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The Impact of Achieving the Objectives of the Overall Safety Policy on Economic Development in Palestine

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INTRODUCTION

The primary objective of macro prudential policy is to contain systemic risks or large-scale financial instability[1]. Therefore, the systemic risk can definition will be as "the risk that financial instability will spread on a large scale and lead to impeding the functioning of the financial system to an extent that affects growth and welfare."

Achieving overall safety in the financial sector of any country may conflict in one way or another with the goals of economic development, or as a least, it might contradict some of those goals in that country. Macro prudential efforts to mitigate systemic risks include a series of policy interventions in the financial and credit markets, as well as a variety of countercyclical stabilization techniques designed to influence price formation, credit flows, and direct investment from the domestic economy to other regions outside this economy. Adequately tested so far.

The IMF survey of countries' practices in this area shows that a number of countries have used some macro safety tools to address systemic risks at specific times.

The recent global financial crisis has prompted more countries to use such tools, with an increasing focus on rapid asset growth and the accumulation of advantage. The application of such instruments will work as a financial ceiling. These instruments like the value-to-loan (LTV) and debt-to-income (DTI), aim to combat property booms, capping credit growth, reserve requirements, and dynamic provisions. However, the effectiveness of such instruments does not appear to depend on the stage of economic development, or the type of exchange rate indicates that safety tools. Therefore, the instruments are set to be useful in a wide range of countries, as the opposite of the Palestinian economy that lacks the tools of monetary policy and exchange rate policies, it is expected that the benefit from the application of such policies will be greater.

Nowadays, a visible contradiction occurs while implementing fiscal and monetary policies in any economy, which can directly diminish the scale of their effectiveness. This requires a strong coordination between the makers of these policies to avoid possible contradictions, as it has become a necessity to extend coordination to include tools of overall safety. In other words, macro prudential regulation, or macro-safety policies, has become a third arm of economic policy along with traditional fiscal policies and monetary policy tools (Jones, 2011).

The development of an effective overall safety policy framework requires the identification and development of a set of policy tools and operational guidelines for their use. These principles and guidelines should include effective mechanisms for resolving coordination and compliance problems. There are some inconsistencies when using these tools at the micro and macro level. Therefore, mechanisms must be developed, to ensure consistency among them, as there is still no comprehensive nor an agreed theoretical framework. It is too early to select and calibrate a specific set of macro prudential policy tools.

There is a wide range of policy tools available in this area, which include:

- Tools to address risks to financial stability arising from excessive credit expansion and increasing asset prices, including but not limited to, dynamic capital reserve, dynamic provisioning, loan-to-value (LTV), and debt-to-income (DTI)
- Tools to address the mechanisms of systemic risk amplification associated with financial advantage, such as capital instruments.
- Tools to mitigate structural weaknesses in the system and reduce systemic repercussions in times of stress.

The framework is also an important supporting tool, along with the infrastructure and modern payment and settlement systems.

[1] European Central Bank

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PURPOSE OF THE STUDY

The subject of the study is one of the recent developments that have begun to appear in the past few years, or even less, as indicated by some literary references included in the study, some of which date back to the current year 2021.

The issue of the potential contradiction between macro safety policies, economic development, and discussions on this subject are still in their infancy, and this is mainly because total safety policies are relatively recent in application. Since they began to be adopted after the global financial crisis in 2008, and it is still difficult to ascertain of its effects on economic growth, especially in the end. Prior to the global crisis, these policies were unknown except for some small-scale applications in a few countries, such as dynamic provisions in Spain, some capital requirements in India, and loan-to-value ratio in South Korea.

From this point of view, this study aims to examine the contradictions existing in the Palestinian economy, between the application of the requirements of total safety in the Palestinian banking sector and the objectives of local economic development. It also seeks to suggest some possible ways to overcome the points of contradiction between these goals or at least reduce their severity, if any. To this end, the study reviews a group of research papers in this field within the literary review section, as well as some practical applications and experiences of some countries in order to benefit from them if possible.

LITERATURE REVIEW

Macro-safety policies are designed to mitigate the effects of financial and economic crises, but at the same time, they may affect economic growth.

Long before the term macro-safety was coined, macro prudential policies main usage was to address financial stability concerns, particularly in emerging market economies. The interest in them has increased significantly in recent years during and after the major global financial crisis (2007-2009), but even today, there is still debate about understanding these policies and their macroeconomic effects. For example, while the motive behind the use of macro prudential policies is to contain or mitigate systemic risks and thus contribute to macroeconomic stability, these policies may harm economic activity and growth by affecting the volume of credit and investment. (IMF-FSB-BIS) 2016), Galati and Moessner (2017)), (Sanchez and Rohn (2016))

Of course, judging the effectiveness of precautionary policies or macro safety policies remains a difficult task to achieve, as it was found in the basis to reduce and mitigate the effects of severe financial crises, which are characterized by two important characteristics:

1. The slow relative recurrence of major financial crises.
2. The difficulty of linking these crises to a specific cause or even to a specific set of causes.

Therefore, there is a wide consensus that evaluating the effectiveness of precautionary policies is through evaluating their effects on economic growth and the fluctuations of the economy in the long term.

In order to empirically investigate the extent of cooperation between total safety policies and economic performance, with the help of data collected from 64 countries divided between developed and emerging, the data was measured by production and growth fluctuations over a period of five years. The researches and studies of a wide range of specialists concluded similar results, which can be summarized as follows: the following:

1. That the more a country uses macro-safety policies, the per capita GDP growth rate tends to rise in that country, as well as the volatility in GDP growth will become less severe. However, there are no enough evidences found to date that non-use of Total safety policies lead to a decline in the per capita share and more severe fluctuations in the growth of the gross domestic product. (No tradeoff)
2. The good effects of the overall safety policies related to the growth and fluctuations of the domestic product depend on the degree of economic openness and the degree of financial development. For economies that are, economically open, or financially sophisticated (but not both) macro prudential policies tend to be less effective. As for economies that enjoy both elements (openness and development), macro prudential measures are highly effective.
3. As found that irregular macroprudential interventions usually hinder economic growth.

(Pierre-Richard Agenor, Yavuz Arslan, Claudio Borio, Stijn Claessens, Benjamin Cohen, Dietrich Domanski, Mathias Drehmann, Ingo Fender, Enisse Kharroubi, Hyun Song Shin, Nikola Tarashev and Kostas).

The adoption of macroprudential policies around the world in the past few years has led to an ongoing debate about the effects of these policies and their interaction with existing conventional monetary policies.

Possible impact channels of macro-safety policies on growth and production

Macro prudential policies are usually designed to increase flexibility in the financial system and reduce systemic risks arising from financial intermediation. As argued that macro-safety policies may succeed in supporting macroeconomic stability,

but at the cost of reining in economic activity and long-term growth. That is, there is a trade-off, and a reciprocal relationship between stability and sustainable prosperity. (Agenor and Silva 2017).

