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Palestine Economic Policy Research Institute

Government Borrowing and Liquidity and the Stability of the Palestinian Banking System

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Foreword

As part of its ongoing monitoring and analysis of the Palestinian economic policy scene, MAS has maintained a special focus on monetary and fiscal issues. In this respect, cooperation with the Palestine Monetary Authority (PMA) is crucial, and MAS has collaborated closely with this important institution in identifying topics for research that address pertinent policy concerns. This has allowed MAS to provide the PMA and other official policy-makers with independent, timely, and probing analysis of issues of national significance. In doing so, MAS combines its own institutional research resources with expertise from other Palestinian and international economists in order to ensure that the most relevant and feasible policy recommendations are provided.

The present study is the latest to result from the continuing MAS-PMA cooperation. It focuses on government borrowing from the domestic banking system in the context of the serious fiscal challenges and liquidity risks that the Palestinian government faces. Past cooperative arrangements between the Palestinian National Authority (PNA), the PMA, and the banking system have enabled coping with shocks emanating from Israeli punitive measures, in particular the withholding of clearance revenues, and have been successful in averting a financial crisis. However, the set of circumstances that permitted that success should not be taken for granted, and this reality is what dictated the need for this research. Clearance revenue withholding is but one in a set of punitive measures which Israel has imposed in several occasions, and although isolating the effect of this measure is not possible, the aggregate effect is readily discernable as various studies, including by the World Bank, have shown. In addition, political uncertainties highlight clearly the vulnerability of the Palestinian banking system to any future suspension of clearance revenues. Thus, the author of this study attempts to come up with workable recommendations to alleviate the situation in the future.

MAS would like to express its gratitude to the authors for their efforts as well as to the reviewers, especially those from the PMA. We are confident that the PMA, the PNA Ministry of Finance (MoF), and decision-makers in the banking sector will find the findings and recommendations helpful in their efforts to maintain the stability and integrity of the Palestinian financial and banking sectors. Finally, on behalf of MAS, I would like to extend our thanks to the PMA for the grant which it provided, enabling MAS to carry out this important research.

Nabeel Kassis, Ph.D.
Director General

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Executive Summary

The Palestinian National Authority (PNA) has for many years operated in the context of serious budget deficits, even in the absence of suspension of clearance revenues payments on trade with and through Israel, which account for more than two thirds of the PNA revenues. The PNA direct tax revenues are not sufficient to cover its current expenditures. Despite receiving substantial financial assistance from donors, the PNA has incurred a debt domestically since 2001 to finance its budget deficits and internationally since even prior to 2000 to cover its development expenditures. By 2016, the Palestinian public debt-GDP ratio had reached 35.2%, which is higher than in many developing countries with more stable macroeconomic environments. If the PNA budget deficits continue, the Palestinian public debt threatens to become a source of instability for the Palestinian economy because of the PNA small tax base and the risk of disruptions to the flow of PNA revenues owing to clearance revenues suspensions and other Israeli punitive measures.

A large share of the PNA debt is domestic, short-term debt owed to the Palestinian banking system. Both the scale and the currency composition of the PNA debt represent significant sources of potential instability for the banking system. At the end of 2016, the net liability of the PNA to the domestic banking system amounted to USD 891 million, equivalent to 60% of domestic banks' total capital. Most of the PNA bank credit is denominated in NIS (75% of the total at the end of 2016). In conditions of limited deposits in NIS, the predominance of public borrowing in NIS can constrain the availability of NIS denominated credit and increase its cost to private borrowers, many of whom borrow in USD or JD at lower interest rates. Since the main source of income for most private borrowers is denominated in NIS, having to borrow in a different currency increases the foreign exchange-induced credit risk exposure for the domestic banking system. Additionally, loans to PNA employees backed by their salaries account for a substantial share of the bank credit, constituting another channel of exposure of the domestic banking system to shocks from adverse changes in the PNA financial conditions that affect its ability to pay the wage bill. At the end of 2016, the total credit to PNA employees backed by their salaries was USD 1.3 billion, which is around 88% of the total capital in the domestic banking system.

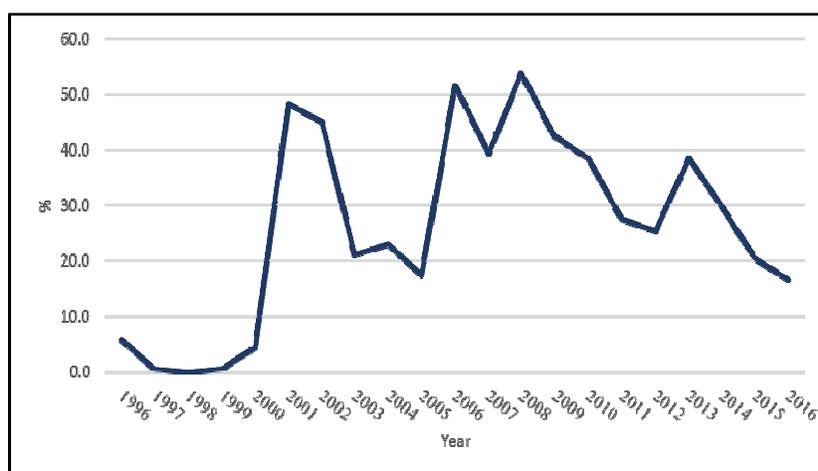
Depending on their duration, the impact of clearance revenues suspensions on the Palestinian banking system has been transmitted in past episodes through more PNA borrowing, the interruption of loan payments by PNA employees and private sector suppliers, and increased credit risk due to deteriorating economic conditions. So far, clearance revenues suspensions have not caused major disruptions to the banking system. Cooperative arrangements between the Palestine Monetary Authority (PMA), the PNA Treasury, and the banking system have been successful in past episodes in averting financial crisis. However, an uncertain political and international diplomatic horizon brings to the fore the issue of the vulnerability of the Palestinian banking system to any future clearance revenues suspensions. Since the last extended suspension (in 2006-2007), the credit-deposit ratio of the Palestinian banking system has doubled, and banks have expanded lending to PNA employees, thus increasing the systemic liquidity risk. Oil prices have dropped sharply since then, diminishing the ability of Arab oil-exporting countries, which account for a large share of the PNA budget support, to increase their financial assistance to the PNA in a future clearance revenues suspension, while regional instability and conflict as well as international developments add uncertainty to short-term political prospects.

In this environment, any extended clearance revenues suspension may destabilize the Palestinian banking system and undermine public confidence in the system. Such an eventuality calls for PNA vigilance in its bank borrowing, consultations between the PNA Ministry of Finance (MoF) and the PMA regarding strengthened public debt management, and exploring options for credit facilities underwritten by donors that would allow the PNA to address potential bank instability in case of any clearance revenues suspension or other shocks to the banking stability.

1. Public Debt and Clearance Revenues Suspensions

The PNA budget is heavily dependent on donors, and their assistance has played a major role in financing the PNA's current expenditures (see Figure 1). Despite such assistance, the PNA has had to borrow domestically and use donor grants to cover its current expenditures. In 2016, the PNA received USD 762 million in donor aid, of which USD 608 million was allocated to budget support (accounting for 16.6% of current expenditures) and USD 154 million to finance development projects. Unlike most other years, the PNA did not have to borrow from banks to finance its 2016 budget deficit. In fact, PNA outstanding bank credit declined by USD 3.5 million in 2016.

Figure 1: Donor Budget Support as Percentage of Current Expenditures, 1996-2016



Source: The percentage is calculated by the author based on data obtained from the PMA website.

Persistent budgetary pressures have entailed a growing recourse to domestic sources of finance, incurring an increase in the Palestinian central government debt (public debt), which is comprised of four components:

1. Debt to the Pension Fund;
2. Arrears to private sector suppliers and municipalities;
3. Domestic debt to banks and some public institutions; and
4. External debt to official creditors.

