

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**THE PALESTINIAN ECONOMY: ACHIEVEMENTS OF THE
INTERIM PERIOD AND TASKS FOR THE FUTURE**



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THE PALESTINIAN ECONOMY: ACHIEVEMENTS OF THE INTERIM PERIOD AND TASKS FOR THE FUTURE*

Executive summary

This study examines Palestinian economic performance and institutional development since 1994 in the context of an assessment of immediate tasks of institutional reform, and bearing in mind persistent policy challenges and the imperatives of elaborating a Palestinian development vision. While the Palestinian Authority has made concrete progress in a number of areas affecting the economy, the reform process which has begun to unfold needs to be pursued and expanded with vigour in the coming years. Further reform of the regulatory environment is a prerequisite for addressing the structural weaknesses of an economy emerging from prolonged occupation, while elaborating policies to guide national economic development.

Policy measures are needed to help avoid macro instability and micro inefficiency, including policies to encourage savings, investment and exports and to curtail emerging monopolistic practices. An examination of present monetary arrangements reveals different alternatives for the future. Trade relations between Israel and Palestine will continue to have profound political and economic implications and should bolster independent Palestinian economic policy-making and management rather than undermine them. At the same time, trade arrangements between Palestine and its partners should reflect the dynamic needs and sequential stages of the Palestinian reconstruction and development programme.

A new effort to articulate a vision of Palestinian development is called for with the explicit aim of establishing a framework in terms of which Palestinian economic priorities can be spelt out, and identifying stages through which goals can be achieved in a gradual manner. Such a framework needs to recognize the objective conditions of the Palestinian economy, be directed towards fulfilling Palestinian aspirations and be designed in accordance with lessons learned from the development experience of other countries. As discussion of these issues begins at the Palestinian level, a number of major issues are highlighted here, which have a bearing on the formulation of Palestinian economic development policy.

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Chapter I

MAJOR DEVELOPMENTS IN THE PALESTINIAN ECONOMY DURING THE INTERIM PERIOD

The exercise of Palestinian interim self-government arrangements in the West Bank and Gaza Strip as from May 1994, pursuant to the Israeli-Palestinian accords, had two conflicting economic effects. The formation of a government authority with a commitment to reconstruction and growth was a positive development that inspired confidence and led to expansion in the public and private sectors. But the sporadic eruption of violence, intermittent closures of borders, building of settlements and continued uncertainty about permanent status issues constrained economic activities for prolonged periods and deepened mistrust and uncertainty. For much of the period, the latter effects dominated the Palestinian economy, which continued to perform below its potential during the interim period, as it did under prolonged occupation.

Indeed, in 1996-1997 a major contraction occurred, leading to severe unemployment and the spread of poverty. The economic situation improved somewhat after 1997, as a result of fewer closure-induced disruptions and of positive political developments. However, the deadlock between Israel and the Palestinian Authority (PA) and the cessation of the peace process until 1999 increased uncertainty, with adverse consequences for investment and growth. This chapter provides a brief review of major developments in the economy of the occupied Palestinian territory,¹ with emphasis on the period 1997-1999. This review, although not intended to be exhaustive, reflects key achievements and persistent weaknesses, regarding which a broad international consensus has emerged.

A. Major improvements in the economic environment

1. A new enabling environment for economic activity

The establishment of the PA in the West Bank and Gaza Strip allowed important changes in the economic environment. Although not all the restrictive features of the occupation era could be tackled immediately, positive changes have taken place and contributed to an improvement in the economic environment, especially:

- The establishment of a national authority, which began to address the restrictive regulatory regime imposed on business activities during the occupation;²
- A reduction in the number of impediments to domestic and foreign investment through new laws and regulations which encourage investment and provide special tax treatment;³
- A new regulatory environment for private enterprise, which has stimulated private investment, especially in communications, tourism and services. Several major Palestinian holding companies with an international reach have been established and have begun to operate in various fields, capitalized primarily by Palestinian expatriate and domestic sources;

- Improved financial intermediation as the new stock exchange, which began trading in late 1996, matures;
- Removal of pre-1994 restrictions on Palestinian and Arab banks and the establishment of the Palestinian Monetary Authority (PMA), which has transformed the landscape of the financial sector;⁴
- A major expansion of economic activity in the public sector, in which there was a rapid increase in the number of employees, reflecting the urgent need to provide public services neglected during the occupation, to ensure public security and to relieve unemployment by providing public sector jobs;
- A functioning, though not wholly satisfactory, framework for Palestinian external trade relations, which has allowed a degree of diversification in Palestinian trade flows.

2. Donor relations and external trade accords

An important source of support for the PA during the interim period has been the financial resources received from donor countries (see chapter II). While part of this assistance has gone towards financing short-run emergency measures designed to absorb shocks caused by border closures, it has also provided resources for some major development projects, such as the upgrading of a number of public utilities and the building of major infrastructure facilities (airport, seaport and industrial estates).

In order to guide allocation of international donor resources, a series of PA public investment plans have been submitted to donors' annual meetings, identifying priorities for long-term projects and constituting the basis for donor funding.⁵ The PA designed a more comprehensive Palestinian Development Plan (PDP) for 1999-2003, which has helped to better organize PA-donor relations. It identified investment projects to be carried out at a total cost of around \$2,700 million over the five-year period, almost half of which is allocated to infrastructure projects. Priorities are given to water, wastewater, transportation and energy. A quarter of the total public investment budget is allocated to human resources development, and is designed to improve conditions in three subsectors; education, health and living conditions in refugee camps. Some 17 per cent of the budget is allocated to creating an enabling environment for the productive sectors (agriculture, industry and tourism) and 9 per cent is allocated to institutional capacity building.⁶

For a small economy such as that of the Palestinian territory, whose regional and international economic relations were curtailed for decades, developing new trade relations with regional and global markets is essential for reducing the degree of dependence on trade with Israel, as well as for balanced growth and development. This concern is reflected in the PA's efforts to negotiate trade agreements with different countries and regions, and to facilitate wider trade by expanding investments in transportation infrastructure.

A major achievement was the signing of Free Trade Agreements (FTAs) with the European Union (EU) and the European Free Trade Association (EFTA) in 1996 and 1998 respectively. In addition, the United States accorded preferential treatment to Palestinian exports in 1996, while free-trade arrangements were agreed between the PA and Canada in 1999. Furthermore, the PA has sought to reintegrate with Arab economies, and has concluded preferential trade accords with Jordan and Egypt, and is preparing for similar agreements with Morocco, Tunisia, Turkey and the United Arab Emirates. The opening of Gaza Airport in 1998 and the priorities accorded to rehabilitation and expanding transportation infrastructure represent important steps towards facilitating trade and re-establishing links with the rest of the world.

B. Palestinian economic revival in the interim period: high expectations and unforeseen obstacles

The architects of the 1994 Protocol on Economic Relations between Israel and Palestine envisaged the interim period as one of reconstruction and growth. Indeed, the PA promoted the Protocol, just as it tolerated its perceived weaknesses, on the assumption that it would ensure a new, hospitable economic environment markedly different from that of the occupation period. Underpinning that hope were three important factors, which were regarded by policy makers as sufficient to enable the PA to adopt an economic policy emphasizing growth and development:

- The expectation that the new era of peace and cooperation would be characterized by an open border policy, allowing the export of Palestinian labour services to Israel as a cushion to bolster income in the interim period;
- The belief that the removal of occupation-era restrictions, coupled with an end to the confiscation of land and the expansion of settlements, would create an atmosphere free of conflict and strife, in which both the public and private sectors would enjoy more freedom and face fewer distortions and distractions;⁷
- The commitment of the international community to extend financial resources to help finance the Palestinian reconstruction and development effort, envisioned as an instrument to consolidate domestic savings and provide foreign exchange.