It is necessary to note that the interest in the interrelationship between the tools of total safety and economic growth is still limited until now. This relation is limited to a specific set of these tools, such as the capital buffer to counter cyclical fluctuations, the dynamic allocations of banks, and measuring the short-term impact of these tools on the margins and quantities of lending. There are strong opinions suggesting that, poorly designed overall safety devices will necessarily hamper long-term economic growth (Drehmann and Gambacorta 2012).

On the other hand, in contrast to the effect of poorly designed instruments, macroprudential measures can also boost economic growth. Logically, these tools are designed to increase the flexibility of the financial system and facilitate the financial cycle. In addition, well-designed macroprudential instruments can mitigate the adverse effects of capital flow volatility on economic growth, by encouraging temporary capital accumulations (Neanidis 2017).

From the foregoing, the positive impact of aggregate safety tools on economic growth can be summarized through two channels:

First: macro prudential policies can prevent or at least limit the occurrence of financial crises, which are usually followed by marked declines in economic performance and growth.

Second: In the event that the decline in growth is caused by fluctuations in the macro economy and financial fluctuations, and since macroprudential policies are designed to reduce and address these fluctuations, it is logical to link macro safety tools and policies positively to long-term growth.

The following is a more in-depth explanation of the overlap between the total safety tools and other policies:

- **Total safety policies & monetary policies**

Both macro and monetary safety policies are useful as a countercyclical tool. While monetary policy aims primarily at price stability and economic stability, macro safety tools aim at achieving financial stability. Thus, it becomes possible for the tools of these policies to interact with each other, which may reinforce each other, or vice versa, each of which may reduce the effectiveness of the other. International Monetary Fund (2013).

Even when the policies work perfectly, monetary policy alone cannot be expected to achieve financial stability effectively or efficiently, and that is due to the fact that, stability is not always linked to the level of interest rate or the degree of liquidity in the financial system that monetary policy influences to mitigate the effects of financial distortions. Nor when fiscal imbalances are more severe in some sectors of the economy than in others, monetary policy becomes less effective.

On the other hand, the use of macroprudential policies to manage aggregate demand may lead to additional distortions by imposing restrictions beyond where financial instability originates. For example, limiting the growth of public credit can often be very harmful to economic growth. Thus, when both policies are available, it is advisable to maintain the primary focus of monetary policy on price stability and macroprudential policies on financial stability.

Nevertheless, monetary policy affects financial stability through:

- Affect advantage and short-term or foreign currency borrowing. Dell'Ariccia & Marquez (2013).
- By influencing asset prices, relevant external factors, and advantage cycles.

Similarly, macroprudential policies can affect GDP through the processes of regulating the amount of credit in the economy.

It is well established that when macroprudential or monetary policies work incompletely, which is the prevailing situation in general, but to varying degrees from one country to another in the real world, it is expected that the results of these policies will not be perfect and accurate in achieving the desired objectives. On the one hand, there are problems of inconsistency and timing, in addition to political and stakes.

(Curdia & Woodford 2009, Carlstrom & Fuerst 2010).

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Total Safety Matrix

The Source of external factors	Determinants and controls related to borrowers	Determinants and controls at the level of the consolidated budgets of financial institution (Assets & Liabilities)	Capital requirements, provisions, additional fees	Taxes and Levies	Others including enterprise infrastructure
Expansion Phase	Limits on borrowing rules (DTI, LTI, LTV)	Limits and controls on mismatches (In foreign currencies, interest rate) mandatory reserve	Countercyclical capital buffers, leverage control, and dynamic provisions	Taxes or levy on specific assets and/or liabilities	Accounting systems, change in compensation, market discipline, governance
Deflation Phase	Adjustments to specific loan	Provisions and criteria control on liquidity (NSFR, LCR)	Countercyclical capital buffer, dynamic provisions	Taxes or levies on non-core liabilities	Standardized products Safety net (central bank, treasury, liquidity, quantitative support)
The shock of contagion from systemically important institutions	Different determinants on the components of assets and activities. (Vicker, Volckers)	Specific institutional controls for bilateral financial exposures.	Additional fees and capital requirements related to the existing systemic risk	axes, different levies according to external source	Institutional infrastructure. (resolutions, various information)

Blue: relieve the cycle, yellow: enhance flexibility, green: dispel the load from the cycle

The status quo in Palestine and the contradictions

The absence of the national currency in the Palestinian economy is one of the distinguishing features of this economy, as the absence of the national currency necessarily led to the loss or weakness of monetary policy tools in this economy.

Macroeconomic indicators in Palestine for the period 2018-2020[2]

	2016	2017	2018	2019	2020
GDP Growth	10.3%	4.7%	0.9%	4.8%	-8.5%
Unemployment rate	26.9%	25.7%	26.2%	24.0%	27.8%
Inflation Rate	-0.2%	0.2%	-0.2%	1.6%	0.5%
Public Debt/ GDP	16.1%	15.8%	14.6%	16.4%	23.5%
Current Account/ GDP	-13.9%	-13.2%	-13.2%	-10.7%	-9.3%
Customer Deposit Growth	9.5%	13.0%	2.1%	9.5%	13.1%
Credit Growth	27.0%	17.9%	8.6%	5.1%	11.5%

Source: Palestinian Monetary Authority data, Palestinian Central Bureau of Statistics, World Bank reports

- **World Bank Estimation:**

The high unemployment rate in the Palestinian economy is one of the main problems facing this economy, and it is noticeable that the unemployment rate is not affected by the growth rates in the gross domestic product. Logically, we assume that

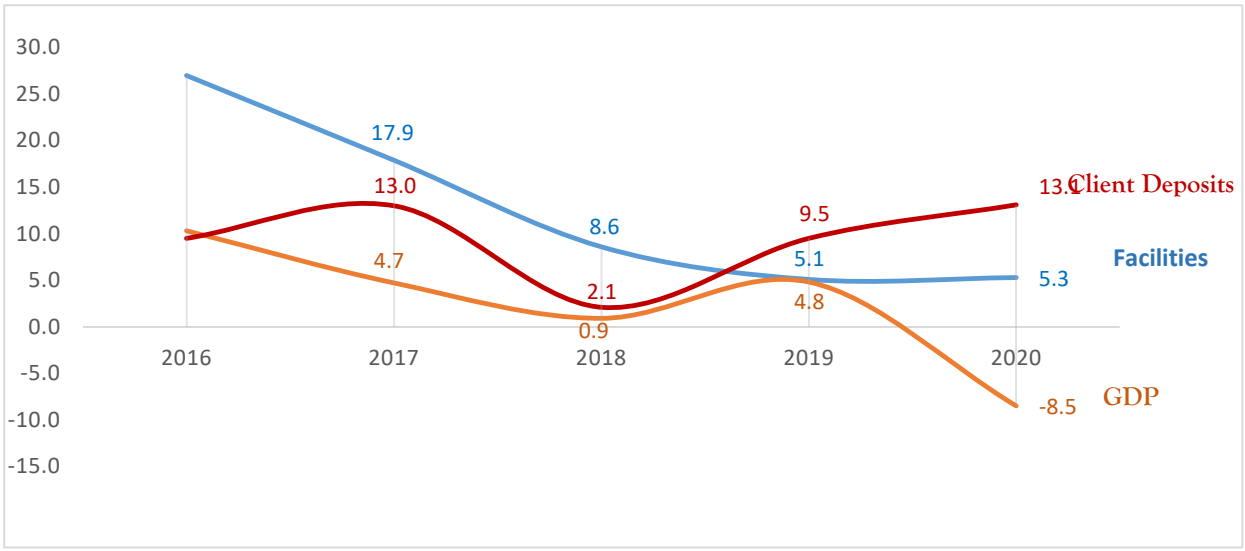
[2] Some of the Monetary Authority's data attributed to the GDP are still preliminary data