These liabilities are conventionally considered to constitute domestic and external public debt; however in the PNA MoF definition and data series, obligations to the Pension Fund and arrears to the private sector are not classified as public debt. The total stock of public debt (including all these components regardless of their maturity) reached USD4.7 billion by 2016, having grown between 2012 and 2015 by around USD1 billion and fallen slightly in 2016 for the first time in many years (see Table 1). By 2016, the Palestinian public debt-GDP ratio in 2016 was 35.2%, which is higher than in many developing countries with more stable macroeconomic environments (see Table 2). While external debt obligations had remained constant around USD1 billion for many years, domestic debt had grown to constitute 75% of the public debt stock, as PNA liabilities to the Pension Fund and to local suppliers and authorities had grown steadily since 2012, equivalent to 12% and 4.5% of GDP, respectively, by 2016. If the PNA budget deficits are not contained and properly managed, the IMF has recently noted that public debt growth risks posing significant sources of instability to the Palestinian economy (IMF, 2017).

Table 1: PNA Public Debt by Major Components (USD million), 2012-2016

Category/ Year	2012	2013	2014	2015	2016
Pension Fund	1057.8	1465.0	1619.2	1922.8	1627.3
Private Sector Suppliers and Municipalities	269.2	554.5	473.2	428.3	608.0
Domestic Debt	1384.7	1267.6	1128.0	1466.5	1439.8
External debt	1097.8	1108.7	1088.9	1070.8	1043.9
Total	3809.5	4395.8	4309.2	4888.5	4718.9
GDP (Current Prices) (USD million)	11279.4	12476.0	12715.6	12673.0	13397.1
Total Public Debt /GDP	33.8%	35.2%	33.9%	38.6%	35.2%
PNA Debt Categories/ GDP					
Category/ Year	2012	2013	2014	2015	2016
Pension Fund	9.4%	11.7%	12.7%	15.2%	12.1%
Private Sector Suppliers and Municipalities	2.4%	4.4%	3.7%	3.4%	4.5%
Domestic Debt	12.3%	10.2%	8.9%	11.6%	10.7%
External Debt	9.7%	8.9%	8.6%	8.4%	7.8%

Sources: The Pension Fund and private sector suppliers and municipalities data are obtained from the IMF (unpublished data); External and domestic debt data are obtained from the MoF website (monthly financial reports) for the years 2012-2016; GDP data are in current prices, from the PCBS website (National Accounts (GDP) statistics).

Table 2: Public Debt-GDP Ratios for Selected Developing Countries*

Country	Public Debt-GDP Ratio (%)	Country	Public Debt-GDP Ratio (%)
Bangladesh	20.8	Jordan	85.8
Brazil	52.2	Kenya	49.5
Costa Rica	40.6	Morocco	63.1
Dominican Republic	34.8	Nigeria	10.5
Georgia	40.0	Peru	21.4
Guatemala	24.1	Turkey	28.8
Indonesia	26.2	Palestine	35.2

Sources: Except for Palestine, the debt ratios are for 2015. Jordan's public debt ratio is taken from the Central Bank of Jordan, Annual Report, 2015. The public debt ratios for other countries were calculated by the author based on data obtained from <http://data.worldbank.org/data-catalog/world-development-indicators>.

*2016 ratio for Palestine and 2015 for other countries.

A very large percentage of PNA tax revenues (68.6% in 2016) is collected by Israel and is transferred to the PNA Treasury through a clearance revenues process that the Israeli government has suspended repeatedly in the past. The PNA expenditures consist mostly of current expenditures, and wages account for a disproportionate share of current expenditures, limiting the ability of the PNA to respond to revenues shortfall by reducing expenditures without causing serious economic disruptions. In 2016, current expenditures accounted for 94.4% of total expenditures, and 52.6% of current expenditures were spent on wages. In fact, the PNA wage bill (USD 1,927.2 million in 2016) is

substantially higher than the total tax revenues collected directly by the PNA (USD 1,166.9 million). The PNA has had to stop paying its employees altogether, or pay only partially, during some clearance revenues suspension episodes, depending on their intensity and duration.

Clearance revenues have been suspended frequently by the Israeli government (see Table 3), causing serious damage to the Palestinian economy and, consequently, to the total net income of the PNA (see Figure 2). A clearance revenues suspension adversely affects the Palestinian economy directly through decreased PNA non-wage expenditures and indirectly through its impact on PNA private sector suppliers, PNA employees' salaries, and the domestic banking system. Irregular payments to PNA employees and suppliers decrease business investment and discourage household consumption. The PNA resort to budget support from donor funds after 2001 was a direct response to this vulnerability, predicated on the assumption that in recessionary conditions, aggregate demand was best sustained through ensuring PNA salaries were paid and re-circulated in the economy through private consumption.

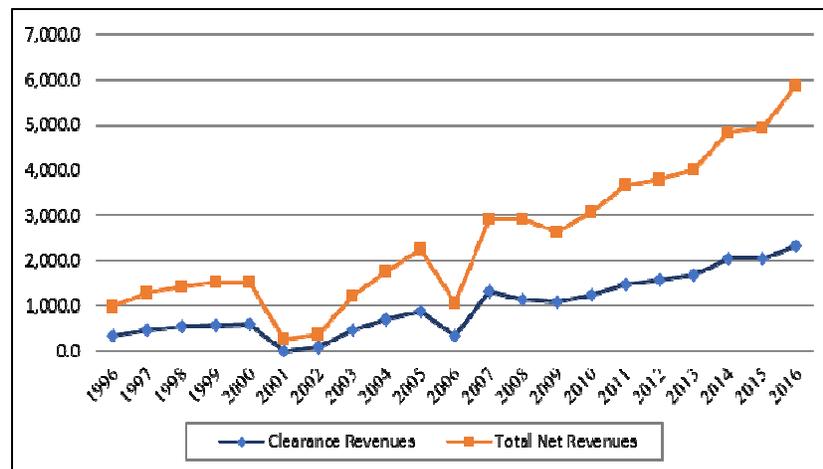
Table 3: Clearance Revenues Suspensions*

Start Date	Total Amount Withheld (USD million)	Release Date of Funds
August 1997	78	September 1997
December 2000	500	December 2002
March 2006	1,100 (est.)	July 2007
May 9 2011	100	23 May 2011
November 2011	100	30 November 2011
November 2012	100	20 January 2013
January 2015	450 (est.)	20 April 2015

Source: IMF, Resident Representative Office - West Bank and Gaza.

Available data on economic performance during previous episodes, such as the extended 2000-2002 clearance revenues suspension, indicate the extent of economic damage such suspensions can cause. The Palestinian economy experienced a large contraction as a result of the 2000-2002 Israeli punitive measures during the Second Intifada, which included closures, military incursions, and prolonged suspension of the transfer of clearance revenues.

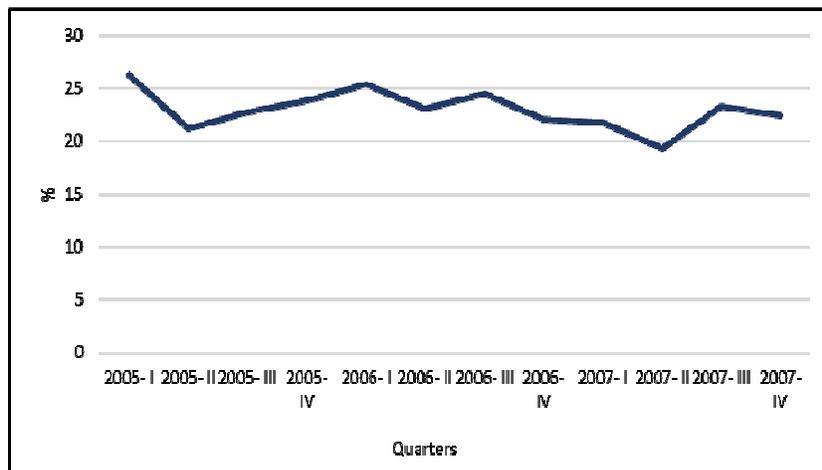
Figure 2: PNA Total Net Revenues and Clearance Revenues (USD million), 1996-2016



Source: Calculated by the author based on data available on the PMA website.