Ultimately, however, political factors combined to create an environment different from that hoped for by policy makers, fraught for several years with violence, mistrust and uncertainty. These engendered adverse repercussions, bringing down income levels for the average Palestinian during the interim period, despite the positive developments cited above.⁸ While these setbacks did not ultimately prevent the inexorable progress of Israeli-Palestinian negotiations, they dampened public satisfaction with the economic and trade arrangements of the interim period.

The first casualty of adverse political developments was the concept of an open border. Throughout the interim period, Israel adopted a policy of intermittent closures, which sometimes lasted for prolonged periods. The closures involved various borders: between the West Bank and Gaza Strip, between the West Bank and Gaza Strip and Israel, or the rest of the world, and between various cities and villages in the West Bank. The economic losses resulting from these

closures were considerable in terms of interruption to the movement of labour and goods between the Palestinian territory, Israel and the rest of the world, which in turn led to falls in production and income.⁹

In addition to the depressing effects of the closures on the economy, continuing Israeli settlement activity perpetuated conflict and mistrust.¹⁰ Israeli-Palestinian relations entered a critical period in 1996-1997, although cooperation to continue the implementation of interim accords was resumed with the signing of the Wye River Memorandum in October 1998. Political discord threatened the implementation of that agreement, perpetuating uncertainty that continued to adversely affect economic relations.¹¹ The parties finally resolved in June 2000 four pending interim-period economic and trade issues first discussed at Wye River.

Adverse political developments also counteracted the positive impact of financial resources injected into the economy by the donor countries and reduced the expected flow of foreign investment. Resources earmarked for long-term investment were allocated instead to emergency efforts such as job creation and financing the budget deficit of the PA. The delay until 2000 in negotiations on permanent status issues infused economic activity with uncertainty, discouraging both domestic and foreign investment despite incentives provided by the PA. Only with resumed implementation of the interim-period accords in late 1999 were the positive elements of the interim accords again reasserted, with negotiations reaching the critical stage of focus on permanent status issues, including future economic relations.

C. Recent economic performance (1996-1999)

Despite the progress made in reform of the enabling environment during the interim period, the Palestinian economy today remains dependent on an adverse growth path emerging from the impact of prolonged occupation. This path is characterized by vulnerability to external shocks, heavy reliance on external resources (factor income, remittances, aid and debt), weak domestic employment generation capacity, and distortions in the use of economic resources, in the structure of production and trade and in resources allocated to health, education and the acquisition of knowledge. These distortions continue to affect the pace of economic activities and result in a low level of per capita income and an erratic, and generally low, rate of income growth.

The economy of the West Bank and Gaza Strip suffered from various adverse shocks throughout the 1990s. The Gulf crisis of 1990-1991 resulted in loss of employment for many thousands of expatriate Palestinians, a virtual halt to trade with once significant markets, losses in domestic production and a precipitous drop in official and private financial flows. Although the economy was on the road to recovery, work-permit and border policies introduced by Israel in 1993 placed a new constraint on economic activities. Economic growth revived in 1994-1995 owing to increased public and private sector activity associated with the establishment of the PA, the initial impact of removal of restrictions on business activities and the beginning of the flow of donor aid. This growth was again cut short in 1996, when the economy went into a tailspin resulting in widespread unemployment.¹² Economic activity subsequently revived, however, leading to optimistic expectations for performance in 1999 and 2000.

Certainly, a small emerging market economy, with 60 per cent of its labour force unemployed, working in Israel or employed in the Government, faces serious structural and policy reform challenges. The post-interim period political and economic framework, yet to be designed, should allow a systematic effort by the PA to reorient macroeconomic and sectoral policies in line with broad economic development goals. However, the continued availability of external resources, coupled with the ability to mobilize Palestinian human resources efficiently, will remain crucial to sustaining the reconstruction and development programme over the coming decade, while helping to create the conditions for sustained growth fuelled by domestic resources and capacities.¹³

1. Population, labour and employment

The Palestinian Central Bureau of Statistics (PCBS) estimated the population of the West Bank and Gaza in 1998 to average 2,858,000.¹⁴ According to PCBS projections, the resident Palestinian population is expected to have exceeded 3 million by the year 2000, reflecting an annual population growth rate of 5.4 per cent. Together with an expatriate Palestinian population of 3-4 million, this constitutes a formidable reservoir of economic and human resources upon which the future Palestinian national economy should be able to draw.

Labour force participation has not changed notably in recent years (the crude activity rate is around 41 per cent). The annual average employment rate grew to 78 per cent in 1998, leaving 15 per cent of the labour force unemployed and another 7 per cent classified as underemployed.¹⁵ The total number of Palestinians working in Israel and settlements reached the pre-1988 level of over 110,000 by 1999. In that year, increased job opportunities in Israel were alone responsible for cutting the unemployment rate by more than 5 per cent.

The public and private sectors shared the increase in domestic employment since 1997 almost equally. Public sector employment stood at 104,000 by the end of 1999, accounting for around 20 per cent of total employment. However, the potential of the domestic economy to absorb a growing proportion of its labour force in periods of expansion is indicated by preliminary data for 1999.¹⁶ These confirm that while Palestinian labour flows to Israel remained important in overall employment, 6 out of every 10 new jobs in 1999 were created in the domestic economy, where almost three quarters of new employment was absorbed into the private sector.

2. Aggregate performance

Following the troubled start of the interim period, the Palestinian economy turned around in 1997 and has since continued to grow and demonstrate its potential for sustained expansion.¹⁷ Table 1 presents a summary of major economic indicators, based on available official statistical sources. Palestinian gross domestic product (GDP) and gross national income (GNI, including labour income from Israel) grew in 1998 by 7 per cent and 8 per cent, respectively.¹⁸ This translates into per capita GDP and GNI growth of 6 and 7 per cent, a rate not recorded since before 1988. Preliminary data for 1999 and 2000 indicate that aggregate, and especially per capita, income is projected to continue to grow, albeit at lower rates.

This performance is reminiscent of 1992-1993 and pre-1988 expansion periods, which were usually followed by a steep decline, highlighting the Palestinian economy's vulnerability to external pressures and shocks. As was the case before 1994, Palestinian GDP constitutes no more than three quarters of gross national disposable income. The structure of aggregate demand features a high ratio of private consumption to GDP, indicating no structural shift from historical economic trends, whereby external income rather than domestic expansion fuels aggregate demand. Meanwhile the share of public consumption has grown to the equivalent of almost a quarter of GDP since 1994, driven by unrestrained government recruitment. The level and share of gross capital formation have grown in recent years, reflecting the unabated boom in private residential construction activity since 1994. Although public investment is a more significant component of aggregate demand than prior to 1994, it remains at levels lower than those consistent with apparent needs as outlined in the Palestinian Development Plan.

