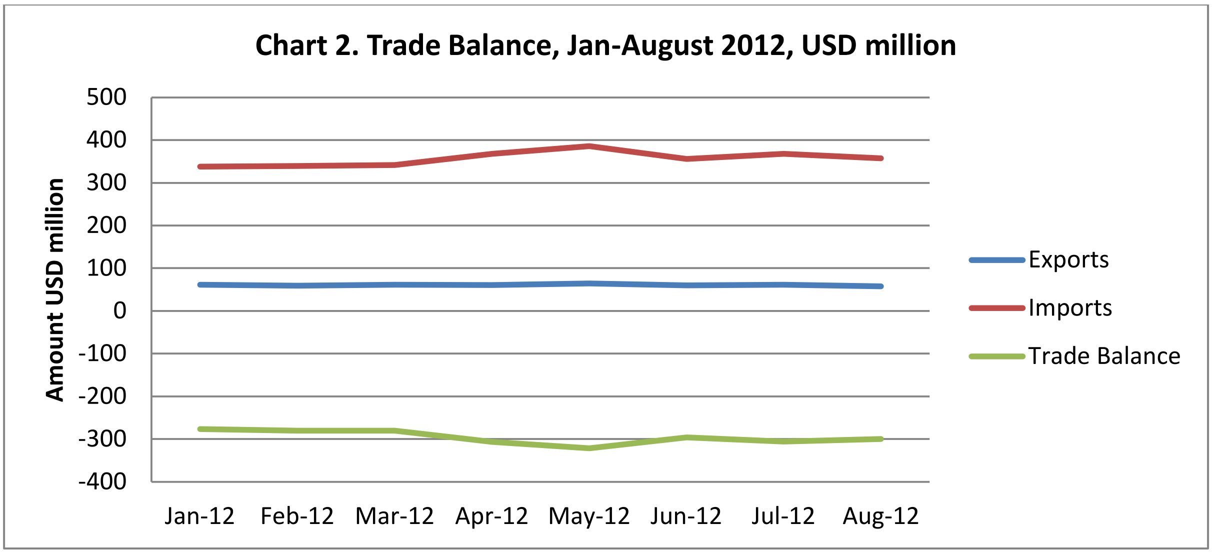
Region	Total	Unemployment		Employment	
	Number	Percentage	Number	Percentage	Number
Palestinian Territory	1,109,300	20.9%	231,900	79.1%	877,400
West Bank	738,200	17.1%	126,600	82.9%	611,600
Gaza	371,100	28.4%	105,300	71.6%	265,800

External Trade Exports for the period Jan-August 2012 amounted to USD 486.6 million with a monthly average of USD 60.8 million, compared to USD 511 million for the same period 2011, decreasing by 5%. Exports to Israel represented 89.6% of total exports for that period. On the other hand, imports during Jan-August 2012 amounted to USD 2.85 billion with a monthly average of USD 357 million, compared to USD 3.16 billion for the same period 2011, decreasing by 10%. This decline reflects the deceleration of economic growth in the West Bank and Gaza. Imports from Israel represented almost 64% of total imports for that period. Trade deficit reached USD 299.9 million in August 2012 for a total trade deficit for Jan-August 2012 of USD 2.36 billion. When compared to the same period 2011, total trade deficit declined by 11%.

Table 3. External Trade 2012, USD millions.

	Jan-12	**Feb-12**	**Mar-12**	**Apr-12**	**May-12**	**Jun-12**	**Jul-12**	**Aug-12**
Exports	61.7	59.2	61.6	60.7	64.3	60.2	61.6	57.3
Imports	338.2	339.7	341.6	367.5	385.8	355.9	367.5	357.2
Balance	-276.5	-280.5	-280	-306.8	-321.5	-295.7	-305.9	-299.9

[5] World Bank, Economic Monitoring Report to the Ad Hoc Liaison Committee September 23, 2012



Exchange Rate: While the 2012 budget exchange rate was projected at US $ 1 = NIS 3.8, the NIS has depreciated against the US dollar during the second half of 2012 bringing the average exchange rate till end September to US $ 1 = NIS 3.85. The exchange rate depreciated during the October-November 10th period reaching to an average of US $ 1 = NIS 3.95, which will raise the average for the full year and reduce the recurrent deficit in US dollar terms.