Even though clearance revenues suspension takes place usually not in isolation but as one of a set of Israeli punitive measures, Figure 2 shows clearly that a dip in clearance revenues is accompanied by an even greater dip in total net revenues; similarly, a rise in the former is accompanied by a greater rise in the latter. Thus, although the quantitative impact of each of the punitive measures cannot be isolated, clearance revenues suspension has a profound adverse impact on aggregate demand and severely undermines the functioning of the PNA. Indeed, by 2003, Palestinian real GDP was 20.6% below its 2000 level, and the poverty rate reached 35.5%, compared to 20.0% in 1998. Between 2000 and 2002, Palestinian unemployment rose from 14.3% to 31.2%. Based on available data, the 2006-2007 tax clearance suspension was not as disruptive to the Palestinian economy as the 2000-2002 suspension, and its adverse impact fell disproportionately on low-income groups. Real GDP declined by 3.9% in 2006, before starting to recover in 2007. The unemployment rate did not increase significantly during this suspension (see Figure 3), but there was a significant increase in the poverty rate, which reached 31.2% 2007, compared to 24.3% in 2005.

Figure 3: Quarterly Unemployment Rates, 2005-2007



Source: PCBS.

2. PNA Domestic Borrowing and Banking System Stability

2.1 PNA Borrowing Trends and Their Implications on the Banking System

The credit-deposit ratio in the Palestinian banking system had risen substantially in recent years to 66.3% by 2016 (total credit facilities to residents as a proportion of total deposits of residents with Palestinian and foreign banks – see Appendix Table 1), but it is still significantly lower than in other developing countries (see Table 4). This should not be surprising in view of the high levels of political and economic uncertainty in the West Bank and the Gaza Strip and the structural vulnerability of the Palestinian economy to external shocks. Another factor that contributes to the relatively low credit-deposit ratio of the Palestinian banking system is the inability of a large percentage of Palestinian households to use their land (which often accounts for a large share of a household’s wealth) as collateral for bank loans due to the lack of proper land registration (Hamed, 1996). However, an active mortgage financing market has arisen in recent years to support new residential real estate ownership and has enabled the steady growth of private credit to new borrowers (Morrar, 2016).

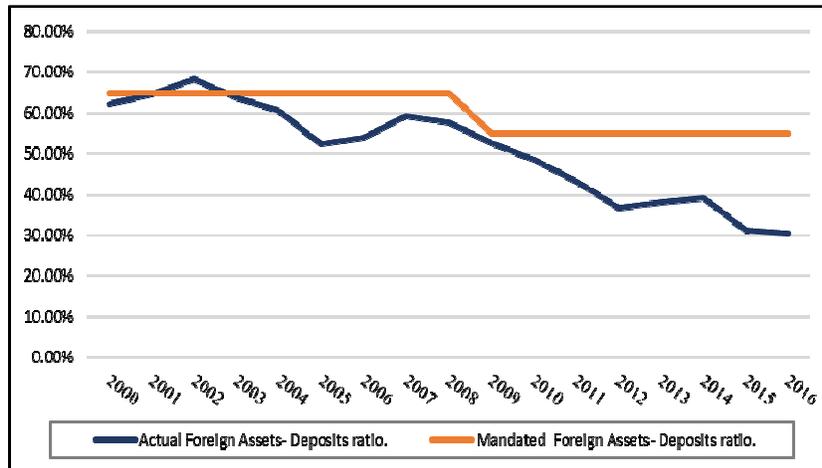
Table 4: Bank Credit-Deposit Ratios for Selected Developing Countries*

Country	Credit-Deposit Ratio (%)
Brazil	104.7
Egypt	101.4
Indonesia	101.2
Jordan	104.7
Kenya	115.8
Lebanon	68.9
Malaysia	107.8
Morocco	95.0
Nigeria	
Peru	104.0
Palestine	66.3

Sources: The credit-deposit ratios listed in this table for countries other than Palestine were calculated by the author, using data obtained from the IMF (2016). Bank credit data used in the calculations include net claim on the central government, which accounts for bank loans as well as government securities held by commercial banks. For Palestine, the figure is calculated from the PMA data in Appendix Tables 1.

* 2016 ratio for Palestine and 2015 for other countries. Deposits here refer to customers' deposits.

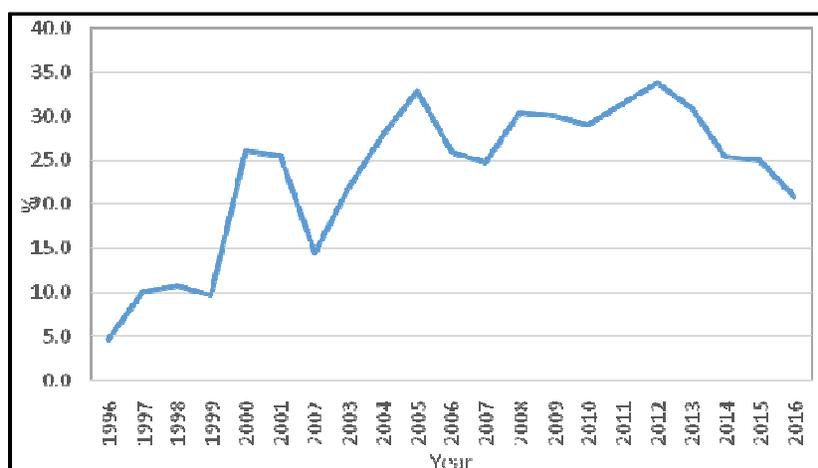
Figure 4: Actual and Mandated Foreign Placements Abroad-Deposits Ratio, 2000-2016



Source: Calculated by the author based on data provided by the PMA.

Until 1998, commercial banks were required to maintain a minimum credit-deposit ratio and a ceiling on the percentage of deposits banks could invest in foreign assets. The credit-deposit ratio was 30% before June 1998, and was raised to 40% and stayed at that level until the minimum was eliminated by PMA regulations in 2007. The foreign assets ceiling was 90% before 1998, when it was lowered to 65%, and was lowered again to 55% in 2009, remaining at that level since then. By 2016, the ratio of foreign assets to total deposits was 30.5%, significantly below the ceiling mandated by the PMA. This reflects a substantial expansion in the capacity of the domestic banking system to identify local credit opportunities.

Figure 5: PNA Share in Total Bank Credit, 1996-2016



Source: Calculated by the author using data provided by the PMA.

While the share of PNA borrowing in total credit extended by the Palestinian banking system has fluctuated over the years, there was a clear upward trend until 2012 (see Figure 5). Since then, there has been some decrease in this ratio, but it is too early to tell if the decrease represents a trend reversal. At the end of 2016, the PNA accounted for 20.8% of the total outstanding credit of the domestic banking system. At the end of the same year, the net liability of the PNA to the domestic banking system (PNA bank credit - PNA bank deposits) was USD 891 million (see Appendix Table 1).