Table 1: Palestinian territory:^a key economic indicators, 1994 and 1996-1998

| Indicator/Units | 1994 | 1996 | 1997 | 1998 |
|--|-------------|-------------|-------------|-------------|
| <i>National accounts</i> | | | | |
| Gross domestic product - GDP (million US\$) | 2 624 | 3 413 | 4 173 | 4 484 |
| Gross national income - GNI (million US\$) | 3 096 | 3 864 | 4 906 | 5 475 |
| GDP per capita (US\$) | 1 274 | 1 497 | 1 500 | 1 548 |
| GNI per capita (US\$) | 1 503 | 1 695 | 1 763 | 1 890 |
| <i>Expenditure on GDP</i> | | | | |
| Private consumption, including non-profit institutions (percentage of GDP) | 105 | 106 | 100 | 98 |
| Government consumption (percentage of GDP) | 13 | 20 | 23 | 24 |
| Private investment, including changes in inventories (percentage of GDP) | 23 | 26 | 35 | 32 |
| Government investment (percentage of GDP) | 6 | 7 | 7 | 6 |
| Goods and services trade balance (percentage of GDP) | -51 | -59 | -65 | -60 |
| <i>Balance of payments</i> | | | | |
| Goods and services balance (million US\$) | -977 | -1 856 | -2 074 | -2 439 |
| Net factor income - NFI (million US\$) | 575 | 469 | 606 | 828 |
| Net current transfers - NTR (million US\$) | 559 | 594 | 385 | 354 |
| Current account balance: goods, services, NFI, NTR (million US\$) | 157 | -793 | -1 083 | -1 256 |
| Donor finance (million US\$) | 665 | 735 | 716 | 549 |
| Net capital movements, errors, omissions and statistical discrepancies | 822 | -58 | -367 | -707 |

| Indicator/Units | 1994 | 1996 | 1997 | 1998 |
|---|-------------|-------------|-------------|-------------|
| <i>Population and employment</i> | | | | |
| Population (thousands) | 2 060 | 2 279 | 2 782 | 2 896 |
| Unemployment (percentage of labour force) | 15 | 24 | 20 | 15 |
| Employment in Israel (percentage of total employed) | 18 | 14 | 17 | 21 |

Sources: National accounts, population and employment: (a) Palestinian Central Bureau of Statistics (PCBS) and (b) Palestine Economic Policy Research Institute (MAS), *MAS Economic Monitor*, No. 6, April 2000.

Expenditure on GDP: for 1994, UNCTAD secretariat estimates; for 1996-1998, PCBS.

Balance of payments: Palestinian Authority and International Monetary Fund, *West Bank and Gaza Economic Policy Framework: Progress Report*, 31 May 2000.

^a Excluding east Jerusalem.

3. Investment and banking

Political uncertainty, combined with disruptions in the movement of people and goods brought about by border closures, made investment in the Palestinian economy during the interim period risky and difficult. Construction activities still constitute the main component of domestic investment. Although total construction activities grew in 1998, they grew more slowly than the year before. The rate of planned business construction accelerated, whereas the rate of residential construction increased much more slowly.¹⁹ Data for 1999 indicate that planned business construction had grown significantly, while residential construction start-ups faltered, suggesting an overall decline in construction activity in the near term.²⁰

Fixed business investment did not show any great improvement in 1998. Indeed, there were some negative signs related to (a) the lower number of new companies registered, and (b) the lower value of approved investment projects qualifying for tax exemption under the Law on the Encouragement of Investment.²¹ Preliminary indications for 1999 point to stagnation of private investment as well as a downward trend in public investment, the result of reduced levels of donor disbursements in 1999.²²

The banking sector continued to expand throughout the interim period. One more bank and 5 new branches were opened in 1998, bringing the total to 22 banks and 100 branches. The total value of deposits and total outstanding credits rose during 1998, the former by 16 per cent, reaching \$2,414 million, and the latter by 36 per cent, reaching \$833 million.²³ A little over 50 per cent of outstanding credits were loans advanced to the private sector and the rest were borrowed by the public sector. Loans advanced to facilitate commercial activities still constitute the most important component of bank lending to the private sector. In 1998 under half of total bank lending to the private sector was absorbed by commercial activities, the remainder going to enterprises in agriculture, manufacturing, construction and services.

4. External trade

Since 1994, the customs union that had been applied by Israel in the occupied Palestinian territory since 1967 was replaced by a trade protocol whereby the PA effectively adopted Israeli import policy, with certain exceptions. Trade between the two parties is free of duties, fees and similar charges, although non-tariff barriers continue to affect Palestinian export flows to Israel. The 1994 agreement provides for a common external tariff between Israel and the PA deriving from the Israeli import regime, with three lists of duty-free imports from Arab and Islamic countries, intended to encourage trade with those markets.

As shown in table 1, the deficit in trade in goods and services has grown sharply since 1994, owing mainly to an unprecedented surge in imports. The unrestrained growth of imports is also reflected in a ratio of imports to GDP that has now returned to historically high levels. On the other hand, the value of Palestinian exports has only recently returned to the level attained in the early 1980s, while the export ratio has fallen. The merchandise trade deficit accounts for the bulk of the current account deficit, which is dominated by trade with Israel. However, trade in services has grown in significance over the past decade.

The current account balance, which was historically in surplus, has recorded a deficit since 1996. Exports, net factor income from work in Israel and current transfers from Palestinian expatriates and other non-official sources help to finance the huge import bill. These items, however, are insufficient to balance the current account deficit, which is partially offset by official donor finance. Since 1996, supplier credit and other forms of short-term commercial debt, as well as official debt, have covered that part of the deficit which appears to be related to import financing needs,²⁴ while capital movements to banks outside the territory appear to be another factor.

Table 2 summarizes the most recent published merchandise trade statistics. These demonstrate that the merchandise trade deficits that characterized the occupation era have intensified and are worse than previous estimates suggested. There has been a sustained increase in imports and a stagnation of exports at a low level. Meanwhile, the concentration of Palestinian trade with one predominant partner has not diminished, but rather reversed its direction. Until the early 1990s, 90 per cent of Palestinian merchandise imports originated in Israel and 70 per cent of exports went to Israel. However, the merchandise imports from Israel declined to 81 per cent by 1998, while exports to Israel rose to 94 per cent of the total.

The expansion in merchandise imports since 1994 has followed a more diversified trend than before, owing to new, direct trade possibilities with Arab countries and the rest of the world. Weak export growth and an increased orientation towards Israel reflect several factors. Foremost among these are the various infrastructural, logistic and physical weaknesses affecting Palestinian export flows, as well as the continuing impact of security and related considerations. In addition, Palestinian productive sectors have not yet been able to achieve new competitive market entries, in Israel or in regional or global markets, and thus remain locked into production patterns geared to satisfying Israeli consumer demand. Indeed, exports to the domestic economy have yet to regain the levels of the early 1980s, when they accounted for some 40 per cent of GDP.

Meanwhile, the composition of trade reflects the same trend: a decline in the scale and diversity of exports as compared with increasing diversification of imports. The most important export items remain stone and marble, vegetables and fruits, and furniture and footwear, while imports cover the range of capital and intermediate goods, petroleum and related products, cereals, iron and steel, and a variety of consumer goods and foodstuffs.²⁵

Table 2. Palestinian merchandise trade (West Bank^a and Gaza Strip), 1994, 1996-1998

| Item/year | 1994 ^b | 1996 | 1997 | 1998 |
|--|-------------------|--------|--------|--------|
| <i>Merchandise exports (million US\$)</i> | 243 | 340 | 382 | 395 |
| - To Israel (%) | 84 | 93 | 93 | 94 |
| - To Arab countries (%) | 13 | 6 | 3 | 5 |
| - Rest of world (%) | 3 | 1 | 4 | 1 |
| <i>Merchandise imports (million US\$)</i> | 1 075 | 2 016 | 2 238 | 2 375 |
| - From Israel (%) | 87 | 86 | 85 | 81 |
| - From Arab countries (%) | 1 | 1 | 3 | 4 |
| - From rest of world (%) | 12 | 13 | 12 | 15 |
| Exports percentage of imports | 23 | 17 | 17 | 16 |
| Merchandise trade balance (million US\$) | -832 | -1 677 | -1 783 | -1 980 |
| Exports as percentage of GDP | 9 | 10 | 9 | 9 |
| Imports as percentage of GDP | 41 | 59 | 52 | 53 |
| Merchandise trade deficit as percentage of GDP | -32 | -49 | -43 | -44 |

Sources: For 1994, UNCTAD secretariat estimates (see UNCTAD/GDS/SEU/2).