Section 2: Fiscal Operations Jan-Sep 2012

A. Budget execution highlights:

- **The recurrent budget deficit** for Q3 2012 is significantly above the budget target[6], mainly due to an increase in total expenditures and net lending, and a shortfall in revenues. The recurrent budget deficit for the first nine months of 2012 amounted to NIS 3.57 billion, exceeding the budget target by NIS 853 million. This increase can be attributed to a shortfall in gross revenues and an increase in total expenditures and net lending over their approved budget, by NIS 378 million and NIS 535 million respectively. Projections for the full year indicate that the recurrent budget deficit at NIS 4.95 billion will exceed the budget target (NIS 3.62 billion) by around NIS 1.33 billion (USD 345 million).
- **Total gross revenues** for the first nine months of 2012 amounted to NIS 6.33 billion, and were below the budget target by NIS 378 million, due to shortfalls in domestic tax and clearance revenues by NIS 211 million, and NIS 191 million respectively.
- **Investment profits** of NIS 118.9 million were received from Palestinian Investment Fund (PIF) in July, exceeding the budget target by about NIS 24 million.
- **The wage bill** in the first nine months of 2012 amounted to NIS 5.15 billion and was on track with the budget target.
- **Nonwage expenditures** in the first nine months of 2012 amounted to NIS 3.98 billion and were running above budgetary appropriations mainly due to an increase in transfers expenditures above their budget by NIS 358 million.
- **Net lending** amounted to NIS 490 million in the first nine months of 2012, and was largely above the budget target by NIS 190 million. As detailed below, this was partly due to higher electricity rates charged by IEC and higher monthly electricity deductions by Israel from clearance revenues to pay back previous accumulated debt.
- **Budget support** disbursement was only 59% of the amount budgeted to finance the recurrent budget deficit target while the **development projects financing** was only 34% of the budget target. The total **financing gap** for the first nine months of 2012 amounted to NIS 1.65 billion ($429 million).
- **Domestic debt stock** level increased to NIS 4.33 billion ($1.11 billion) as the Treasury increased its **domestic debt** slightly by NIS 182.7 million mostly to commercial banks, during the first nine months of 2012. **Long term Bank loans** decreased by NIS 346 million during Jan- Sep 2012.
- **Total net accumulation of arrears** during the first nine months of 2012 reached NIS 1.4 billion ($363 million) including development expenditures arrears of NIS 125.3 million and tax refund arrears of NIS 151.3 million. Arrears to the private sector including the tax refunds arrears came to NIS 515.4 million.

[6] Budget target is 9/12 of the approved annual budget.