As a percentage of deposits (8.7% at the end of 2016), the PNA net liability to the domestic banking system is still low, compared to in other developing countries (see Table 5). However, the PNA future tax revenues are unpredictable because of the impact of possible clearance revenues suspensions and other arbitrary Israeli punitive measures on the economy at any point in time. Consequently, the default risk on the PNA debt is substantially higher than in most developing countries. In this environment, it is not advisable to allow the PNA debt to the domestic banking system to exceed the total bank capital. At the end of 2016, the abovementioned net liability of the PNA to the domestic banking system accounted for 53% of the total end-of-year capital of the Palestinian banking system.

Table 5: Government Net Bank Liability as a Percentage of Customers' Deposits for Selected Developing Countries*

Country	Government Net Bank Liability* (%)
Brazil	34.0
Egypt	52.0
Indonesia	8.3
Jordan	33.2
Kenya	24.1
Lebanon	28.8
Malaysia	7.7
Morocco	16.9
Nigeria	
Peru	24.1
Palestine	8.7

Sources: The government net liability percentages were calculated by the author using data taken from the IMF (2016).

*2016 percentage for Palestine and 2015 for other countries.

The PNA bank credit has been increasingly denominated in NIS (see Figure 9). At the end of 2016, the NIS debt accounted for 75.4% of the PNA bank credit, and the share of the PNA in NIS-denominated credit extended by the Palestinian banking system was 43.4%. The high share of the PNA in the overall NIS-denominated credit makes the Palestinian banking system vulnerable to foreign exchange-induced credit risk. Since the income of most households and firms in the West Bank and the Gaza Strip is denominated in NIS,¹ we should expect most West Bank and the Gaza Strip borrowers to prefer credit denominated in the same currency.² While most deposits in the Palestinian banking system are in USD or JD and housing loans are usually made in USD (or JD) at interest rates below NIS-denominated credit, many borrowers who receive their income in NIS incur loans denominated in other currencies and are hence exposed to foreign exchange risk. Further increase in the share of NIS in the PNA credit risks reducing the availability and increasing the interest rate cost of NIS credit to the private sector, exposing more private sector borrowers to foreign exchange risk by taking loans in currencies other than the one in which their main source of income is denominated. This in turn can increase the exposure of the Palestinian banking system to foreign exchange-induced credit risk by increasing the possibility of default on loans denominated in USD and JD.³ This represents a major source of potential instability in the Palestinian banking system.

Figure 6: Monthly Percentage of NIS in the PNA Bank Credit, 2006-2016



Source: Calculated by the author based on data provided by the PMA.

2.2 Government Borrowing and Private Sector Credit in Developing Countries

Despite the PNA unique situation, comparative experience is instructive in analyzing the relation of government borrowing to the banking system liquidity and stability. If a country has its own currency, and its central bank is not politically independent, government budget deficits can be transmitted to the domestic banking system (and the rest of the economy) through a higher price level. Another mechanism for transmitting a budget deficit to the domestic banking system is decreased private sector lending, a mechanism usually referred to in the economic literature as crowding out.

It has been long established in the literature that financing a budget deficit through money creation is inflationary. Nevertheless, money creation has continued to be a major source of finance for budget deficits, especially in developing countries. In the 1970s and the 1980s, many developing countries experienced inflationary problems because of heavy budget reliance on money creation, with runaway inflation rates in some countries. In view of this experience, budget deficits in developing countries in

¹ According to a PCBS survey conducted in 2014 as part of a study of Palestinian money supply, 93% of employed Palestinians in the West Bank and the Gaza Strip are paid in NIS. See Hamed, 2015 for more details.

² Strong demand for NIS credit compared to credit denominated in USD and JD is indicated by its higher relative intermediation spread (Hamed, 2015).

³ If a household (firm) has a bank loan in USD (JD), while its main source of income is in NIS, an unexpected depreciation of the NIS against the USD (JD) reduces the capacity of the household (firm) to make its loan payments. See Hamed, 2015 for further elaboration on this point.

recent years have been financed mainly by borrowing, and government borrowing has increasingly been done in the domestic market instead of internationally. This has been the case even in low-income countries. World Bank data from 36 low-income countries show the share of domestic borrowing in total public debt in 2011 to be 40%, almost three times as much as in 1996. In the period 1996-2011, government securities accounted for three quarters of government domestic borrowing in these countries. In recent years most domestic borrowing in developing countries has been done by issuing government securities, most of which have been held by the domestic banking system (Bua et al., 2014).

Increased reliance of developing countries on domestic borrowing in financing budget deficits has raised serious issues about the impact of government public debt programs on private sector access to bank credit. The impact of government borrowing on private sector credit has been investigated extensively in the economic literature and is of growing significance in economic policy-making, especially in developing countries. Some economists have concluded that increased government borrowing has had a positive impact on private sector credit. Some advocates of this view have argued that increased government borrowing raises national income, thus increasing private investment to meet the resulting demand for goods and services, and some of the increase in private investment comes from bank credit (Eisner, 1984). Other advocates have said that increased government borrowing could stimulate private sector credit because some borrowed funds are spent on public investments such as infrastructure, which has the potential to enhance private investment (Asclauer, 1989), increasing private sector demand for bank credit. Supporters of the positive impact of government borrowing on private sector credit have also argued that government borrowing could potentially increase private sector credit because it lowers the credit risk of banks' portfolios, allowing banks to make riskier private sector loans (Kumhof and Tanner, 2005).

Nevertheless, some economists argue that government borrowing can have an adverse effect on private investment and private sector access to bank credit. According to these economists, in an economic environment with market-clearing interest rates, increased government borrowing raises market interest rates, decreasing private sector credit.⁴ In an environment that experiences financial repression due to government intervention in credit markets, the impact of increased government borrowing on private sector credit is channeled mainly through lower credit supply. The assumption here is that banks consider private sector borrowers to be riskier than the government, and that budget deficits provide banks with the opportunity to decrease the credit risk of their portfolios.

In developed countries, there is some evidence that increased borrowing has a negative impact on private sector credit through higher interest rates.⁵ In developing countries, in contrast, available evidence does not show that increased government borrowing has a significant impact on interest rates, but it still has an adverse effect on private sector access to bank credit. Analyzing 21-year data from 25 developing countries, Emran and Fawzi (2008) have shown government borrowing to have a significant adverse effect on private sector credit. According to them, an increase in government borrowing by USD 1 resulted in a USD 0.68 decrease in the supply of private sector credit. A similar conclusion was reached by Christensen (2004), using data from 27 African countries. Using data from 27 oil-dependent countries, Anyanwu et Al. (2017) found that government borrowing had an adverse effect on private sector credit (a 1% increase in government borrowing decreased private sector credit by 0.22%) but no impact on interest rates.

2.3 Clearance Suspensions and Banking System Stability

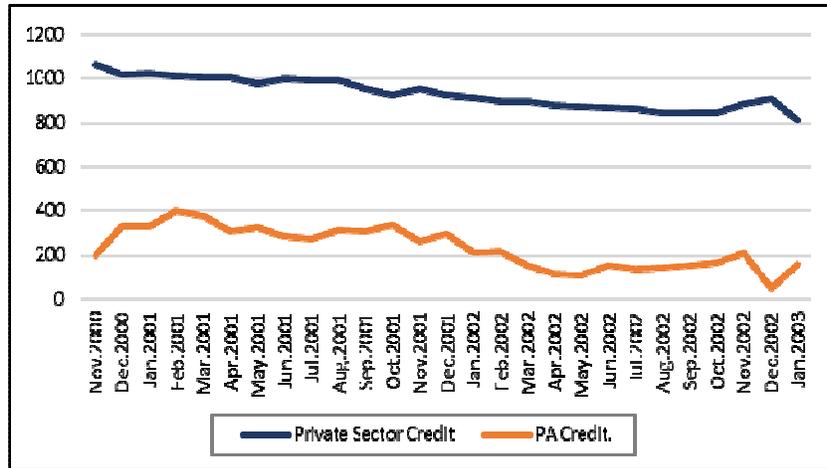
The price channel does not currently represent a significant mechanism for transmitting the impact of higher budget deficits during clearance revenues suspensions to the Palestinian economy because the PNA does not have a national currency. The main transmission channels of higher budget deficits during clearance revenues suspensions are therefore increased PNA bank borrowing and higher credit

⁴ Milton Friedman, for example, has argued that the impact of higher interest caused by increased government borrowing is large enough to completely offset the impact of increased government borrowing on aggregate demand.