unemployment rates will decline during periods of high growth and vice versa. However, this reciprocal relationship between output growth and unemployment are not visible in the Palestinian economy, and the reason for this may be due to the fact that, the growth in the gross domestic product comes from growth in the West Bank, while the high unemployment rate comes from the Gaza Strip. It can also be due to the presence of a percentage of the Palestinian labor force working in Israel or that the shadow economy constitutes not a small percentage of the Palestinian economy.

Regardless of the reason for this, it is natural that fighting high unemployment rates requires investment growth and high production growth rates. It is also noted that there is a continuous growth from year to year in customer deposits in the Palestinian banking sector. Palestinian economy.

In addition to the above, there is a structural deficit in the Palestinian current account, which averaged about 12% of the GDP during the past five years. Also, the government public debt amounted to about 23.5% of GDP at the end of 2020, up from about 16.4% at the end of 2019.

Figure (1): Quarterly growth of customer deposits, private sector facilities and GDP for the period 2016- 2020



Source: Statistical Bulletin - Palestinian Monetary Authority, Palestinian Central Bureau of Statistics

The previous figure indicates a near-continuous fluctuation in the growth rates of customer deposits and credit facilities provided to the Palestinian private sector, as well as in the growth of GDP. It is also noted that the recorded growth rates are usually positive, especially on an annual basis, but they are remarkably volatile, with the exception of the growth The gross domestic product for the year 2020, which recorded a negative rate, is an exceptional year at the level of the world as a whole.

The growth rates recorded for both customer deposits and private sector facilities indicate a lack of consistency in the growth rates of these two variables, noting that the fluctuation in the growth of facilities provided to the private sector is less severe compared to the fluctuations in the growth of customer deposits. It is natural that the facilities are subject and affected by the policies set, whether at the individual level of banks, or at the overall level through the instructions of the Palestinian Monetary Authority, while deposits remain outside the control or influence of these policies.

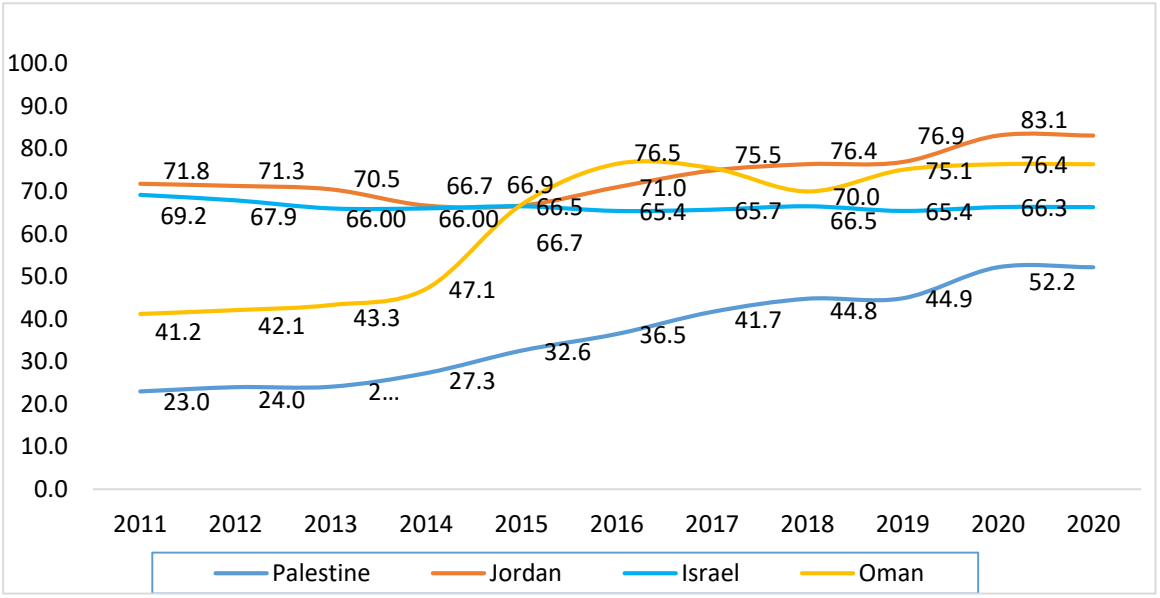
Financial depth

The ratio of credit provided to the private sector to GDP

This indicator can also be used as another function of the equilibrium point that can be reached for the value of credit in the Palestinian economy.

The collected data from the International Monetary Fund and the World Bank indicates that, the ratio of credit provided to the private sector to GDP at the global level reached about 148% at the end of the year 2020. Once compared, we can see that it was about 132% at the end of the previous year, and in the group of Arab countries, this ratio in Qatar reached about 137% as the highest Arab country, while in Sudan, it reached about 8%, as the lowest among the Arab countries. It is noteworthy that the increase in the global percentage is due to the increase in this percentage in the United States, where it reached about 216% at the end of the year 2020.