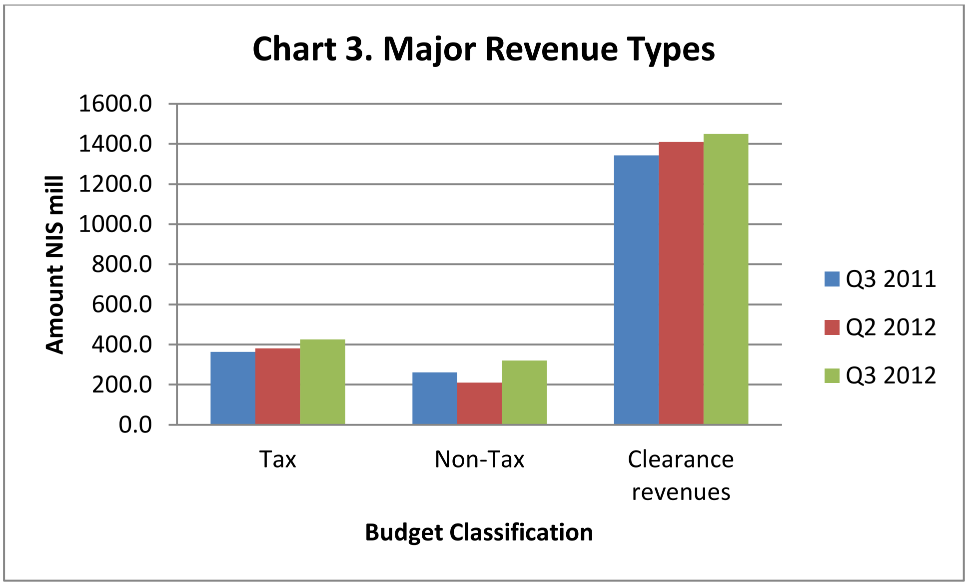
Table 4. Consolidated Fiscal Operation Analysis of Jan-Sep 2012 on Commitment Basis								
	Q3 2012	Q3 12 over Q2 12	Q3 12 over Q3 11	Actual Jan-Sep 2012	Budget 2012	9 months share of approved budget	share of approved 2012 Budget	Deviation from the 75% of 2012 approved Budget
	NIS mill	%	%	NIS mill	NIS mill	NIS mill	%	NIS mill
Gross Revenues	**2195.9**	10%	12%	6332.1	8947	6710	70.8	-378
Total Revenue	**2116.0**	11%	13%	6051.5	8493	6370	71.3	-318
Tax	**425.7**	12%	17%	1382.4	2124	1593	65.1	-211
Income Tax	132.0	9%	33%	545.0	------			
Value Added Tax	157.5	0%	18%	473.5	------			
Customs	34.7	24%	-40%	123.2	------			
Excises on tobacco	94.9	32%	33%	224.1	------			
Excises on beverage	5.6	571%	593%	7.3	------			
Property Tax	1.0	-12%	6%	9.3	------			
Nontax	**320.5**	53%	22%	746.5	963	722	77.5	24
Civil Registration Fees	8.5	-42%	-55%	37.7	------			
Health Insurance	40.9	-7%	1%	130.2	------			
Transportation	21.6	-9%	10%	70.7	------			
Licenses	47.9	0%	5%	149.2	------			
Other charges and fees	82.6	3%	31%	239.8	------			
Investment Profits	118.9			118.9	------			
Clearance Revenue	**1449.7**	3%	8%	4203.2	5859	4394	71.7	-191
Customs	522.7	10%	11%	1462.2	------			
Value Added Tax	456.4	-6%	8%	1391.4	------			
Petroleum Excises	466.1	4%	10%	1336.8	------			
Purchase Tax	0.0			0.0	------			
Income Tax	0.0			5.6	------			
Other	**4.6**		19%	7.3	------			
Tax refunds (-)	**80.0**	-18%	-18%	280.6	454	341	61.8	-60
Total Expenditure and Net Lending	**3293.1**	-2%	13%	9620.2	12114	9086	79.4	535
Wage Expenditure	**1757.0**	1%	9%	5151.4	6813	5110	75.6	42
Nonwage Expenditure	1319.0	-11%	11%	3978.7	4901	3676	81.2	303
Operational Expenditure	505.2	5%	35%	1456.1	1959	1469	74.3	-13
Transfers	806.8	-18%	1%	2506.3	2864	2148	87.5	358
Minor Capital	**7.1**	23%	-45%	16.3	78	59	20.8	-42
Net Lending	**217.0**	73%	115%	490.2	400	300	122.6	190
Current Balance	**-1177.1**	-18%	14%	-3568.7	-3621	-2716	98.6	-853
Development Expenditure	259.5	13%	0%	703.8	1330	998	52.9	-294
Balance	**-1436.6**	-14%	11%	-4272.5	-4951	-3713	86.3	-559
Financing	**1436.6**	-14%	11%	4272.5	4951	3713	86.3	559
Budget Support	723.5	-6%	-45%	2234.2	3811	2858	58.6	-624
Development Financing (1)	208.8	64%	-40%	389.3	1140	855	34.1	-466
Net Domestic Bank Financing	-582.0			-423.2	------			
Expenditure Arrears (Net Accumulation)	340.6			1255.5	------			
Net Clearance (2)	-759.0			-697.0	------			
Tax Refunds (Arrears)	-31.1			151.3	------			
Nontax Refund (3)	0.0			-59.3	------			
Residual	17.7			27.7	------			