⁵ Feldstein (1982) reached that conclusion using US data and Knot and Haan (1999) using German data.

risk caused by deteriorating economic conditions, which may decrease the volume of bank credit available to the private sector and change its currency composition. The interruption of bank loan payments by PNA private sector suppliers and PNA employees may also transmit an adverse effect on bank liquidity. During the 2000-2002 clearance revenues suspension, the PNA bank credit first rose sharply and then began to decline because of an increase in donor assistance in support of the PNA current expenditures (see Figure 7). Furthermore, private sector credit declined throughout the 2000-2002 suspension period due to deteriorating economic conditions caused by the clearance revenues suspension and other Israeli punitive measures.

Figure 7: Monthly PNA and Private Sector Credit (USD million), December 2000-December 2002



Sources: Calculated by the author based on data provided by the PMA.

A similar analysis of PNA and private sector credit in the extended suspension period (2006-2007) is not possible due to the lack of monthly or quarterly data for this period. However, based on annual data, the PNA bank credit actually declined and the private sector credit increased in 2006 (see Table 6). Commercial banks apparently considered lending to a Hamas-led PNA government to be too risky and the deterioration in economic conditions to be temporary. The impact of the 2000-2002 and 2006-2007 clearance suspension episodes on bank liquidity was not significant because of the excess liquidity at the time in the Palestinian banking system.

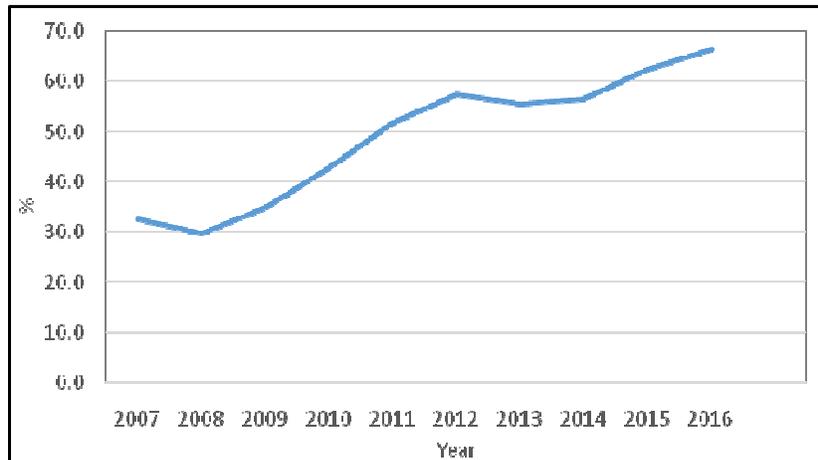
Table 6 : PNA and Private Sector Credit, 2005-2016

Year	Private sector credit		PNA credit	
	% change	USD million	% change	USD million
2005		1,130.50		565.2
2006	12.86	1,275.90	-19.4	455.7
2007	-5.52	1,205.50	-11.3	404
2008	-3.28	1,165.93	28.1	517.4
2009	24.28	1,449.01	21.2	627.2
2010	37.39	1,990.79	30.9	821.2
2011	20.25	2,393.93	33.8	1098.9
2012	14.74	2,746.71	27.7	1402.9
2013	11.78	3,070.35	-2.2	1372.7
2014	18.27	3,631.19	-9.7	1239.1
2015	19.78	4,349.32	17.4	1455.0
2016	23.73	5,381.49	-2.6	1416.6

Source: The PMA.

The underlying factors of the vulnerability of the domestic banking system to clearance revenues suspensions have increased substantially since the last prolonged suspension. Since then, the credit-deposit ratio of the Palestinian banking system has increased steadily (see Figure 8), even as the share of the PNA in total bank credit fell from around 33% to 20% between 2012 and 2016. Meanwhile, the share of foreign chartered banks in total deposits and credit in the Palestinian banking system also decreased significantly (see Figure 8). Additionally, banks expanded their credit facilities to PNA employees. The uncertain regional and international political landscape injects structural risks to the PNA budget in the event of renewed interruptions (or unilateral deductions) of clearance revenues flows.

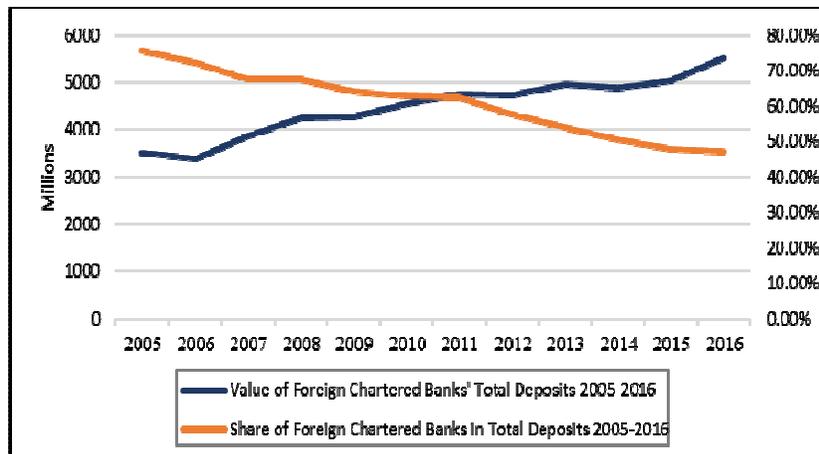
Figure 8: Credit -Deposit Ratio, 2007-2016



Source: Calculated by the author based on data provided by the PMA.

Figure 8 shows the increase in the credit-deposit ratio in the Palestinian banking system since 2007. By the end of 2016, the credit-deposit ratio of 66.3% was more than twice its level in 2007 and some 3 percentage points above the previous year level. If this trend continues, clearance revenues suspensions could have a disruptive impact on the Palestinian banking system. If the Palestinian credit-deposit ratio reaches current levels in developing countries, evidence from these countries implies that increased PNA bank borrowing during future clearance suspension would result in a crowding out effect on private sector credit (as outlined in Section 2.2). Since the PNA bank credit already accounts for a large share of the capital of the banking system (See Section 2.1), increasing credit to the PNA in case of future suspensions may put the Palestinian banking system at liquidity risk. Meanwhile, the declining share of foreign chartered banks in the Palestinian banking system in recent years, even while their

Figure 9: Share of Foreign Chartered Banks in Total Deposits:

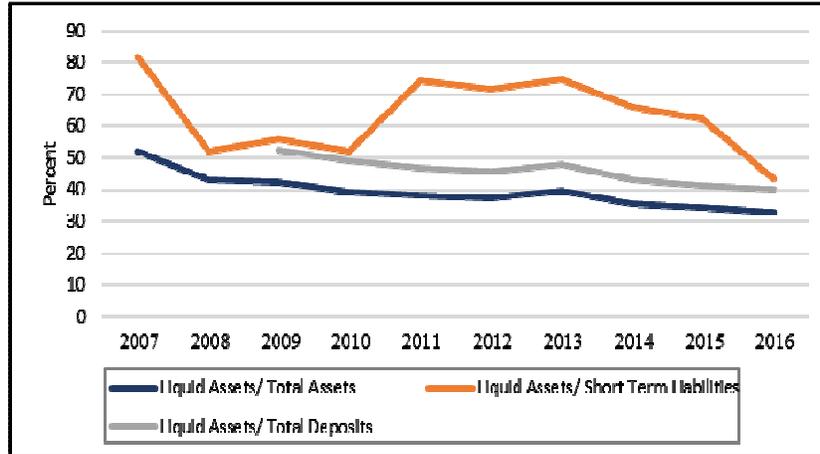


Source: Calculated by the author based on data provided by the PMA.

total deposits have grown (see Figure 9), reduces the relative significance of a key source of liquidity for the banking system (external liquidity with the head offices of foreign chartered banks).