For 1996-1998, (a) Palestinian Central Bureau of Statistics and (b) *MAS, Economic Monitor*, No. 6, April 2000.

^a Excluding east Jerusalem.

^b Data estimates for 1994 are the least reliable for the period.

Chapter II

MAJOR ACHIEVEMENTS OF THE PALESTINIAN AUTHORITY AND UNFINISHED TASKS OF THE INTERIM PERIOD

The establishment of the PA led to substantial changes in the economic policy environment. The most significant of those changes are those relating to:

- The institutional and regulatory environment;
- The role of the public sector in providing infrastructure and public services;
- The availability of financial resources for public expenditures.

This chapter assesses interim period performance in these three areas, describing notable improvements and identifying some shortcomings that remain to be further addressed as part of the immediate reform agenda. That agenda, while driven by Palestinian imperatives, has increasingly become the focus of international interest as the PA prepares to assume increased responsibilities in the coming period. Already the prerequisites of sound financial management, rational public administrative development and the rule of law and institutions are among the serious challenges that the PA must address if it is to successfully negotiate itself into a permanent status accord that responds to basic Palestinian goals. They are an equally relevant component of any successful development effort in the years to come.

A. Institutional and regulatory development

Pursuant to the Israeli-Palestinian accords, the PA is composed of three branches:

- The executive, comprising the elected President and a Council of Ministers;
- The elected legislature - the Palestinian Legislative Council (PLC);
- The judiciary, composed of several levels and types of civil and criminal courts.

Much of the PA's political energies and focus since 1994 has been directed to developing government institutions capable of setting priorities and policies and managing the reconstruction process, while laying sound bases for a market-led revival of the economy. In addition to the various functional ministries of the PA dealing with the economy (especially the Ministries of Agriculture, Economy and Trade, Finance, Industry, Planning and International Cooperation and Supply) the Presidency has assumed an active role in economic domains. Several new government departments were created by presidential decree and/or attached to the Presidency, including the Higher Commission for Investment and Finance, the Palestinian Economic Council for Reconstruction and Development, and most recently, the Higher Council for Development.

The Council of Ministers meets regularly to coordinate the work of various PA ministries as a functioning public sector. Through its key ministries, the PA has taken charge of collecting taxes and managing public revenues and expenditures, while providing basic services in social sectors, especially education, health, social welfare, public utilities and infrastructure, with local government playing an important service and developmental role.

Alongside direct elections for the President of the PA, the 88-member Palestinian Legislative Council was elected in January 1996, and held its inaugural session in March 1996. Its mandate was limited by the Israeli-Palestinian accords, barring it from legislating on issues related to permanent status issues or dealing with foreign policy. In other areas, the Council's function is to deliberate on proposed legislation submitted either by its own members or by the Council of Ministers, and it has the power to review, amend, reject or accept. Specialized committees cover various fields, including a legal committee that reviews and makes suggestions about legislation before submitting it to the Council in plenary session for a final reading.

Meanwhile, the PA forged ahead with the preparation, review and adoption of a range of new draft laws governing political, social, economic and other activities. By mid-2000, a total of 128 draft laws had been submitted to the Ministry of Justice for review and transmission to the Council of Ministers and the Legislative Council. Of these, 40 had been signed into force, while another 20 were at different stages of legislative review, including some in important economic and business spheres. Among those that have direct bearing on the economy are the Organic Budget Law, Industrial Zones and Industrial Free Zones Law, Banking Law, Insurance Law, Securities Law and Secured Lending and Leasing Law, while the PLC is deliberating a new income tax law. Only once the full range of pending laws and regulations affecting the economy have been drafted and/or passed will it be possible to fully abandon the complex and inconsistent legal framework inherited from successive administrations during the twentieth century. Despite the constraints that characterized the interim period, the increasing evidence of the rule of law in all aspects of Palestinian life represents a significant achievement for the new Palestinian Government and an encouraging sign for future economic and social development.

The PLC has taken some important first steps to strengthen mechanisms to ensure the accountability of the executive branch. These include a regular question period in plenary sessions, ad hoc committees to investigate government management, resolutions calling for executive authority action and submission of written requests for information or action to the executive on specific issues. Inspection, auditing and control functions, exercised by both the PLC and central PA agencies, have been increasingly active in monitoring executive branch performance and PA central financial management. The process of formulation, review and adoption of the PA budget for 2000 was a milestone in the interaction between the three branches of PA governance.

Even though the institutional environment under the PA is a far cry from that under the occupation, it remains in a state of flux, with relations among the three branches continuing to evolve. As has been noted by several international and Palestinian reports, PA institutions suffer from a range of weaknesses, many of which have a bearing on Palestinian economic performance and require urgent remedies. A recent report by the Council for Foreign Relations, endorsed by the PA, provides a thorough examination of strengths and weaknesses in this area,

and proposes an exhaustive and comprehensive reform programme for the PA for the immediate future.²⁶ However, it should be recalled in any such assessment that PA institutions were established to guide the Palestinian territory through the interim period and that their future status and role remain to be more clearly defined once permanent status issues have been resolved. Accordingly, recommendations for structural reform of a still-evolving institutional set-up should recognize the limitations facing any reform effort in an undecided political context.

A significant step on the path to improved management of public finances was taken with the establishment in January 2000 of the Higher Council for Development with a clear and unequivocal reform mandate. This is expected to include consolidation of all public revenue into one central account, enhanced public investment policy, strategies and instruments, a move to privatize PA commercial holdings and oversight of PA public debt operations. These sensitive functions, to be carried out by the respective PA ministries, will be subject to full accountability and transparency, while benefiting from policy coordination at the highest levels of the PA, as well as with donors. This move was widely welcomed as a sign that the PA was well aware of the resource management and broad policy imperatives that it faced in the final phase of the interim, self-government period.

B. Infrastructure development

The PA has launched an impressive and widely recognized programme to rehabilitate physical infrastructures and social services in the territory under its jurisdiction. In these areas, the major constraints on greater achievements have been largely external, i.e. lack of resources and the inherent uncertainties facing any PA attempt at long-term physical and development planning.

1. Physical infrastructure

One of the most problematic legacies inherited by the PA was the poor state of the basic physical infrastructures that are essential to economic reconstruction and development. Many decades of minimal investment and poor maintenance had resulted in an inadequate and unreliable infrastructure. Compared with neighbouring countries, infrastructure in the Palestinian territory is underdeveloped, perpetuating poor and deteriorated public services and constituting a significant brake on growth and development.²⁷ To overcome this major constraint, the PA has been faced since the outset with the paramount tasks of rehabilitating transport, communications, electricity and water. Under the PA, public utilities have remained mainly government-owned and operated, although privatization has begun and measures in this direction are expected to expand gradually.

Most of the major roads in the West Bank and Gaza Strip were constructed more than 30 years ago and then experienced decades of neglect. By 1999, the PA had begun to address this problem with a major road-building and improvement programme. As regards international transport links, the PA remains largely dependent on access through Israeli routes. Operation of Gaza Airport since 1999 was a first step towards establishing direct links with the outside world. However, construction of the Gaza seaport, agreed in the context of the 1998 Wye River accords, has been slow to begin owing to a variety of logistical difficulties.

Per capita ownership of fixed telephones in the Palestinian territory was, until recently, still lower than in neighbouring countries. This has important ramifications for communications in general, while also adversely affecting investment and services in tourism in particular. The private sector's contribution to investment in physical infrastructure has been confined to telecommunications. The Palestine Telecommunications Company (PALTEL), formed in 1995 by a group of Palestinian expatriate and domestic investors, together with a PA minority shareholding, has become the driving force in the sector. PALTEL has increased the number of fixed and mobile telephones considerably and played a major role in preparing Palestinian communications infrastructure for integration into global networks in line with international standards. Meanwhile, a Palestinian international direct dial code (970) and Internet domain (.ps) were recently endorsed by the competent international bodies.