➢ **Figure (2): Credit provided to the private sector in a group of countries for the period 2011-2020**



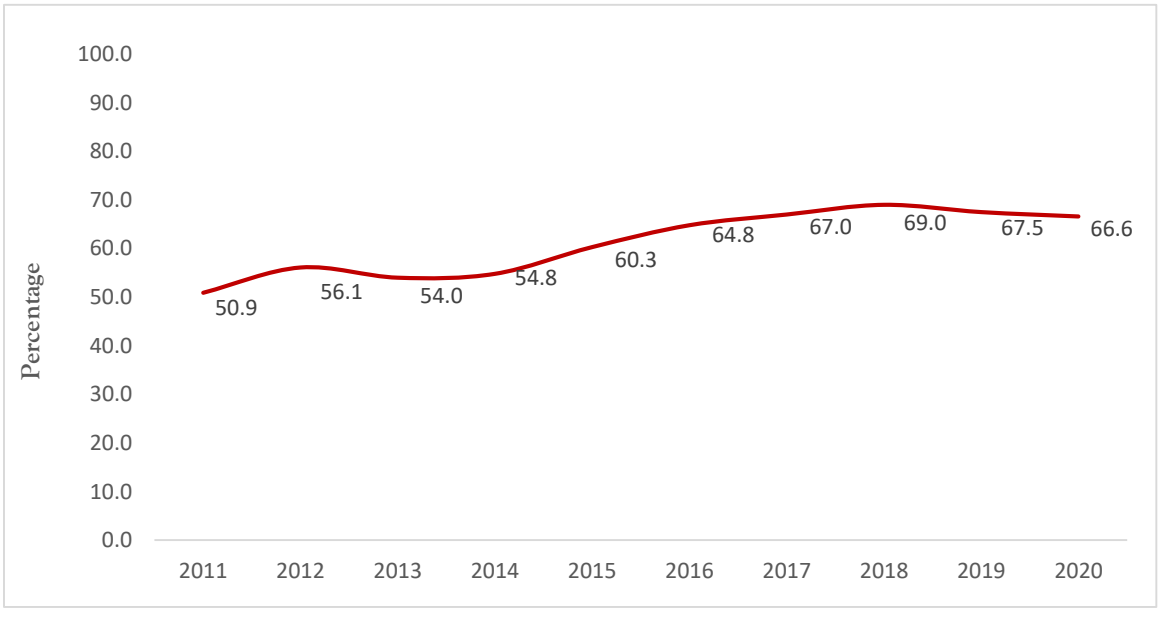
Source: worldbank.org/indicator/FS.AST.PRVT.GD.ZS

In Palestine, the ratio of credit provided to the Palestinian private sector to the nominal GDP at the end of 2020 was about 52.2%, up from 44.9% at the end of the previous year. Historical data for the development of this indicator indicates an upward trend in it from year to year, as this percentage was at 23%, said ten years ago, and was below this percentage before that.

The available World Bank data on this percentage in the group of Middle East and North African countries indicates that, it amounted to the total of the countries of this group about 61.2% at the end of the year 2020. This indicates that there is room to raise this percentage in Palestine by 10 percentage points to become around the average of countries the group, which means that the Palestinian private sector has been deprived of about $150 million in facilities that are supposed to be available from the Palestinian banking sector for the year 2020 only. It is noteworthy here that the amount of facilities obtained by the Palestinian private sector during the year 2020 amounted to about 396 million dollars, while it could have reached about 446 million dollars. Credit to customer deposit ratio

This percentage in the Palestinian banking sector at the end of the year 2020 amounted to about 66.5%, declining from about 67.5% at the end of the previous year. Figure (3) shows the historical development of this percentage.

➢ **Figure 3: Credit ratio in the Palestinian banking sector for the period 2011-2020:**

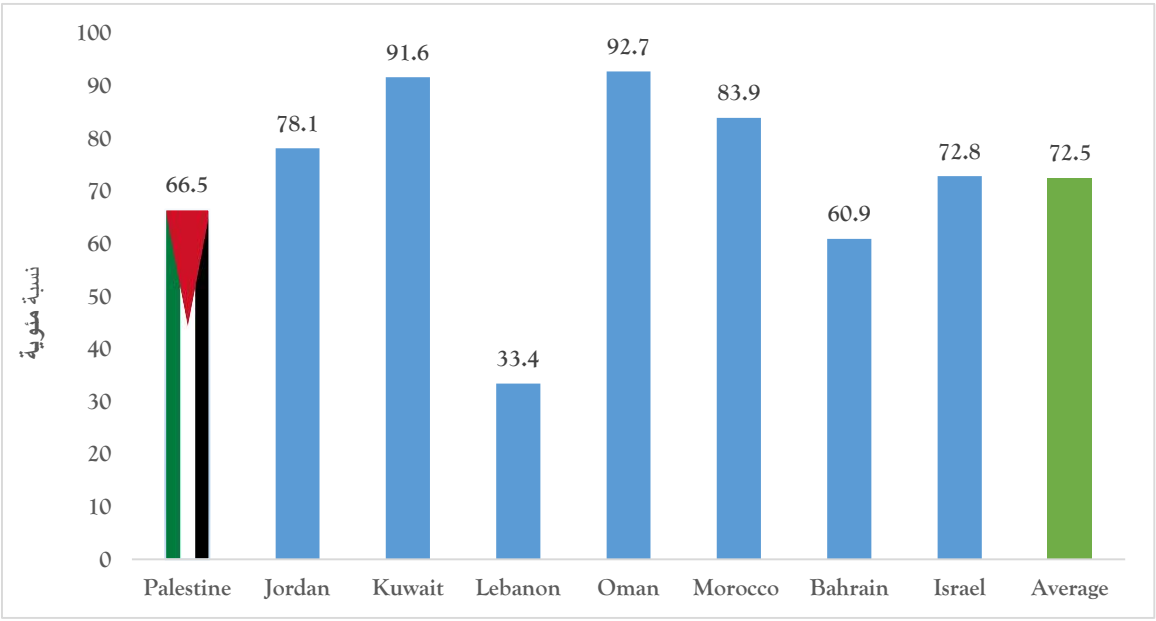


Source: Palestinian Monetary Authority data

This ratio is considered one of the ratios that may bear a contradiction between the requirements of overall safety and the requirements of economic growth. On the one hand, the necessities of overall safety require keeping this ratio relatively low at certain limits to preserve the safety of the banking sector and depositors' money and reduce banking default rates. In contrast, the requirements of Economic growth and the increase in production push the direction of raising this percentage to the maximum possible extent.

In the absence of a clear international standard on this ratio, and with the aim of finding a possible equilibrium point for the credit ratio in the Palestinian-banking sector, the average of this ratio in the group of neighboring countries may be a good and acceptable indicator in this field.

- **Figure 4: The ratio of credit facilities to customer deposits in a group of countries at the end of the year**



Source: ceicdata

In a group of countries in the region and neighboring countries, this percentage ranged between 33.4% in Lebanon and 92.7% in the Sultanate of Oman, while the average percentage in the countries mentioned in the previous figure was about 72.5%. This means that the percentage in the Palestinian economy is less than the indicated rate by about 6 percentage points, which means that the Palestinian economy in general, and the private sector in particular, has been cumulatively deprived of about $1.37 billion of facilities until the end of 2020.

Although raising the ratio of facilities to customer deposits will increase risks and require more capital for banks to face these risks, the economic benefits on the other side, both in terms of economic growth as well as in terms of raising the profitability of banks because of increasing facilities, require bearing those risks.