Figure 10 shows that the liquidity of the Palestinian banking system since 2007 has decreased sharply, which would adversely affect the ability of this system to face future clearance revenues suspensions and other fiscal shocks.

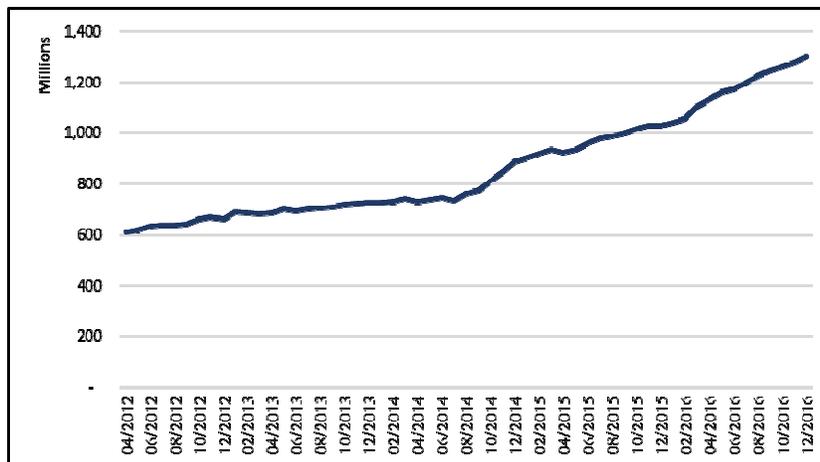
Figure 10: Liquidity Ratios in the Palestinian Banking System, 2007-2016



Source: Calculated based on data provided by the PMA.

Bank credit to PNA employees has expanded substantially in recent years, doubling in the last four years (see Figure 11). By the end of 2016 it reached USD 1,299.6 million, accounting for 19.1% of total credit extended by the Palestinian banking system. Increased lending to PNA employees further exposes the Palestinian banking system to the potential shock of clearance revenues suspensions. During a clearance suspension, the PNA either stops paying the salaries of its employees or provides them with partial payments. Since PNA employees account for a large share of the employed in the West Bank and the Gaza Strip, and most of their salaries are paid in NIS, prolonged disruption in the payment of salaries would have a negative impact on total bank deposits and the share of NIS in total deposits, and in turn decrease bank liquidity. Loans to PNA employees are usually backed by their salaries, and payments on these loans are deducted directly from salaries as they are credited to clients' accounts, since banks require

Figure 11: Bank Credit to PNA Employees, April 2012-November 2016



Source: Calculated by the author based on data provided by the PMA.

PNA employees (as well as private sector employees) to have their salaries transferred directly to them as a condition for receiving loans. When PNA salaries have been suspended in the past, all PNA employees' loan payments were postponed by an agreement between the banks, the PMA, and the PNA. When PNA employees' salaries are paid partially the PMA usually arranges with banks to reduce loan payment deductions commensurate with salary payment reductions.

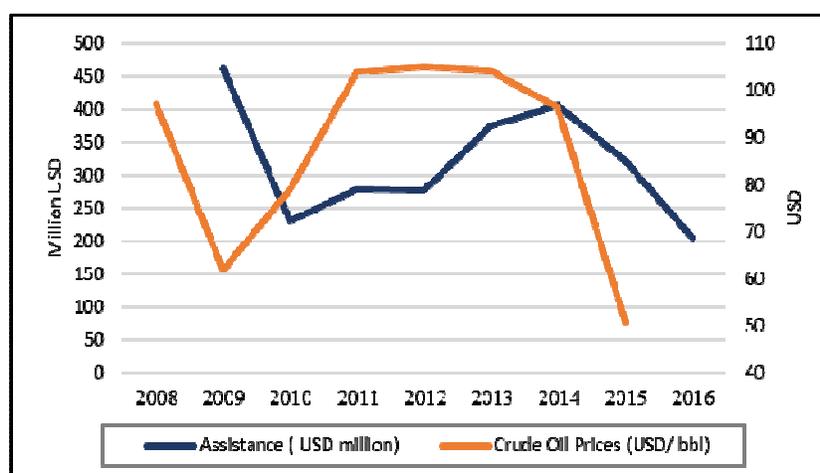
Recent regional developments that have implications on the vulnerability of the Palestinian banking system to clearance revenues suspensions include lower oil prices and regional conflict, which constrain the ability of Arab countries to increase their financial assistance to the PNA. Since a large and growing share of donor assistance has come in recent years from Arab oil-exporting countries (see Table 7)⁶, and since oil prices have decreased sharply recently, the PNA may not be able to count much on increased Arab donor assistance during clearance revenues suspensions in the future. This may result in an increased need for PNA borrowing in future clearance suspensions. Indeed, Figure 12 shows that financial aid to the PNA in any year correlates strongly with oil prices in the previous year (a correlation coefficient of 0.76), which is to be expected if the aid budgeted for any year depends on the revenues that accrued in the previous year. The correlation is still positive but much weaker (only 0.23) if the two variables are taken in the same year. This suggests that the price of oil has a strong

Table 7: Arab Oil –Exporting Countries Assistance and its Share in Total PNA Budget Support

Year	Share (in %)	Assistance (USD million)
2008	25.29	445.9
2009	34.07	461.6
2010	20.13	230.8
2011	35.40	278.89
2012	35.17	276.34
2013	30.64	375.24
2014	39.82	406.6
2015	46.71	322
2016	35.12%	203.5

Source: Calculated by the author based on data obtained from the MoF website.

Figure 12: Arab Oil-Exporting Countries Assistance to the PNA (USD million) Compared with Crude Oil Prices, 2008-2016



Source: Calculated by the author based on data obtained from the MoF website and MAS Economic Monitor.

⁶ Arab oil-exporting countries are those that are members of the OAPEEC in addition to Oman. The Table shows that the budget support that these countries have provided to the PNA has taken a downward trend since 2008, except for 2013 and 2014, presumably because of the war on Gaza in 2014 (see Figure 12).

bearing on the ability of Arab oil-exporting countries to meet their obligations (pursuant to the Arab Summit resolutions) and to extend extra assistance if the transfer of clearance revenues is suspended. An uncertain international diplomatic environment adds further risks that any eventual Israeli unilateral action affecting clearance revenues will not be met with a coordinated multilateral response, further constraining the PNA limited options.

3. Policy Options

3.1 Fiscal Shocks and Bank Stability

The PNA ability to contain the disruptions caused by clearance revenues suspensions is extremely limited. It cannot currently decrease the share of clearance revenues in its total revenues significantly by increasing the productive capacity of the domestic economy (to reduce dependence on imports). Because of the small size of the Palestinian economy, Israeli restrictions, and Israeli direct control of large areas of the West Bank (limiting investment in these areas), and the narrow fiscal space for proactive industrial policies. Increasing Palestinian imports from and through Jordan, which are not subject to clearance revenues, is limited by the Paris Protocol, which governs the economic relations between the PNA and Israel, and is contingent on Israeli cooperation. Tax reform may increase locally collected tax marginally, but it cannot be expected to decrease the PNA dependence on revenue clearance significantly.