B. Revenues

Gross PNA revenues in Q3 2012 amounted to NIS 2.2 billion, an increase of 10% and 12% over Q2 2012 and Q3 2011, respectively**.** While **Total net revenues** were NIS 2.11 billion in Q3 2012, an increase of 11% and 13% over Q2 2012 and Q3 2011, respectively. **Gross PNA revenues** obtained in the first nine months of 2012 by the PNA amounted to NIS 6.33 billion growing by 9.7% compared to the same period of 2011**.** This is in line with economic growth considering that nominal GDP growth in the West Bank, which is the source of most of PNA's revenues, amounted to about 9% during the same period. **Total net revenues** amounted to NIS 6.05 billion in the first nine months of 2012 growing by 10.7% compared to the same period of 2011.

Despite the good performance of **Gross revenues** and **Net revenues**, both are below the 75% budget target. Net revenues obtained up to the end of Q3 2012, are below the budget target by 5% due to the shortfall of domestic revenues and clearance revenues by 13% and 4%, respectively. Nontax revenues on the other hand, exceeded the budget target by 3%. Revenues fell short of the budget targets, since the 2012 budget assumed reaching agreements with the Israeli authorities on customs and VAT data sharing which would reduce tax avoidance on the Palestinian side and reduce clearance leakage. These assumptions did not materialize, and their effects will not been seen in the 2012 budget year.

When projected for the full year, gross revenues may reach NIS 8.43 billion with a shortfall of NIS 520 million from its budget target. When comparing the projections for 2012 over 2011 performance, gross revenues are expected to grow by 8.9%, less than the 15.6% increase entered as the budget target. This target assumed, as mentioned above, an increase in VAT revenues after reaching an agreement with the Israeli authorities which did not materialize. Moreover, the economic growth in the West Bank, which generates most of PNA's revenues, is expected to slow down by the end of the year given the withdrawal of fiscal stimulus through fiscal retrenchment and the uncertainty about the financial sustainability of the PA which inhibits private sector activity and causes households to reduce their spending.



Domestic tax revenue of NIS 426 million during Q3 2012 increased by 12% over domestic tax revenue collected in Q2 2012 and 17% over Q3 2011. Among the measures taken by the PA to raise domestic tax revenue was, unifying the customs and VAT departments together, improvements in the Large Taxpayers' Unit staffing and management, and the establishment of the Palestinian Revenue Council in the second half of 2012. The Revenue Council developed a comprehensive action plan to reform tax administration.

In Q3 2012, income taxes amounted to NIS 132 million, an increase of 9% over Q2 2012. This increase is attributed to settling some outstanding cases after systematically reviewing tax liabilities by the 100 largest corporations. Income tax in Q3 2012 increased by 33% over Q3 2011, due to advances paid by the taxpayers on the new tax bracket of 20% for individual and corporate income exceeding NIS 125,000 annually introduced on January 1st 2012. In addition to income tax payments, 15 companies suspended their income tax exemptions under the investment promotion law for two years (2013-14) and will be contributing about NIS 50 million in 2012.

Domestic VAT in Q3 12 remained at the same level of Q2 12 reaching around NIS 158 million but increased by 18% over Q3 11. On the other hand, excises on tobacco increased by around 32% in Q3 2012 over both Q2 2012 and Q3 2011, as a result of the MoF's decision to increase excise on tobacco by 20% in late July, following the Israeli increase.

Projecting domestic tax revenues to the end of the year 2012 indicate a shortfall of around NIS 300 million from the budget target.

Nontax revenue of NIS 202 million (excluding dividends) during Q3 2012 decreased by 4% over Q2 2012 and icreased by 8% over Q3 2011. Investment profits received from PIF in July 2012 amounted to NIS 118.9. Including these divideneds, nontax receipts were above the budget target by NIS 24 million.

Investment profits of NIS 95 million budgeted as dividends in 2012 have been exceeded since the PNA received NIS 119 million from the PIF in the second half of 2012, making up for the shortfall in domestic fees and charges.

Overall, by the year end, non-tax receipts are expected to meet the budget target of 2012.