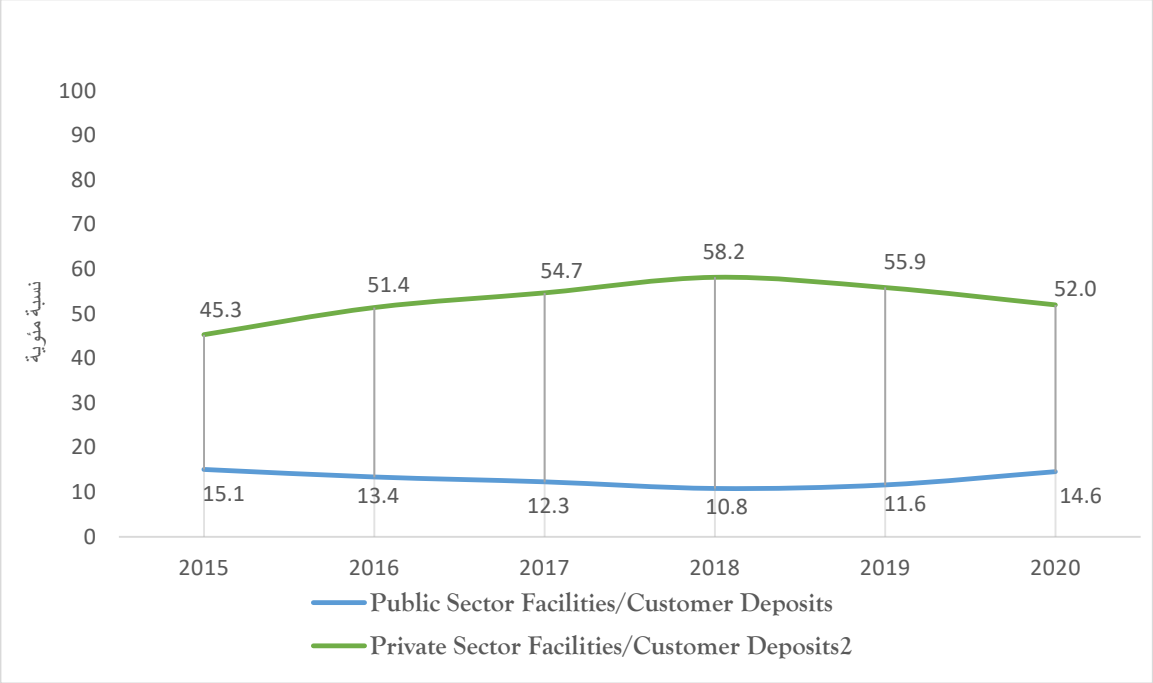
However, the capital adequacy ratio for all banks in Palestine reached about 15.75% at the end of the year 2020, which is higher than the international requirements for sufficiency ratios, as well as higher than the local requirements for sufficiency ratios, which means that there is a margin to increase the credit facilities ratio.

Crowding out the public sector for the private sector

The Palestinian public sector depends to varying degrees from time to time on the Palestinian banking sector to finance part of its expenditures according to the economic and political situation prevailing in the Palestinian territories.

The value of the facilities provided to the Palestinian public sector until the end of the year 2020 amounted to about $2.2 billion, constituting 21.9% of the total facilities, and about 14.6% of customer deposits. When the private sector facilities are added, the percentage of facilities to customer deposits becomes 66.6%, as explained previously.

➢ **Figure (5): Facilities from the public and private sectors out of the total facilities for the period 2015-2020**



The previous figure (5) suggests that there is a phenomenon of crowding out of public sector facilities with the facilities of the private sector in the Palestinian economy, where there is a reciprocity in the ratio of each of the two variables (private sector facilities, public sector facilities) to customer deposits over time. As the highest ratio of private sector facilities to customer deposits was matched by the lowest ratio of public sector facilities to customer deposits at (58.2%, 10.8%) in 2018, and vice versa in 2015, when the ratios were (45.3%, 15.1%) and this applies to the rest of the years in the shape.

Here, as noted that the proposed increase in the volume of facilities as a percentage of customer deposits by 6 percentage points to reach 72.5% would be entirely directed to the share of the private sector. This increase can be formed through:

1. Increasing the private sector's share of facilities at the expense of the public sector's share due to the phenomenon of crowding out.
2. The private sector's share of the facilities can be increased by increasing the size of the facilities without compromising the facilities of the public sector, by continuing to reduce the volume of foreign investments.
3. The share of the private sector can be increased from the previous two exporters together. That is, by increasing the volume of facilities and decreasing the public sectors share at the same time.

It is noteworthy here that the Palestinian Monetary Authority had set a ceiling for public sector borrowing from banks operating in Palestine, so that the ceiling would be equal to the total bank ownership rights. The Monetary Authority's data indicate that the value of public sector facilities canceled about 112.1% of banks' equity at the end of 2020, which means that public sector facilities exceeded banks' ownership rights by about $238 million.

Supply and demand for credit facilities

1. Supply side:

Banks operating in Palestine are the main source of credit facilities in Palestine, and therefore they represent the largest part of the supply side of the facilities, while the Palestinian Monetary Authority influences this offer through the instructions it issues to banks in this regard. In the absence of monetary policy tools that affect the volume of credit, the instructions of the Monetary Authority acquire great importance in this field. Especially since these instructions are more likely to be closely related to the tools of total safety, whether derived from international instructions and standards such as allocations, reserve ratios, adequacy ratios and other tools. Overall safety, or those specific to the Palestinian case, such as the ratios of foreign investments, the ratios of government debt, and others.

Moreover, through what was stated in the study regarding the low rates of financial depth in the Palestinian economy compared to the prevailing rate in neighboring countries, which indicates the presence of sources at banks to increase the side of the supply of facilities (foreign investment, public sector facilities, increasing facilities as a percentage of customer deposits).

2. Demand side:

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It is not possible to determine the size of the demand for credit facilities in the Palestinian economy accurately, but it is possible to look at some indicators that may help to know the presence of demand capable of absorbing the supply of credit facilities if this increase in supply is allowed. Among the indicators that indicate the existence of this demand:

- The presence of requests for facilities rejected by the banks.
- An increase in the supply of facilities can create demand for them (Say's law)
- Existence of other sources of facilities other than banks.

It is important to note that, the presence of an unmet demand for loans will necessarily lead to a part of this demand going to other channels, which will revive the phenomenon of shadow banks and moneylenders.

The credit gap in the Palestinian banking sector

One of the results of the global financial crisis in late 2008 was that global institutions concerned with the safety of the financial and banking sectors around the world. Such as the International Monetary Fund, the World Bank, the Basel Committee, the Bank for International Settlements, and other international institutions that intensified the processes of analysis and research, and the development of supervisory and early warning tools. This facilitated the mission to avoid the world from falling back into deep financial crises. The credit gap is one of the emerging indicators in this context.