Per capita consumption of electricity is also substantially lower than in neighbouring countries. Electricity is almost entirely supplied by Israel and is prone to large system losses. Since it is the major source of energy for the manufacturing sector, the PA considers it of the utmost importance that an autonomous electricity generation capacity be developed in order to ensure that supplies cannot be disrupted and are able to cope with growing demand.²⁸

The Palestinian territory also faces a serious water supply problem, including shortages and deterioration in quality, resulting in both seawater seepage and depletion of aquifers. A testament to the adverse situation of Palestinian infrastructure is the fact that only 25 per cent of households are connected to sewerage networks. Water is one of the permanent status issues under negotiation, with the expectation that this will result in improved Palestinian access to a critical natural resource and in a common strategy to safeguard and develop shared resources.

The PA was not able to embark on a comprehensive programme of rehabilitating physical infrastructure in the first three years of the interim period. Political instability and unemployment resulting from border closures forced it to shift its attention from long-term investment projects to short-term income maintenance programmes. Weaknesses in the Palestinian public institutional absorption capacity, combined with slower than expected donor mobilization, also contributed to delays in investment in infrastructure projects. However, there has been a considerable improvement since 1996. Whereas donors' funds disbursed to investment in infrastructure did not exceed 10 per cent of total funds during 1994-1995, they reached 57 per cent by 1998.²⁹ The increase in 1998 was partly due to the fact that the PA succeeded in eliminating its budget deficit, thus releasing more donor resources to long-term investment projects. Furthermore, donor aid in 1998 was integrated into the Palestinian Development Plan (PDP) for 1999-2003, responding more closely to PA priorities.³⁰

2. Education and health

Administration of the educational system is divided among the PA, the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA) and the private sector. In the academic year 1997-1998 there were a total of 76,467 students, a 7 per cent increase over the previous year. Public schools run by the PA cater for the majority of the

students (68 per cent of the number of the total number of students). UNRWA is the second most important provider of education services (26 per cent) and the private sector provides primarily for pre-school and for vocational and university education.

The education sector is significant for the PA: it usually accounts for one fifth of its total budget, and teachers constitute around 5 per cent of the labour force. In 1996 the PA divided responsibility for the education sector between the Ministry of Education (MoE), responsible for pre-tertiary education, and the Ministry of Higher Education (MoHE), responsible for post-secondary education. The tasks facing the ministries are challenging, the most pressing being to expand the educational system in order to absorb the yearly increase in students. Another task is to overhaul the structure, with the aim of creating a new unified system strategically designed to meet the requirements of economic development and growth.

Meeting these challenges is a major undertaking, especially in the light of the pressure of population growth and political considerations, and even more so if the Palestinian economy is to be able to draw on a qualitatively different pool of human resources to strengthen its long-term development and competitive advantages. The poor state of education in many Arab countries should stand as a glaring example of the long-term cost that is the inevitable result of short-term solutions dictated by political expediency. In this regard, the education plan drawn up jointly by the MoE, the MoHE and the Ministry of Labour is a good start for designing a long-term vision of the education system. The plan includes projects for establishing centres for vocational training education that cater to both students and workers. It will save on costs by eliminating duplicate programmes and will benefit from economies of scale.

Parallel to education, the health sector in the West Bank and Gaza Strip has a diversified institutional structure. In 1995, total expenditures on health services were estimated at \$250 million, equivalent to around 7 per cent of GDP. Four major sources provide health care. The Ministry of Health (MoH) provides selected primary health care for all Palestinians. It also services those insured by government insurance through nine hospitals in the West Bank and five hospitals in the Gaza Strip. UNRWA provides direct primary health services, including drugs, to refugees. Non-governmental organizations (NGOs) constitute an important group, operating non-profit clinics in rural areas. Finally, there are private sector practitioners and companies.

According to a survey conducted in 1996, 55 per cent of the sample in the West Bank and 77 per cent in the Gaza Strip have medical insurance. The government health insurance plan covers most of those insured. There are three other types of insurance: UNRWA, which caters exclusively to the refugee population; social security insurance; and private insurance, which covers a small proportion of the population. The survey also shows that government insurance has wider coverage among town people than inhabitants of rural areas, while the MoH reports a continuous increase in the number of persons insured by the government insurance scheme.³¹

Although Palestinians in the West Bank and Gaza Strip spend 7-9 per cent of GDP on health services, a relatively high share, they continue to receive inadequate health care in terms of coverage and quality, and the availability of health services lags behind the availability of such services in neighbouring countries.³² The Gulf crisis of 1990-1991 reduced considerably

Arab aid to NGOs and forced them to curtail many health services. Although the MoH started to coordinate and pool its efforts with those of UNRWA and NGOs, especially in the domain of primary health, it still faces a number of challenges. Expanding insurance protection to cover poor families is a major task, which is likely to call for major reform of the whole insurance structure, making it compulsory and providing it with a more solid financial foundation.

3. Human resource development

It is increasingly considered that the most important strategic asset of the Palestinian economy may be its human resources, which are currently underutilized or inefficiently allocated. Given the general statistical relationship between years of schooling and per capita income, the World Bank has estimated that Palestinian per capita GNP should be around \$10,000.³³ The fact that the Palestinian economy is operating at under a fifth of this level highlights the wide gap between actual and potential performance. While closing this gap requires a complete change in the political and institutional environment, human resource development is also needed. In addition to improvements in education and health services discussed in the previous section, targeted programmes are needed to tackle two serious problems.

The first is the low labour participation rate, which is significantly less than that in neighbouring labour markets.³⁴ While demand factors play their role, the low rate appears also to be due to the marginal role of women in the formal economy. Several areas merit attention: ensuring that new legislation promotes greater participation of women in the economy; creating an appropriate institutional framework to support women professionals; and improving women entrepreneurs' access to credit, finance and legal assistance. In a similar vein, allowing the chronically unemployed and former Palestinian prisoners to participate fully in economic life calls for rehabilitation and training programmes.

This point is especially relevant in the context of the determinants of per capita GDP: labour productivity, employment rate and participation rate. While the three are interdependent in the short run (over the business cycle), in the long run there are social and technological factors that affect each separately. The important point is that in the long run, even if the problem of Palestinian unemployment is solved, per capita GDP will still be relatively low as long as the labour participation rate is low.

A second problem relates to the low productivity of Palestinian labour, especially in the manufacturing sector. This calls for the creation of a link between scientific facilities in the universities and industrial firms. There is also a need to establish technical institutions suitable for training industrial workers, and other institutions to train professionals in the service fields. The potential role of foreign investment in promoting technological innovation and relevant research and development capacities is another area for action that needs to be carefully examined. A high-technology industrial estate currently being established by the PA in the West Bank will play an important role in attracting Israeli and other foreign investment in technology-enhancing industrial production and services provision.

The Palestinian Development Plan (1999-2003) has recognized the importance of human resource utilization, and a set of policies has been adopted to improve the general condition of the people and ensure their participation in the development process. These include programmes geared to women's progress, rehabilitation of former detainees, and provision of comprehensive social insurance and social security for the entire population. However, the match between available public and donor resources and the range of pressing human development programmes has yet to be fully ensured through planning and donor aid coordination mechanisms, thus leaving the Palestinian Development Plan as simply a statement of PA development needs and priorities.