Clearance revenues which account for two thirds of total PA revenues amounted to NIS 1.45 billion in Q3 2012, an increase of 3% and 8% over Q2 2012 and Q3 2011 respectively. The yearly increase is in line with nominal economic growth rate of 8% expected in West Bank. Clearance revenues are still below the budget target by NIS 191 million (4%). This is due to the lack of progress in reaching the expected agreements with the Israeli authorities on customs and VAT data sharing which would reduce tax avoidance on the Palestinian side which were assumed in the 2012 Budget.

There have been increases in two main categories in clearance revenues customs and petroleum excises in Q3 2012 compared to Q2 2012, by 10% and 4% respectively. The VAT revenue declined in Q3 2012 by 6% when compared to Q2 2012 partly due to the high level of VAT collected from the Palestinian sales to Israel. When compared to Q3 2011, customs, VAT, and petroleum excises increased by 11%, 8% and 10% respectively.

For the full year 2012, clearance revenues are expected to increase by 10.7% in 2012 over 2011 compared to a budgeted increase of 15%. Nevertheless, Clearance Revenues are still performing very well, considering that the nominal growth rate expected in the West Bank in 2012 is about 8%.

Tax refunds have been running at about NIS 31 million per month during the first nine months of 2012 for a total of NIS 280.6 million. Tax refunds for Q3 2012 amounted to NIS 80 million on a commitment basis. However, on a cash basis, NIS 111 million was disbursed. This reflects the new efforts of the PA of reducing debt to the private sector in order to gain back their confidence in the PA's institutions and pump some life into the private sector, which contributed to a slight decrease in tax refunds arrears accumulation of NIS 151 million during the first nine months of 2012. Tax refunds in Q3 2012 decreased by 18% over both Q2 2012 and Q3 2011. Tax refunds are below their budget target by NIS 60 million.

C. Expenditures and Net Lending during Q3 2012 reached NIS 3.3 billion, on a commitment basis, a decrease of 2% from the expenditure level in Q2 2012, and an increase of 13% over Q3 2011.

Table 5. **Budget Execution, Recurrent Expenditure by Sector, Jan-Sep 2012, (thousand NIS).**

Sectors	Recurrent Total Expenditures	2012 Sector Budget	% of Sector Budget
Central Administration	601,868	812,800	74%
Security and Public Order	3,163,330	3,711,028	85%
Financial Affairs	692,685	1,082,165	64%
Foreign Affairs	187,965	234,304	80%
Economic Development	182,539	329,670	55%
Social Services	3,777,243	5,219,221	72%
Cultural and Information Services	123,673	232,064	53%
Transport and Communication Services	63,543	92,500	69%
Total	8,792,848	11,713,756	75%

The recurrent expenditures execution over which the PNA has control is kept within budget targets with total recurrent expenditures reaching 75% of the budget target in the first nine months of 2012. The deviation in the Security and Public Order sector is due to the unbudgeted pension payments to the security sector retirees.

Wage expenditure in Q3 2012 amounted to NIS 1.76 billion, an increase over the wage bill in Q2 2012 and Q3 2011 by 1% and 9%, respectively. This increase reflects the yearly wage adjustment, wage drift, and a limited increase in net PA employment, not exceeding 3,000 employees annually. By end September 2012 additional employment in the PNA was 1074, significantly lower than the yearly ceiling on an annualized basis. This is the result of a freeze on PNA employment decreed by the PNA President on August 27, 2012.

The cost of living allowance, agreed to with the civil service union, became effective on January 1st 2012, and was disbursed in the March payroll retroactively.

Table 6. Budget Execution, Wages and Salaries by Sector, Jan-Sep 2012, (thousand NIS).			
Sectors	**Wages and Salaries**	**2012 Sector Budget**	**% of Sector Budget**
Central Administration	281,009	349,041	81%
Security and Public Order	2,335,132	3,021,144	77%
Financial Affairs	168,304	230,311	73%
Foreign Affairs	103,891	123,616	84%
Economic Development	136,711	192,455	71%
Social Services	1,968,703	2,704,666	73%
Cultural and Information Services	88,839	120,963	73%
Transport and Communication Services	50,940	70,500	72%
Total	**5,133,528**	**6,812,695**	**75%**

Nonwage expenditures in Q3 2012 amounted to NIS 1.32 billion, a decrease over Q2 2012 by 11%, and an increase of 11% over Q3 2011. Payments of the social safety net that were supposed to get paid in September were paid in October causing this shortfall of Q3 2012.