The credit gap is defined as; the deviation of the growth ratio of bank credit to nominal GDP in the short term (usually a quarter) from the long-term nominal credit growth curve (from the long-term average)[3].

It is one of the indicators approved by the Basel III Committee to monitor the volume of credit granted by banks to the private sector, as international experiences have proven that the significant increase in the growth of credit directed to the private sector contributes to the occurrence of financial crises. The Basel Committee recommended that this deviation should not exceed 2% in the positive direction from the long-term growth curve, while deviation from that curve by any percentage in the negative direction does not constitute a source of risks, even if it reflects a state of atrophy in the volume of facilities provided to the sector. The private sector, or high growth in nominal domestic product, is not accompanied by sufficient and supportive growth in credit facilities directed to the private sector.

The rate of 2% or more, determined by Basel committee as a growth in the private sector facilities gap, indicates the existence of risks from this growth, was determined after realizing that this percentage increased to more than 2% was a common characteristic of most countries that suffered deeply from the financial crisis. This does not necessarily mean that a financial crisis will occur when the gap exceeds 2%, or even that it will not occur when the gap is less than 2%. Rather, this indicator is helpful and complementary to a wide range of other indicators through which the safety of the sector is recognized. banking as a whole.

It is worth noting here that this indicator was not developed after the global financial crisis, but it existed long before the crisis, and it was calculated regularly in some developed countries to guide it in the process of regulating and controlling bank credit. This indicator commonly known in the United Kingdom, but its importance gained additional momentum after the recent global financial crisis, until the Basel Committee adopted it and recommended that countries should calculate it, and considered it one of the obligations that countries must provide when implementing the decisions and recommendations of Basel III.

Later, in late 2013, the International Monetary Fund approved the credit gap index provided to the private sector as one of the financial safety indicators that different countries must calculate and prepare within the list of financial safety indicators.

Gap analysis in the Palestinian banking sector during the past five years

A remarkable increase was observed in the credit gap of the Palestinian banking sector in the second half of the year 2016, as the credit gap recorded 5.92% and 3.82% for the third and fourth quarters of that year, respectively. It seems that the growth in credit facilities that occurred during that period was not matched by an adequate growth in the GDP, which pushed the gap to rise as shown in Figure (6).

Figure (6): The credit gap of the Palestinian private sector for the period from the first quarter 2000 to the fourth quarter 2020[4].

[3] Bank for International Settlements

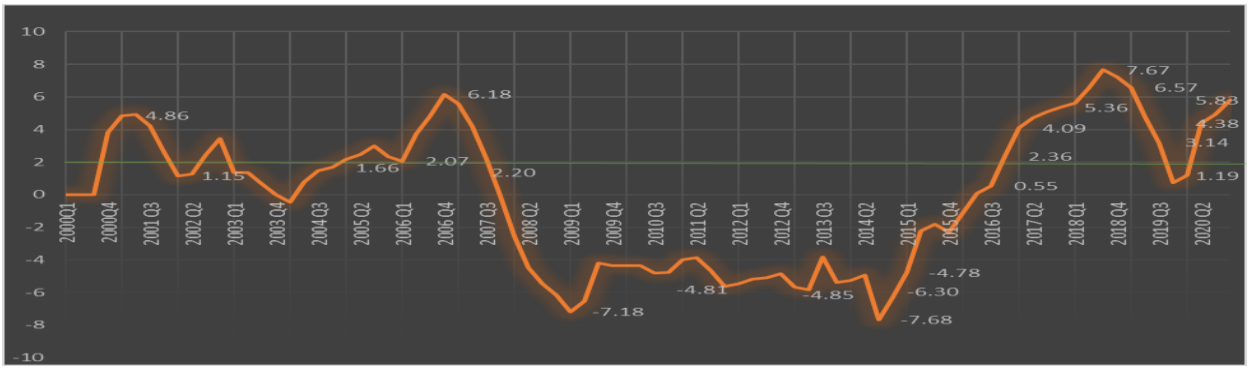
BIS (2010): Guidance for national authorities operating the countercyclical capital buffer

[4] Calculating the percentage of facilities to the sum of the first three quarters of the quarterly GDP in a particular year in addition to the value of the domestic product for the fourth quarter of the previous year.

Draw the general trend curve for the ratio of growth in facilities to nominal GDP using the method:

Hedrick-Prescott Filter with λ = 400,000 Basel III Recommendation.

The credit gap is measured by the difference between the short-term (Q) nominal facility-to-nominal GDP ratio to the long-term curve or trend of that ratio, calculated in the previous step.



The gap continued to rise above the 2% barrier throughout the years 2017 and 2018 because of the continued growth in credit facilities without sufficient growth in nominal GDP, reaching the gap to its highest level in the third quarter of 2018 at 7.67%. After that, it returned to decline until it fell below the 2% barrier in the fourth quarters 2019; the first is 2020, as shown in the previous figure. The relative growth in nominal GDP had a positive impact on the decline of this percentage, in addition to a slight negative growth in credit facilities in that period, where the credit gap ratio amounted to about 0.72%, 1.19% for the last two quarters of 2019 and the first of 2020.

Furthermore, the economic and financial situation suffered at the beginning of the second quarter of 2020, during the peak of worldwide COVID-19 pandemic, and the closures that accompanied to that situation, caused a sharp decline in economic activities and the deterioration of business on both local and global markets. This complication negatively and significantly affected the economic growth of almost all countries. The Palestinian economy was isolated from these developments, as it suffered great losses, in addition to the Israeli side's seizure of Palestinian clearance funds. All of this resulted in a decline in economic growth, which recorded a negative growth of -8.5%, according to estimates by the World Bank.

This decline in growth, led to a rise in the credit gap again, as it initially rose to 4.38% in the second quarter of the year 2020 and continued to rise to reach 5.83% by the end of the year. If it had not been for the relative stability in the growth of credit facilities that fluctuated slightly during the same period, the rise in the gap would be much greater than the level it reached.

The credit gap is one of the strong links between the financial sector and the real sector in the economy, as it links the credit facilities provided to the private sector and the growth in nominal domestic product. It is also directly proportional to the credit facilities and inversely to the growth in nominal GDP (assuming the stability of the other variable), and it is One of the indicators that may bear a clear contradiction between the objectives of overall safety and economic growth. On the one hand, the requirements of overall safety push towards keeping this ratio below the 2% barrier, which means reducing credit facilities when the ratio is above this barrier. On the other hand, stimulating economic growth requires increasing facilities. Credit rating even when this ratio is above the 2% barrier.

This state of contradiction applies to the Palestinian economy in the past few years, where the ratio of the credit gap at the end of the year 2020 reached about 5.83%, at the same time when the nominal GDP recorded a negative growth of about 8.5%. In this case, reducing the gap requires reducing the facilities provided to the sector The Palestinian private sector, while stimulating growth requires increasing those facilities (short term).