C. Resources for reconstruction and development

As indicated in chapter I, the Palestinian economy is characterized by relatively large capital flows. Inflows include remittances from migrant Palestinians in the region, and international donor finance, as well as foreign investment, including expatriate Palestinian investment. Capital outflows consist mainly of transfers of private savings to neighbouring countries and elsewhere for deposit or investment purposes, through the banking system as well as informally. A marked change in the composition of capital flows has taken place since 1990, and has intensified since 1994. Migrants' remittances have declined significantly since the late 1980s, while external aid and, to a much lesser extent, foreign investment have increased with the establishment of the PA. At the same time, the Ministry of Finance has been successful in steadily increasing revenue from tax collection, and the new banking sector has succeeded in attracting a large volume of deposits. However, the uncertain policy environment, a financial intermediation system still in the process of formation and limited domestic investment opportunities have encouraged the flow of savings abroad. Consequently, the PA now has at its disposal three major financial resources, namely donor finance, domestic revenue, and external debt.

1. Donor community

Following the international conference of donor countries held in Washington, DC, in October 1993, which pledged \$2,400 million to assist the Palestinian reconstruction and development programme (1994-1999), further contributions raised the total to \$3,400 million. About one quarter of the funds pledged are loans made on concessional terms and the remainder is in the form of grants. Neither the Palestinians nor the donors were fully prepared in 1994 to create the necessary mechanism by which funds could be transferred and used with accountability, transparency and efficiency. Beginning in 1995, the coordinated efforts of the PA and key donors, aided by the World Bank and the United Nations Special Coordinator in the Occupied Territories, created liaison and consultative mechanisms to facilitate the flow of funds.

The initial understanding between the PA and the donors was that funds would not be used for short-term budgetary requirements after 1994, but for long-term public investment, which includes financing infrastructure projects, supplying capital assets in kind and providing support to the private sector. This understanding could not be adhered to because of severe economic conditions caused by border closures. The ensuing problem of widespread unemployment and the spread of poverty shifted attention, with short-term income maintenance

projects being favoured instead of public investment. During the first three years (1994-1997), total disbursements reached \$1,527 million, of which half was allocated to short-term support, 34 per cent to public investment and the remainder to technical assistance.³⁵ The relative improvement in general economic performance since 1997, especially the notable decrease in the PA budget deficit, has directed attention once again to long-term investment. This was evidenced in the integration of donors' resources into the Palestinian Development Plan (1999-2003).

Several aspects of the PA-donor experience during the interim period merit further consideration as this special relationship enters a new phase:

- The extent to which pledged, committed and disbursed aid actually corresponded to the complex, not always rationalized, but largely accurate, statement of PA needs embodied in the Palestinian Development Plan, particularly the 1999-2003 version;
- The extent to which the channels and mechanisms currently in operation to ensure PA transparency, efficient economic management and good governance will remain subject to donor-driven imperatives;
- The extent to which the PA can afford to allow public debt to grow as the grant/loan composition of aid increasingly favours the latter (see below).

2. Taxation and other government revenue

Tax revenue accrues to the PA from two sources: domestic tax collection (direct and indirect) and tax clearances remitted by the Israeli Treasury. The latter, which are by far the major source of PA taxation revenue, consist of several flows:

- Value added tax (VAT) collected by Israel on goods sold by Israel to Palestinians;
- 75 per cent of the income tax paid by Palestinians working in Israel;
- 100 per cent of income tax paid by Palestinians working in Israeli settlements;
- Customs and excise duties collected by Israel on goods imported through Israel and specified as destined for the PA.

Domestic tax collection capacity has steadily improved since 1995, thanks to concerted efforts by the Ministry of Finance (MoF), including training of tax collection staff, public awareness campaigns and an improved ability to identify potential taxpayers and to detect tax fraud. Tax clearance from Israel suffers from a persistent problem of leakage, since a large proportion of Palestinian imports coming through Israel are not explicitly destined for the West Bank and Gaza Strip. Accordingly, the forgone customs revenue paid by Palestinians on

these imports, recently estimated to be around 3 per cent of GDP, accrues to Israel and is not transferred to the PA.³⁶ A satisfactory resolution of this leakage problem and continuous improvement of domestic tax administration promise to increase tax revenue and keep budget deficits closed.

A major component of public revenue is generated from outside the accounts of the Ministry of Finance, from a variety of recently declared forms of PA commercial and investment interests. The involvement of the PA in market operations, albeit through recognizable intermediaries, has in some cases also blurred the distinction between the private and public sectors, with adverse implications for efficiency and growth. It is now recognized that such practices must be curtailed, and the PA has pledged that by end of 1999 it will begin to phase out its involvement in private sector activities.³⁷

The report presented by the PA to the meeting of the Consultative Group of Donors in 2000 constituted a milestone in PA transparency and commitment to reform in this sensitive area, although concrete steps towards privatization are now awaited.³⁸ An earlier report by the Council for Foreign Relations had squarely addressed this issue:

“There is an urgent need to consolidate accounts under the MoF, and for all public revenues to accrue to it. This applies especially to the import monopolies and quasi-monopolies and other ventures run by or on behalf of the PA ... The situation regarding monopolies highlights the need for transparency, accountability and legislation to ensure competition. The PA is understandably concerned about the need to secure its revenue base, following past delays and suspension of the transfer of clearance revenues from Israel. It also sees a need to provide venture capital and pave the way for private investment in a market fraught with political uncertainty and low economy of scale. However, this should not prevent the PA from implementing its formal commitment in 1996 to form boards of directors for the monopolies and to bring their revenues under MoF control.”³⁹

3. Government budget and public debt

While the management of PA public finances has improved in recent years, the domestic and external financial challenges faced by the emerging Palestinian economy have become greater. The PA budget for 2000 grew to \$1,363 million, 70 per cent of which is devoted to payroll and operating expenditures.⁴⁰ Development expenditures remain almost totally dependent on donor finance, which is increasingly made available in the form of loans. As indicated by the data in table 1, the ratio of official development assistance (ODA) to GDP declined from around 20 per cent in 1995 and 1996 to around 13 per cent by 1998-1999. While absolute levels of donor finance are not expected to decline further in the immediate future, the ODA/GDP ratio will continue to decline as GDP grows.

The budget deficit, which had reached around 3 per cent of GDP in 1996, has been reduced since 1997, as deficits accruing from current expenditures have declined. Since then, the bulk of the deficit has been generated by capital expenditures, which have been financed by grants from donor countries and from short-term commercial bank overdraft. The budget deficit

should be eliminated as of 2000, but arrears remain from previous years. It should be noted, however, that owing to donor assistance the effective deficit was not a large proportion of the total expenditure budget. The deficit was projected to be \$52 million for 2000, which was less than 5 per cent of the total expenditure budget for that year.⁴¹

A significant new challenge to emerge is the growing PA public debt, which stood at more than \$600 million by 1999. Although the proportion of debt to GDP, at around 13 per cent, is low compared with that of many indebted developing economies, this rate should be viewed in the light of the short period during which the PA external debt accumulated. While debt service on most loans is low and has yet to begin, balance-of-payments pressures could fuel further official indebtedness. In this respect, the PA will have increasingly to plan its expenditures on the assumption that donor aid will dwindle in a few years. It is neither feasible nor desirable to replace donor assistance with foreign commercial borrowing and domestic non-bank borrowing, and the banking system has so far been reluctant to lend to the PA. Therefore, it would be prudent for expenditure growth to be planned in tandem with increases in revenues.

Needless to say, caution should be exercised at this stage in incurring additional official external debt and clear and efficient mechanisms are needed from the outset to monitor and manage a growing debt burden. The PA is just beginning to elaborate policy and technical criteria for incurring public debt, which has so far been accumulated without any central guidance or resort to defined objectives and priorities, nor has it been accumulated in accordance with established economic feasibility. The Ministry of Finance has recently committed itself to establishing a modern and transparent system for this purpose, with donor funding and technical assistance from UNCTAD.