Since wages account for a large share of PNA expenditures, sustained fiscal consolidation through reducing PNA employment and public wage freeze is an available avenue to decrease the vulnerability of the PNA budget to clearance revenues suspensions. The pursuit of such an option carries its own serious risks, including the macroeconomic impact of reduced aggregate demand and the social effects of cutting public employment. However, the share of PNA employees of total employed in the West Bank and the Gaza Strip is high, so (at least) zero public job growth can be achieved without major disruptions to public services, and PNA commitment to that goal should be upheld. The PNA budget deficits have not caused significant disruptions to the Palestinian banking system so far. The PNA has continued to receive adequate assistance from donors to help it limit the need for additional bank credit. The Palestinian public has maintained its confidence in the domestic banking system, even during clearance revenues suspensions. International pressure has played an important role until now in ending suspensions, and donors have increased their financial assistance during suspensions, limiting PNA bank borrowing.

Nevertheless, in an environment of increased vulnerability of the PNA budget and the domestic banking system to future suspensions, public confidence in the Palestinian banking system may be weakened, and a bank panic cannot be ruled out. The Palestinian deposit insurance system is not in a financial position (USD 75.3 million in total assets at the end of 2016) to withstand a run on banks, while the financial resources of the PNA are too limited to deal with the economic instability it would cause, especially under circumstances of a clearance revenues suspension. The PNA should raise this issue with the international community to highlight the possible consequences of future clearance revenues suspensions, and the PMA could initiate discussions with the IMF and donors to identify a source of international credit line that could be resorted to in order to stabilize the Palestinian banking system in a crisis scenario.

Meanwhile, the PMA should pursue discussions with the MoF on the need to limit PNA bank borrowing, especially in periods of calm, when there is no clearance revenues suspension. The PMA needs a clear and public commitment from the MoF to limit the PNA net liability to commercial bank total capital and to put in place bank regulations and other best international practices that reflect that need. The PMA should also consider monitoring bank lending to PNA employees to ensure that it does not reach excessive proportions and that banks can withstand the stress of reduced reimbursements in times of crisis.

3.2 Government Debt and Bank Lending in Developing Countries

Undoubtedly, government securities provide an efficient mechanism for financing budget deficits in many countries with independent macroeconomic policies. If properly designed, they can make the government more fiscally disciplined, deepen the domestic financial system, and provide policy-makers with important tools for conducting monetary and foreign exchange policies. Financing budget deficits through government securities increases fiscal discipline if government securities are issued through a transparent market driven mechanism. A public debt program can facilitate the deepening of the domestic financial market by creating some of the necessary infrastructure for a corporate bond market and providing benchmarks for pricing corporate bonds and other financial instruments. An efficient public debt market increases the effectiveness of monetary policies by strengthening its transmission mechanisms and providing policy-makers (through the public debt's yield curve) with information about market expectations regarding future macroeconomic developments⁷. Policy-makers can use the public debt market to minimize the impact of capital flows on the domestic currency's foreign exchange rates.⁸

An efficient public debt program lets market forces determine prices and yield for government securities with a wide range of maturities. The resulting yield curve enables financial markets to set interest rates for corporate bonds and other financial instruments with comparable securities by adding a risk and liquidity premium to yields on corresponding government securities that reflect differences in risk and liquidity. The importance of public debt benchmarks to pricing private sector financial instrument has convinced Singapore to float new issues of government securities even when it had no need to borrow (Valle, 2001). That has also been the case in Hong Kong, where funds generated by issuing government securities are often invested abroad (Herring, 2000).

The legal and regulatory infrastructure of a public debt program has to be in place before a government starts issuing securities, and setting up the required infrastructure has a substantial fixed cost. The infrastructure should include a registry for recording ownership and a settlement system to process the delivery and payment needed for security transactions. As a secondary market for government securities develops, a network of security dealers, brokers, and analysts will have to be created.

Macroeconomic stability is a necessary condition for a successful public debt program. To generate demand for its securities, the government should convince potential buyers that it can make principal and interest payments on its securities in a timely fashion. If the government is to extend the maturity of its securities beyond the short term, it must create a stable price and foreign exchange environment.⁹ If government securities are to be effective as benchmarks for pricing other financial instruments, they should be priced through a transparent competitive bidding mechanism. To provide timely price signals that reflect changes in market conditions, government securities are issued periodically, and new issues are spread throughout the year. This requires that the issuing government authorities provide market participants with periodic and reasonably accurate forecasts about the size and timing of their borrowing needs.

Early on, a government security program is typically limited to money market instruments (maturity of less than a year). Longer maturities are not usually issued until the market for short-term maturities is well established. Extending the maturities of a new government security program is usually made gradually, often starting with adjustable-rate medium-term instruments. This means that it may take a new government security program a long period of time to produce a yield curve that guides the pricing of private sector financial instruments. In Hungary, for example, it took eight years to extend

⁷ The slope of the yield curve provides important information about market expectations regarding future interest rates. A steep positive yield curve, for example, indicates a significant increase in market interest rates in the future.

⁸ A central bank can sterilize the impact of capital inflows on foreign exchange rates by buying government securities.

⁹ Inflation increases market interest rates, reducing the prices of government securities on the secondary market. Such price decrease is higher for longer maturities. Unstable foreign exchange rates discourage foreign investment in the government securities market.

the maturity of the government security program beyond one year (Arvai, 2008). To establish credibility for its yield curve, a successful government security program focuses its efforts on a few spread-out maturities (1, 3, 4, 5, 10 years, for example) and offers new issues of these maturities frequently. The existence of a liquid secondary market plays an important role in enabling a government security program to issue medium- and long-term securities because it helps create confidence in the program by providing an exit mechanism, and lowers the liquidity premium for medium- and long-term securities (Arvai, 2008).

A broad investor base and an active money market are essential to the emergence of a liquid secondary security market. Institutional investors (such as pension funds, life insurance companies, and mutual funds) make up key components of the investor base of a security market. In countries that do not have a significant presence of institutional investors, most of the stocks of government securities are held by the domestic banking system, and trading in government securities is limited.¹⁰ Of government securities issued by members of the West African Union, for example, 75% are held by commercial banks (Diouf and Boutin-Dufresne, 2012). An active inter-bank market is the backbone of money markets in developing countries. An interbank market is likely to develop if commercial banks have the incentive to manage their liquidity actively. Monetary authorities can encourage interbank lending by avoiding steep penalties for bank failure to meet reserve requirement and by extending the period used for required reserve averaging (Valle, 2001).

3.3 Feasibility of Issuing PNA Securities

Unlike the options available to most developing countries, issuing government securities to finance the PNA budget deficits does not appear to be a realistic option under the current conditions. The feasibility of successfully issuing government securities was shown above to be contingent upon the ability of the issuing government to make its debt and interest payments on these securities in a timely manner. This in turn requires a stable tax base and a steady flow of tax revenues. The PNA obviously cannot meet the financial obligations of government securities during clearance revenues suspensions since clearance revenues account for two thirds of PNA revenues. In fact, the PNA may not be able to meet the financial obligations of a government securities program even if a clearance revenues suspension is not in effect, due to closures and other arbitrary Israeli restrictions. Additionally, the West Bank and the Gaza Strip economy does not currently have the necessary investor base for a government debt program or a significant presence of institutional investors. Apart from the government provident fund, which is managed directly by the PNA, private pension funds are few, and their assets are still limited, despite recent positive developments in the social security sector (Hamed, 1997; Jamil, 2016). In the absence of a significant life insurance market in the West Bank and the Gaza Strip, Palestinian insurance companies sell mostly health and automobile insurance products, which do not generate long-term investable funds. There are no mutual funds in the West Bank and the Gaza Strip. In this environment, the only potential buyers of government securities are commercial banks. The PNA could hypothetically induce banks to buy its securities through moral suasion or political pressure. In fact, moral persuasion and/or political pressure have probably played a role in bank's decisions regarding PNA credit requests, especially during clearance revenues suspensions.