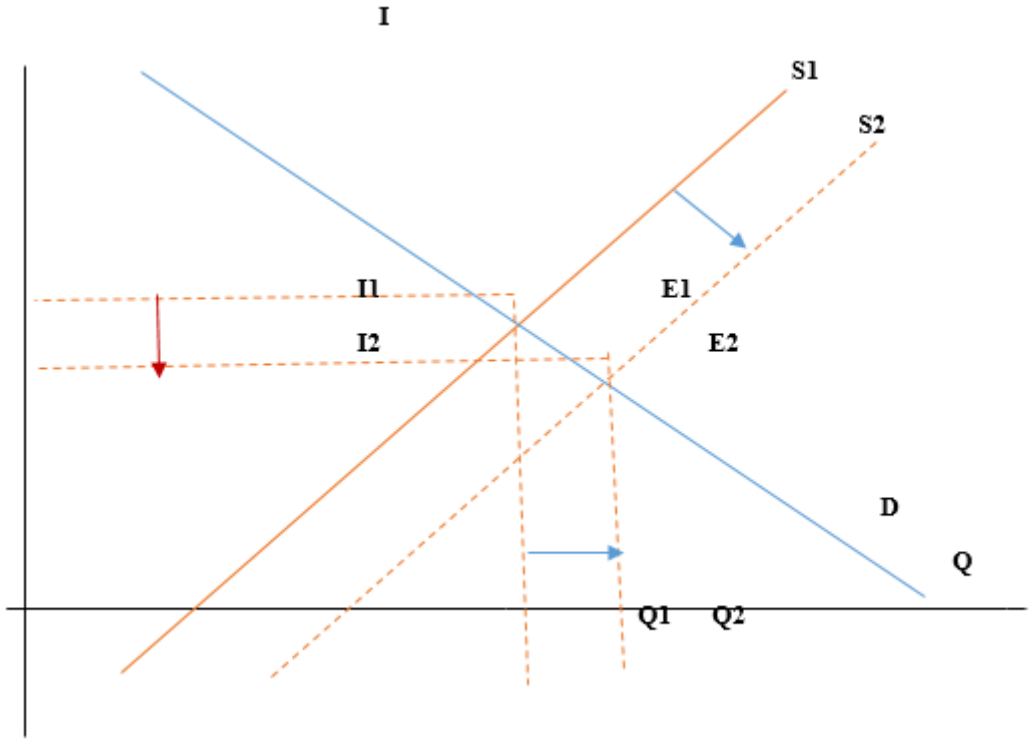
In the medium term, the increase in the facilities could increase the credit gap at first, but the increase in the facilities will positively affect the growth of the GDP, making the gap decrease again. As it is illogical to reduce credit facilities in light of the decline in growth in the GDP, as such a reduction will exacerbate the decline in growth, which in turn will increase the value of the gap, and vice versa.

Increasing the supply of facilities improves growth and competition and makes the market more stable

The interest rates on credit facilities in the Palestinian market are generally considered high, especially when compared to the interest rates in the countries of origin of the currencies used in the Palestinian economy.

Monetary Authority data indicate that the weighted interest rates on the currencies used in Palestine at the end of the year 2020 amounted to 2.62%, 6.84% for deposits and lending, respectively, for the Jordanian dinar, and 2.43%, 5.52% for the US dollar, and 2.23%, 6.88% for the Israeli shekel.

Figure (7): Supply and demand for credit facilities



The previous figure states that, the economy will be in a better position when the facilities available to the economy increase. As moving from the supply curve S1 to the curve S2, due to an increase in the supply of facilities, the result will be a decline in the interest rate from I1 to I2. At the same time, as the value of the required facilities from Q1 increases to Q2, where the equilibrium point moves from E1 to E2, creating a better equilibrium point for the entire economy than the previous point, as it allows an increase in investments at lower costs.

- **The negative effects of the growth of facilities**

Periods of economic growth are generally accompanied by some negative economic and financial effects, which can be viewed as side effects of growth that are inevitable; some of these effects can be summarized as follows:

1. Price inflation: The price level is likely to rise, due to the increase in general demand resulting from the growth of facilities in the economy. In the Palestinian case, it is not expected that the general level of prices will be affected by the growth of facilities, with the exception of the real estate market. This belief is because the absence of the national currency does not allow any increase in the monetary mass that causes the price level to rise, while the growth in facilities will result from the growth in bank assets by increasing the financial depth ratios.

As for the real estate market, it is possible that prices will increase in this market, as a result, of not a small part of the increase in credit facilities going to investment in the real estate and construction sector. Here, the increase in the prices of these real estates is the result of both the increase in the available credit facilities, as well as the permanent market expectations that make the price curve continue to rise.

It is possible to avoid an increase in real estate prices by imposing new taxes, or increasing the rates of existing taxes on capital gains. A group of experts (Xinyu Zhao, Michael Sukin and Wei Cheung) presented a research paper supporting this idea, after the three researchers studied the evolution of house prices during the real estate bubble, and compared countries based on the change in capital gains tax rates in each country.

The researchers discovered that countries with higher taxes on capital gains are less likely to bubble and burst, and more precisely, experts discovered that countries that impose low taxes on capital gains, are witnessing an increase in the purchase of real estate assets without the aim of keeping them as their prices rise.

The simplest explanation for this model is that higher prices without higher taxes make people expect that prices will not fall again, they start thinking that the upward trend in prices will continue in the near future and therefore continue to buy.