Chapter III

PERSISTENT CHALLENGES TO THE SUSTAINED DEVELOPMENT OF THE PALESTINIAN ECONOMY

Into the year 2000, the Palestinian economy faced an uncertain future. The five-year interim period, which was planned to conclude with a permanent status agreement in 1999, had been extended without the conclusion of negotiations on permanent status issues. The formation of a new Israeli Government in 1999 and the subsequent resumption of interim and permanent status negotiations helped to renew the peace process, though with no clear picture emerging on the shape of future Palestinian economic relations at bilateral or regional levels.

The shortcomings in the interim-period economic accords, now widely accepted by Palestinian and international observers, and the deterioration of Palestinian economic performance during most of the interim period demonstrated two simple truths about the Israeli-Palestinian economic relationship. First, it has become abundantly clear that policies during the occupation period have engendered adverse trends in Palestinian aggregate economic development, as outlined in chapter I. Second, over the six years of limited self-rule it has not been possible to overcome structural weaknesses and imbalances or to redirect the economy along a qualitatively different development path that could lead to a genuine peace based on equality and mutual interests.

Notwithstanding the achievements of the interim period, the essence of the relationship between the two economies has remained as it was before: the large economy's interests often call for policies and measures that have the consequence of keeping the small economy weak and dependent. This is already seen as inherent in the post-1994 customs union, which remains rooted in Israel's trade policy. Furthermore, a relationship between two closely inter-linked economies, whereby measures taken by one can cause the other to lose overnight and for an indefinite period the income of a quarter of its labour force, and interrupt or impair its external trade flows, is simply untenable. Disproportionate dissociation costs render the current Israeli-Palestinian economic relationship unstable. Future relations will continue to be subject to the interplay of immediate commercial or political interests unless a roughly equal distribution of dissociation costs can be achieved and both sides view the relationship as equitable and leading to more rapid economic growth.

Such a path calls for creation of a new environment, free of conflict and mistrust. It also requires that the PA adopt a comprehensive strategy geared towards building institutions and executing policies aimed at bolstering the new environment and fully realizing its potential. This chapter deals with key elements of that strategy. Section A outlines essential elements of the legal and institutional environment. Measures essential for achieving macro stability and micro efficiency of the new environment are also discussed. Section B examines present monetary and trade arrangements and indicates prospects for change.

A. Creating a hospitable economic policy environment

1. Resolving permanent status issues

Developments during the six-year interim period have clearly demonstrated that in the realm of the Israeli-Palestinian relationship economic and political issues are inextricably intertwined. The deliberate separation between the two in the interim accords was based on the assumption that economic cooperation between the two sides could advance and pave the way to resolving political issues. This, however, did not happen during the interim period. Whenever economic cooperation was able to produce agreements on how to resolve the different problems that arose during the period, unrelated political disagreements usually postponed or otherwise undermined the understandings or agreements reached between the two sides' economic or trade negotiators.⁴²

The shortcomings of this approach have been demonstrated at two levels. First, postponement of consideration of the key issue of sovereignty allowed Israeli settlement expansion over the interim period, which continued to be a source of friction and detrimental to Palestinian economic activity. Second, the establishment of a self-governing authority without sovereignty created a mismatch between authorities and responsibilities. For example, a prospective investor can obtain a licence for starting a business from the PA, but bringing capital goods and manpower from outside to initiate investment activities requires the approval of the Israeli authorities. A similar situation faces Palestinian importers or exporters, who can smoothly complete most required procedures and transactions on the PA side of the border, but are often frustrated by Israeli security, customs and other controls on the Israeli side.⁴³ This duality of authority created a multidimensional uncertainty that has been quite discouraging for domestic and foreign investment, as well as for export trade.

In the light of this experience, two points appear essential if economic cooperation is to contribute to establishing peace and creating mutual interests. First, the two sides should rapidly move to resolve the shortcomings of the interim period, so as to strengthen the atmosphere of dialogue and trust, in which negotiations on permanent status can be concluded in good faith and with reasonable expectations of success. Second, these negotiations should result in an agreement that clearly and unambiguously provides the Palestinian side with the requisite sovereignty over land, water and borders. Ambiguity on this fundamental issue will continue to undermine the Palestinian endeavours to mobilize and manage human and natural resources for the longer-term development effort and to create a new economic environment conducive to development and growth.

2. Governance and building national economic institutions

Understandably, the PA institution-building effort has been characterized so far by short-term political considerations. Political instability, combined with economic hardship, has meant that the interim period has not provided the optimal environment for long-term planning. At the same time, however, current exigencies should not determine the path along which public institutions are built. In this regard, several priority areas need urgent attention. These differ somewhat with respect to the "unfinished tasks" of the interim period referred to in the preceding

chapter, insofar as they are elements of the future agenda of a Palestinian national authority, which can only be addressed once permanent status issues have been resolved. These areas are closely interrelated, and concern the long-term relationship between the three branches of government, streamlining the role of the judiciary, restraining the unchecked growth of government bureaucracy and enhancing the rule of law. Though these issues are not strictly within the realm of economic policy reform, they have an important influence on the pace of economic recovery and on the long-term prospects for Palestinian economic development, and as such merit being noted in this context.

3. Avoiding macro instability

The Palestinian economy suffers from a chronic incapacity on the supply side. Since 1994, total domestic absorption (domestic consumption plus investment) has grown to over one and a half times the domestic economy's production (GDP). Imports fill this gap and assume a very important role in the economy, financed from external sources. As noted in chapter I, this exaggerated dependence on external sources of income renders the Palestinian economy vulnerable to external shocks.

Obviously, the resource gap and the labour market imbalance (unemployment) cannot be closed and corrected in a short period of time. They are the outcome of market distortions, which emerged over decades and thus need quite some time to be remedied. Removing legal and institutional obstacles that currently constrain private sector activities is the most important step on the road to restoring stability. Of equal importance are fiscal and monetary policies, which should be designed with the aim of encouraging savings, investment and trade. As a broad benchmark, Palestinian development policy should be directed towards creating an enabling environment in which an increasing part of growing income is saved so as to close the resource gap, and an increasing part of growing output is exported so as to reduce the trade and foreign exchange gap. In the meantime, social safety nets should be designed to alleviate the short-run impact of external shocks.

4. Reducing inefficiencies

Price levels in the Palestinian economy have been linked intrinsically to those in Israel for a long time, notwithstanding the wide disparities in per capita income between the two economies, and therefore do not perform their functions in allocating economic resources efficiently. This situation is due mainly to the fact that the West Bank and Gaza Strip are operating under a trade regime dominated by considerations relevant to the Israeli economy. That regime is still characterized by a substantial level of protection, which is historically related to the objective of developing Israeli industry. In addition to causing inefficiencies in the production of consumer goods, this protective shield has raised the cost of capital and intermediate goods to Palestinian producers as well.

Recent studies show, for instance, that the cost of garment production in the West Bank is greater than that in Jordan by a factor of 2.17. An important component in that difference is due to the fact that Palestinian producers pay double the price for their imported Turkish textiles, compared with the superior-quality East Asian materials imported by Jordanians. Palestinians

cannot import Asian textiles because of the prohibitive tariff imposed by Israel to protect its own industry.⁴⁴ Similarly, the cost of agricultural products, pharmaceuticals and shoes is lower in Jordan, partly because of differences in imported input prices.

Another reason for the high cost of Palestinian production in both agriculture and industry is the relatively high wage rate. It is estimated that the wages of Palestinian workers are higher than in Jordan by a factor of 2 or 3 in agriculture, a factor of 2 in the garment industry and a factor of 2.3 in the shoe industry.⁴⁵ These high wages are the result of distortions in the labour market created by the hiring of Palestinian commuters to work in Israel. Removing these distortions in prices and costs should be examined in the context of negotiating a new trade regime designed to advance Palestinian and Israeli interests equitably and reasonably.