Operational expenditures of NIS 505 million during Q3 2012 increased over Q2 2012 and Q3 2011 by 5% and 35% respectively.

The PNA has adopted policy measures to decrease operational expenditure over the remainder of the budget year such as:

1. Cutting travel allowances and limiting contractual employment.
2. The freezing of all additional rentals of government offices.

Table 7. Budget Execution, Operational Expenditure by Sector, Jan-Sep 2012, (thousand NIS).			
Sectors	**Operational Expenditure**	**2012 Sector Budget**	**% of Sector Budget**
Central Administration	212,937	319,353	67%
Security and Public Order	202,196	306,432	66%
Financial Affairs	119,099	229,627	52%
Foreign Affairs	70,083	89,773	78%
Economic Development	15,890	45,922	35%
Social Services	568,619	860,921	66%
Cultural and Information Services	23,997	91,941	26%
Transport and Communication Services	7,564	15,390	49%
Total	**1,220,385**	**1,959,359**	**62%**

Table 7 above shows that almost all of the sectors fell short of the 75% of their budget target for operational expenditures. However, these expenditures are expected to reach their budgeted amount of NIS 1.96 billion by the end of the year.

Transfers of NIS 807 million in Q3 2012 decreased by 18% when compared to Q2 2012, and increased by 1% over Q3 2011. Transfers, which include the government contribution to the Pension

Fund, were above the budget target by NIS 358 million, reaching 87.5% of their annual budget target. Transfers were particularly high for Security and Public Order, exceeding their full year budget allocation during the first nine months (Table 8), due to the unbudgeted pension payments to the security sector retirees.

Projecting the first nine months of 2012 to the end of the year indicates that transfers will be above 2012 budget target by about NIS 550 million.

Table 8. Budget Execution, Transfers by Sector, Jan-Sep 2012, (thousand NIS).

Sectors	Transfer Expenditure	2012 Sector Budget	% of Sector Budget
Central Administration	105,872	138,500	76%
Security and Public Order	623,803	358,143	174%
Financial Affairs	404,944	617,928	66%
Foreign Affairs	11,397	15,716	73%
Economic Development	29,722	87,193	34%
Social Services	1,236,977	1,630,135	76%
Cultural and Information Services	8,070	9,831	82%
Transport and Communication Services	4,907	6,260	78%
Total	**2,425,691**	**2,863,705**	**85%**

Minor capital expenditures in Q3 2012 amounted to NIS 7.1 million, an increase over Q2 2012 by 23% and a decrease over Q3 2011 by 45%. These expenditures amounted to 20.8% of its 2012 budget target by the end of the third quarter. This is mainly due to the decision of MoF to prioritize its spending on wages and other recurrent expenditures.

Net lending amounted to NIS 217 million in Q3 2012, marking a significant increase over the levels reached in Q2 2012 and Q3 2011 by 73% and 115% respectively. Net lending reached 122.6% of its annual budget target at the end of the third quarter.

Net lending was above the budget target by NIS 190 million. This is due to the recent increases (in Q4-2011 and Q1-2012) in Israeli deductions of electricity bills from monthly clearance revenues, and Israeli rate increases for electricity by 8.9% in April 2012, which were not passed through by some municipalities. Those municipalities which are registered with NEDCO and JEDCO raised their tariffs in line with higher Israeli tariffs. These two distribution companies remitted electricity payments directly to the IEC. Some of the municipalities which did not join NEDCO did not increase their electricity tariffs and fell behind in remitting their electricity bills. In addition to the monthly deductions of electricity from clearance revenue, another NIS 35 million was deducted in September to repay outstanding electricity debt to JEDCO.