Based on the large proportion of overdraft facilities in the PNA bank credit (54.4% at the end of 2015), it seems that commercial banks are reluctant to extend long-term loans to the PNA. Hence, if the PNA is to issue securities to finance its deficit, the maturities of these securities are unlikely to exceed one year. This means that a PNA security program is unlikely to produce a yield curve, which in other developing countries has been helpful in developing financial markets. Under these circumstances, it is difficult to justify the substantial fixed cost of a government securities program. Trading in PNA-issued securities would be thin because the interbank market in the West Bank and the Gaza Strip is very narrow due to excess liquidity and the major role played by foreign chartered

¹⁰ In some countries, commercial banks are required to have a minimum liquidity ratio and to hold government securities as part of their liquidity requirement.

banks (with access to liquidity from head offices) in the domestic banking system. Such a thin PNA security market would probably feature wide fluctuations in security prices and yields, which would be particularly high during clearance revenues suspensions, when the volume of new issues would be expected to rise sharply. This means that a PNA security program could increase financial instability in Palestine and entail new disruptions in the domestic economy.

The recent issuance of promissory notes by the PNA Treasury (MAS, 2017) has been relatively successful, though small and short-term and not likely to cause major disruptions to the banking system in the way in which a full-fledged program would. The PNA promissory notes program is still limited (USD 100 million), and there is no evidence so far that commercial banks are directly involved in it. Indeed, if the program were to be expanded and commercial banks start discounting its notes, the PNA promissory notes program may unintentionally become a source of instability in the Palestinian banking system.

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Appendix
Table 1: Gross Assets and Liabilities of Banks Operating in Palestine (USD million)

Assets	2016								2016	2015	2014	2013
	M12	M11	M10	M9	M8	M7	M6	M5				
Balances with the PMA	1,305.7	1,189.5	1,166.9	1,212.4	1,157.4	1,196.4	1,237.0	1,200.1	1,305.7	1,134.1	1,041.5	996.6
Balances with Banks in Palestine	340.3	395.2	323.3	364.7	303.4	271.5	327.7	290.9	340.3	365.6	509.8	452.6
Foreign Assets	4,564.9	4,705.6	4,705.6	4,640.6	4,521.8	4,530.8	4,481.8	4,499.5	4,564.9	4,361.4	4,439.5	4,467.8
Portfolio Investment	851.5	844.3	882.6	887.9	893.7	815.6	809.8	803.7	851.5	861.4	894.3	766.7
Balances with Banks Abroad	2,633.0	2,477.5	2,387.2	2,478.2	2,353.7	2,501.8	2,553.2	2,348.0	2,633.0	2,370.6	2,839.8	2,681.1
Credit Facilities (Non-Residents)	65.5	66.1	48.1	47.9	48.7	50.3	21.0	23.6	65.5	19.2	24.1	36.5
Cash	991.2	1,293.3	1,364.7	1,204.4	1,202.3	1,140.2	1,074.2	1,300.7	991.2	1,083.2	658.5	956.0
Investments	23.8	24.3	23.0	22.3	23.5	22.9	23.7	23.5	23.8	27.0	22.9	27.6
Credit Facilities (Resident Customers Only)	6,806.4	6,578.1	6,515.1	6,618.3	6,557.9	6,407.1	6,383.9	6,311.8	6,806.4	5,805.4	4,871.0	4,443.6
Palestinian National Authority	1,416.4	1,369.3	1,341.7	1,472.3	1,453.3	1,397.6	1,436.0	1,404.2	1,416.4	1,455.0	1,239.1	1,372.2
Public Sector and Local Authority	2.4	2.1	2.6	3.3	2.1	2.0	2.1	2.8	2.4	1.1	0.7	1.0
Other Resident Customers	5,387.7	5,206.7	5,170.8	5,142.7	5,102.6	5,007.5	4,945.7	4,904.8	5,387.7	4,349.3	3,631.2	3,070.3
Bankers Acceptances and Bills Discounted	4.8	6.0	4.3	5.7	4.6	4.7	5.1	4.7	4.8	4.1	6.0	7.6
Portfolio and Investments	337.0	348.5	333.8	344.3	361.1	334.4	311.5	289.4	337.0	229.8	213.5	217.8
Certificates of Deposits Issued by Banks in Palestine	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0
Government Bills and Bonds	45.9	58.0	45.1	55.6	85.6	61.5	43.0	25.9	45.9	0.0	0.0	0.0
Securities	109.7	109.7	109.7	107.7	94.7	90.2	90.2	90.2	109.7	91.2	91.2	90.2
Investments	181.4	180.7	179.0	181.0	180.8	182.7	178.3	173.3	181.4	138.5	122.2	127.6
Other Assets	837.2	912.5	844.9	882.6	836.0	900.2	852.6	810.7	837.2	701.9	734.1	604.7
Total Assets and Liabilities	14,196.4	14,135.4	13,893.9	14,068.6	13,742.3	13,645.2	13,599.6	13,407.0	14,196.4	12,602.3	11,815.4	11,190.7
Balances of the PMA	644.5	572.1	539.3	587.4	541.7	562.1	548.1	527.4	644.5	299.2	134.6	189.5
Balances of Banks Operating in Palestine	335.3	385.3	310.1	334.7	309.7	285.8	323.0	301.1	335.3	367.5	499.9	445.4

Assets	2016								2016	2015	2014	2013
	M12	M11	M10	M9	M8	M7	M6	M5				
Deposits of Residents	10,268.2	10,073.9	10,067.8	10,081.9	10,038.1	9,981.1	9,879.8	9,715.7	10,268.2	9,309.9	8,625.8	8,022.3
Palestinian National Authority	525.2	467.7	481.4	447.3	511.6	526.9	514.4	514.1	525.2	487.6	612.3	531.3
Public Sector and Local Authority	148.2	154.3	152.0	160.9	163.6	167.5	164.3	166.5	148.2	168.2	172.9	145.6
Resident Customers	9,594.7	9,451.9	9,434.4	9,473.6	9,362.9	9,286.7	9,201.1	9,035.1	9,594.7	8,654.1	7,840.6	7,345.4
Foreign Liabilities	496.3	666.3	603.4	580.8	549.5	558.5	555.6	581.3	496.3	530.0	402.3	546.7
Deposits of Nonresidents	336.4	336.4	339.8	350.7	334.0	334.8	322.8	347.5	336.4	344.7	308.7	281.4
Deposits of Banks Operating Abroad	159.9	329.9	263.6	230.0	215.5	223.7	232.7	233.8	159.9	185.4	93.6	265.3
Capital	1,682.4	1,650.4	1,636.0	1,623.7	1,552.3	1,535.2	1,495.2	1,454.2	1,682.4	1,461.7	1,464.0	1,359.9
Paid up Capital	1,071.8	1,061.8	1,061.8	1,059.5	1,004.5	1,004.5	984.1	979.1	1,071.8	961.3	976.0	928.1
Legal Reserve	165.8	150.3	150.3	150.3	151.6	151.6	151.7	151.8	165.8	151.8	138.0	123.2
Other Reserves and Allowances	230.5	206.5	203.3	206.5	206.7	204.6	206.7	197.9	230.5	198.0	171.9	168.3
Other	214.3	231.8	220.7	207.5	189.5	174.5	152.7	125.5	214.3	150.6	178.2	140.3
Provision and Depreciation	498.2	510.9	497.8	500.4	493.3	491.5	468.8	473.9	498.2	451.2	429.7	460.0
Other Liabilities	271.5	276.6	239.4	359.9	257.7	230.9	329.2	353.3	271.5	182.8	258.9	166.9