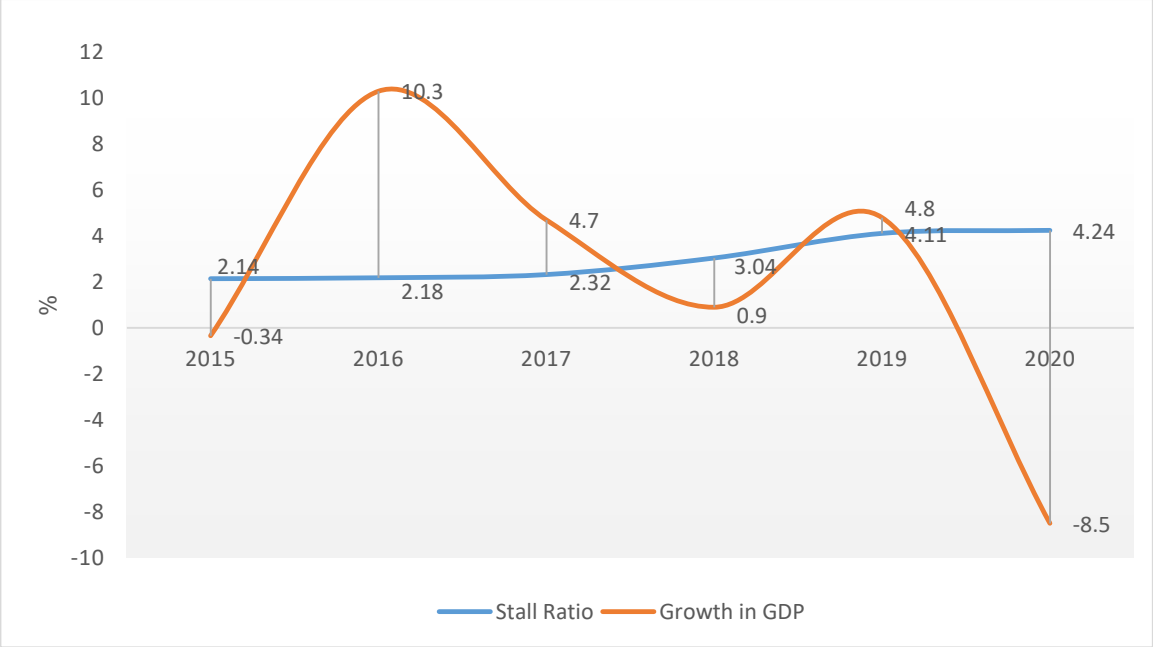
2. Increasing Stall Ratio:

The growth in credit facilities may lead to an increase in default rates, and this is logical in the short term, especially if the increase in credit facilities is accompanied by slow growth in economic activity, as is the case in the Palestinian case. However, this may change in the medium term similar to the dynamic relationship between the credit gap and economic growth, where

default rates are expected to rise initially, as a result, of the expansion of credit, and then begin to decline with the increase in growth and economic activity.

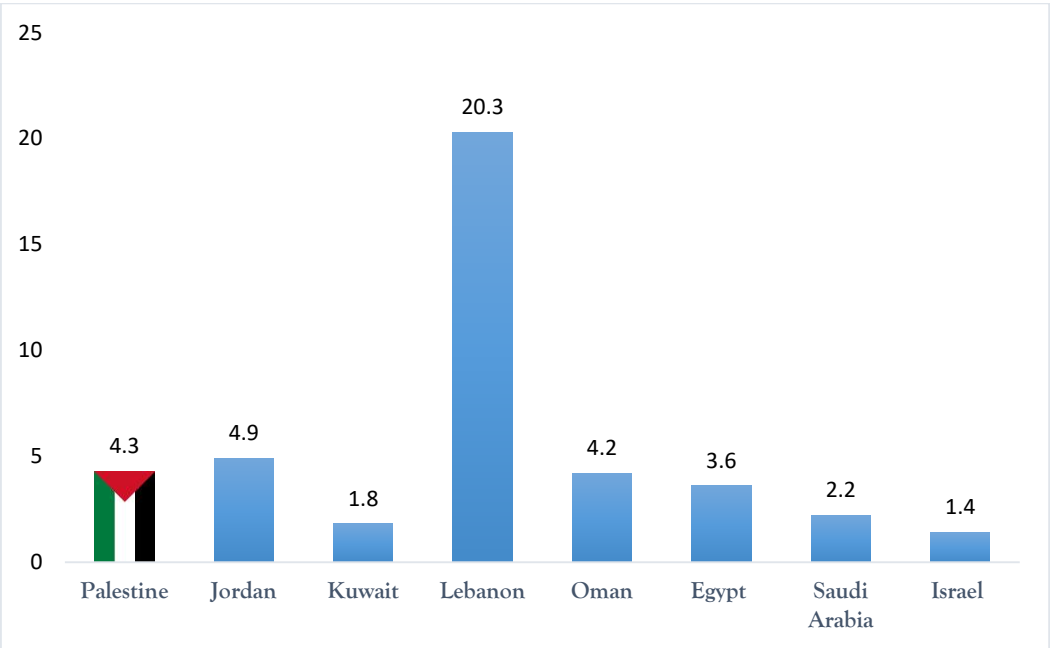
It is worth mentioning, that the default rates in the Palestinian banking sector remained within low ranges over the past years of this sector's life; even in light of the Palestinian economy being subjected to severe crises such as salary cuts and the complications of the Corona epidemic. The default rates remained within reasonable limits and did not witness large increases.

Figure (8): Default rates compared to growth rates in nominal GDP for the period 2015-2020



It is noted from the previous figure that, the rate of default in the Palestinian banking sector has tended to rise during the past few years. Clearly, this rise is accompanied by a decline in growth rates in nominal GDP, especially in the year 2020, when the default rate recorded its highest rate in years at 4.24%, in At the same time, the growth rate in nominal GDP reached its lowest level at -8.5%.

Figure (9): Banking default rates in a group of neighboring countries and the region at the end of the year 2020[5]



Source: ceicdata

[5] The default rate for Jordan is specific to the end of the year 2019.

Data on default rates in some neighboring countries and the region indicate that the rate of default in the Palestinian banking sector is slightly more than the prevailing rate for all of these countries (except for Lebanon) at about 3.3%, and as mentioned previously, this rate can rise with the increase in credit facilities. However, it is logical that this percentage will decrease when the growth in nominal GDP increases. Although there are risks of an initial rise in the default rate, achieving growth in the domestic product and then a decline in the default rate is a much better scenario than taking precautionary measures that lead to an immediate decline in the default rate by reducing credit facilities.

The reasoning for this is that over time, the growth in GDP will be negatively affected by the decline in credit facilities available in the economy, which in turn will increase the bank default rate again.

- **Results and Recommendations**

1. Despite the absence of clear monetary policy tools in the Palestinian economy, as a result, of the absence of a national currency, it is possible to replace it with some macro safety tools that have proven effective in stimulating economic growth without exposing the Palestinian banking sector to additional risks. Nevertheless, it is possible to work on reversing the existing negatives in the Palestinian economy resulting from the loss of monetary policy tools, so that these negatives become positive tools, as economic growth can be increased by adjusting the components of banks' budgets without the need to apply monetary policy tools that may carry some negative effects. On the economy when implemented.
2. Given that credit facilities have become a mainstay and an important driver of the Palestinian economy, there are still a long way in order to increase the size of these facilities. They are still consider below the levels found in other countries, especially in light of an increase in demand for bank facilities, as meeting this demand or Part of it will necessarily reduce the phenomenon of (shadow banks).
3. The need for the precautionary safety tools that target the stability of the financial sector to be of a sustainable nature to have positive effects on economic growth in the medium and long term. In this context, the Estidama Program may be a step in the right direction.
4. Coordination between the Monetary Authority and the Ministry of Finance to set an appropriate tax policy on capital profits. Keeping in regards, the real estate market, as there is almost global consensus that the best way to avoid a real estate bubble is by imposing appropriate additional taxes on real estate to limit the emergence of a bubble in it.

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