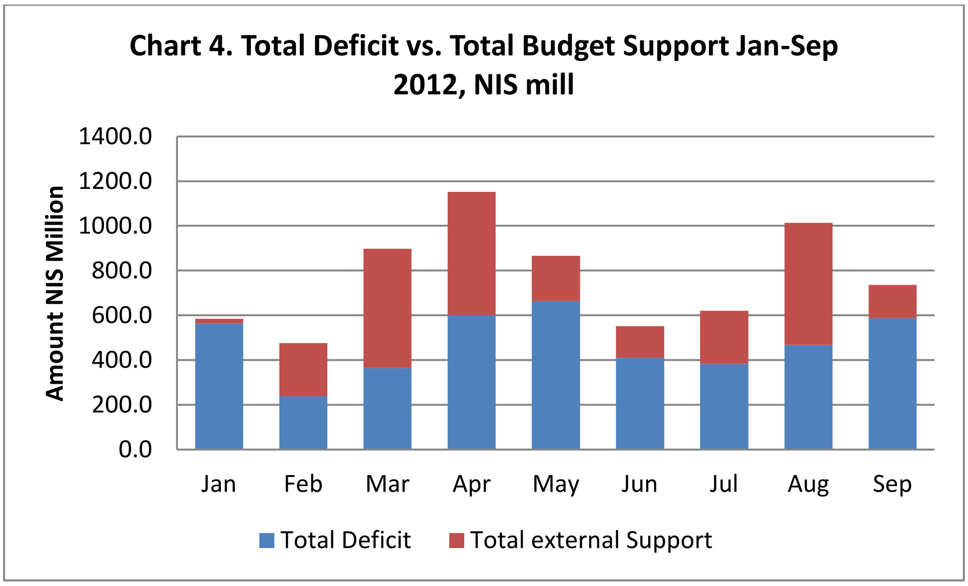
It should be recalled that the budget appropriation for net lending in 2012 has been reduced from NIS 592 million in 2011 to NIS 400 million in 2012, in the context of a policy aimed at eliminating net lending altogether. Unfortunately, progress made in previous years for eliminating net lending may be reversed in 2012 as net lending is projected to reach NIS 650 million by year end.

Development expenditures on a commitment basis channeled through the PA Treasury amounted to NIS 260 million during Q3 2012. This marks an increase by 13% over Q2 2012. Development expenditures in the first nine months of 2012 amounted to NIS 704 million on a commitment basis, and were NIS 294 below the budget target to reach only 53% on its annual budget target. This is mainly due to shortfall in external financing of development projects and MoF's decision to limit financing development projects.

D. Budget Balance and Financing

Balance: In Q3 2012 the recurrent budget deficit amounted to NIS 1.18 billion, a decrease over Q2 2012 by 18%. The recurrent deficit at the end of the third quarter exceeded the 75% deficit target by NIS 853 million reaching 98.6% of the target budgeted. **Total Balance** including the development expenditures amounted to NIS 1.44 billion on commitment basis, a drop of 14% compared to Q2 2012 and an increase of 11% compared to Q3 2011. The decline in the recurrent and total balance during Q3/Q2 2012 can be attributed to an increase in revenues and reduction in total expenditures and net lending between the two quarters.

For the full year 2012, the recurrent budget deficit**,** on a commitment basis, is projected at NIS 4.81 billion ($ 1.25 billion), or 13% of GDP, lower than the 13.5% of GDP achieved in 2011. However, this projection exceeds the budget target by about NIS 1.19 billion, equivalent to 3.2 percentage points of GDP. When development expenditures are taken into account, the overall deficit increases to NIS 5.75 billion (15.5% of GDP).



Financing: In Q3 2012 the total external budget support amounted to NIS 723.5 million. The bulk of the support came from Arab donors (NIS 500 million), followed by the World Bank which provided NIS 153.5 million (Trust Fund providing NIS 144 million) and PEGASE (NIS 70.3 million).

However, the external budget support was substantially short of the total financing requirement for the first nine months of 2012 by NIS 624 million ($ 165 million) reaching 59% of the budget target. Development financing channeled through the Treasury during the third quarter amounted to NIS 208.8 million. Development financing during the first three quarters of 2012 amounted to 34% of the budget target. Development expenditures financed by the PA Treasury as shown in fiscal table

9D amounted to NIS 277 million which makes up the shortfall in external financing for development expenditure.

These development expenditures by the PA increase the recurrent financing gap by the same amount. The total financing gap for the first nine months of 2012 amounted to NIS 1.65 billion ($ 430 million). The Treasury domestic debt stock level decreased to NIS 4.33 billion from its previous high levels as the treasury was forced to limit the increase in its domestic debt by NIS 183 million mostly to commercial banks, during the first nine months of 2012 after nearing the indebtedness to the local banks in 2012.

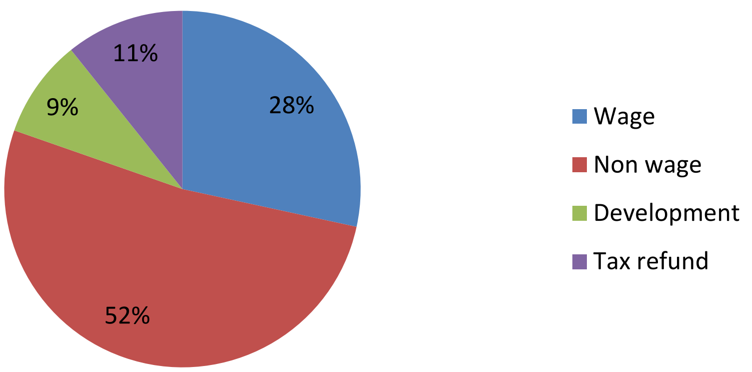
E. Arrears

Total net accumulation of arrears during the first nine months of 2012 reached NIS 1.4 billion including development expenditures arrears of NIS 125 million and tax refund arrears of NIS 151 million. Arrears to the private sector including the tax refunds arrears came to NIS 515.4 million. Arrears to the private sector raise the level of uncertainty in the business community and undermine economic activity.

Table 9: Jan-Sep 2012 net accumulation of arrears

Budget Classifications	NIS mill	Components	NIS mill
Wage	399.5	Employee contribution	399.5
Non wage	730.7	Social security, Government share	462.6
Development	125.3	Private sector	515.4
Tax refund	151.3	Other transfers	29.3
Total	**1406.8**		**1406.8**

Chart 5. Jan-Sep 2012, Net accumulation of arrears by budget classification (%)



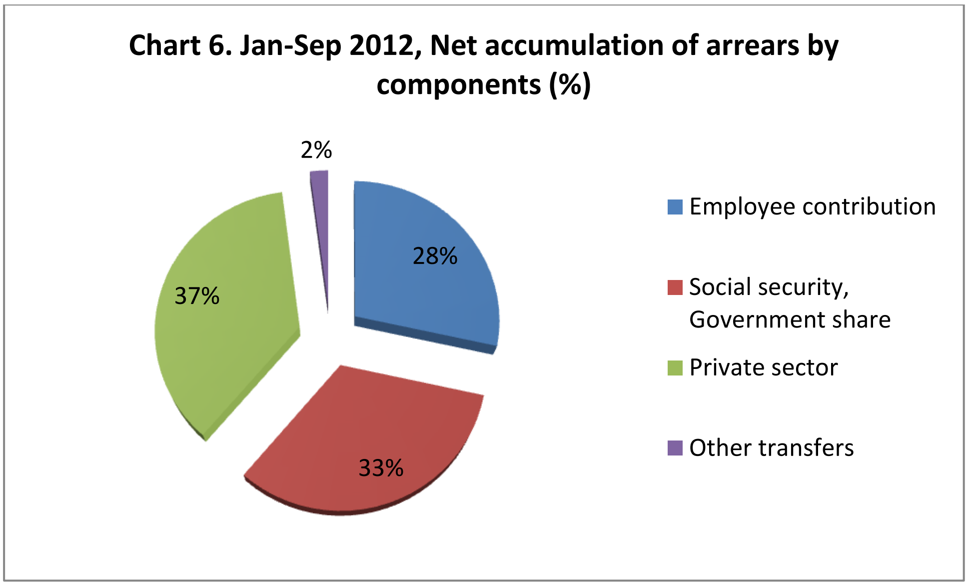


Chart 6. Jan-Sep 2012, Net accumulation of arrears by components (%)
2%
28%
37%
33%
Employee contribution
Social security, Government share
Private sector
Other transfers