Developments which can give rise to distortions in prices have also occurred after the establishment of the PA. The policy of granting monopoly power in important markets such as tobacco, gasoline and cement has contributed to maintaining higher prices. Similarly, telecommunications prices have risen under the new monopoly status of the Palestine Telecommunications Company (PALTEL). This trend towards monopolizing certain sectors of the market started in 1995 with the licensing of a number of firms in specific branches partially or wholly owned by PA-related agencies, in addition to restrictive arrangements affecting imports of certain commodities. Observers have increasingly construed this as an unwelcome sign of powerful rent-seeking tendencies. As noted previously, important steps to phase out these practices were announced in early 2000, although immediate implementation may not be forthcoming.

B. Designing optimal financial and trade regimes

The previous sections have demonstrated that removing macro instability and micro inefficiency depends to a great extent on reforming the monetary and trade regimes. The following paragraphs identify some considerations that could be relevant in the context of ongoing PA reform and planning exercises.

1. Future monetary arrangements

While the monetary arrangements during the interim period are an improvement on those prior to 1994, they are certainly not optimal. Arab banks reopened and new ones have been established, monitored by the Palestinian Monetary Authority (PMA), which has some of the functions of a Central Bank but not the right to issue national currency. The Israeli currency (the shekel) and the Jordanian currency (the dinar) are used as legal tender. The absence of a national currency renders monetary policy ineffective, as in a fixed exchange rate regime. On the other hand, the existence of a dual currency standard has the potential for increasing the costs associated with fluctuations in exchange rates typical of a flexible exchange rate regime.

In addition, a dual currency tends to reduce the ability of commercial banks to perform their function of transforming debt maturities, because of currency mismatching of assets and liabilities. This can discourage them from extending long-term loans, which are essential for investment and growth. Furthermore, the existence of a dual currency standard renders the

Palestinian economy vulnerable to shocks originating both in Jordan and in Israel. A Jordanian monetary shock will be transmitted to the Palestinian economy through the capital account since there is almost free mobility of capital between the two economies and very little trade. On the other hand, an Israeli monetary shock will affect the Palestinian current account, which is composed mainly of trade with Israel in both goods and labour services.⁴⁶

Given that the Israeli shekel had an unstable history in the 1970s and the first half of the 1980s, and that the Jordanian dinar depreciated in value at end of 1980s and early 1990s, it was expected that Palestinians would try to protect the purchasing power of their money by holding a more stable currency. Thus the United States dollar is increasingly becoming the preferred currency of deposit holders. This change reflects in part the considerable depreciation of the shekel during 1998, by 18 per cent against the dollar and the dinar,⁴⁷ which had immediate consequences for the Palestinian economy. It reduced the personal wealth of holders of shekels, including those on the PA payroll, as well as real wages of workers in Israel. Shekel depreciation in 1998 also increased price inflation in the Palestinian territory through its impact on imports from Israel.⁴⁸

The PA may not be able to change this sub-optimal monetary regime during the interim period, or immediately afterwards. Moving towards a more suitable arrangement after permanent status negotiations is crucial to the future development of the economy, and should allow the Palestinian economy to achieve the following two objectives, which are unattainable at present:

- *To enable the Palestinian Government to collect all the seignorage revenue accruing to the Palestinian economy.* Seignorage revenue can be raised once the PMA is involved in issuing high-powered money (currency held by the public and reserves of commercial banks held at the PMA). This revenue is estimated, on average, to account for 2 per cent of public sector revenue for developing countries (roughly \$20 million a year in the Palestinian case); and
- *To instil confidence in both the stability of the general level of prices and the soundness of the financial system.* This could be conducive to increasing domestic as well as foreign investments over the long term.

Given the present economic conditions, the goal of securing confidence in the new Palestinian currency should be given top priority. One arrangement under consideration is the issuance of an independent Palestinian currency. Under this regime the exchange rate of the Palestinian currency would be determined freely in the foreign exchange market by the forces of supply and demand. The PMA would have the option of intervening in the market to peg the exchange rate at a certain rate or within a specified interval (band). This arrangement might be attractive since an independent national currency is both a symbol of sovereignty and an instrument of monetary policy. It would also allow the PMA to choose a monetary policy compatible with the pace and requirements of the Palestinian reconstruction and development programme.

An independent monetary policy can serve both short- and long-term considerations. The former relate to being able to use the exchange rate to absorb external shocks and thus moderate their adverse impact on the domestic economy. The latter relate to the need to accommodate long-term economic growth by supplying liquidity and ensuring the stability of the capital market. But this attractiveness has its drawbacks. A new currency with a flexible exchange rate, and a nascent and still unsophisticated financial sector, have the potential for increasing the costs associated with instability in purchasing power. Some of the emerging economies have suffered from this problem in the past few years.⁴⁹ On the other hand, pegging the new currency to a fixed exchange rate requires the PMA to have a large amount of foreign reserves available, which might not be the case, especially in the early stages.

Furthermore, an independent currency issued by the PMA, which is under the control of the executive branch, could tempt the Government to finance budget deficits through the inflationary instrument of expanding the money supply. This could threaten the value of the currency, and ultimately lead the Government to place restrictions on capital mobility and trade. Under such circumstances, the independent currency could promote distortions and disequilibria harmful to both micro efficiency and macro stability.

An alternative arrangement under consideration, to prepare the ground in a disciplined manner for the issuance of a Palestinian currency, could be the establishment of a Currency Board (CB) with an exchange rate bound to a strong international currency, such as the dollar or the euro. A CB would aim to allow the new Palestinian currency to acquire credibility at the same time as the PMA builds up its central banking expertise and the Palestinian financial markets develop.⁵⁰ The eventual abandonment of this regime and the adoption of an independent Palestinian currency would be viewed as the natural conclusion of a transition process, during which credibility is established, institutions are built up and financial markets develop. An independent Palestinian currency would then permit the use of monetary policy to absorb external shocks through adjustment in prices, rather than reduction in production and employment.

2. Future trade arrangements

As was shown in chapter I, Palestinian trade performance deteriorated during the interim period. Sluggish export performance coupled with surging imports aggravated an already large trade deficit, while most Palestinian trade is still conducted with Israel and is exposed to systemic weaknesses and structural bottlenecks. It would be naive to suggest that the current situation can be transformed overnight once the Palestinian economy is freed of the constraints of the interim period, even assuming that a different trade regime emerges.

Achieving a considerable increase in exports and reorienting trade flows are difficult tasks, which require a well-defined strategy based on a realistic appreciation of both current Palestinian economic conditions and prospects in external markets. The PA needs such a strategy to serve as a guideline for bilateral and multilateral negotiations regarding new trade and economic cooperation arrangements. A comprehensive trade policy and sectoral development strategy remain to be elaborated, but much preparatory work has already been done by the PA, and the experience gained in implementing the interim-period trade regime has been instrumental in establishing parameters and criteria for future arrangements.

In this regard, the PA considers two principles to reflect Palestinian vital interests:⁵¹

- Future Israeli-Palestinian trade relations will have profound implications for the political relationship between Israel and the PA, and vice versa. Trade relations, therefore, need to be conceived in a manner consistent with Palestinian aspirations to statehood, with the West Bank and Gaza Strip continuing to constitute a single geographical entity and economy, as already stipulated in the interim accords. Diversifying trade relations, reintegrating the Palestinian economy into the regional economy and building new trade relations with the rest of the world are thus tasks which are highly relevant to the Palestinian political and economic future.
- Trade arrangements between the Palestinian economy and other countries, including Israel, should be designed in the light of the sequential stages of the Palestinian reconstruction and development programme . Thus, trade relations should evolve over time so as to bolster the objectives of those stages rather than undermine them. A rush to integrate the Palestinian economy into other markets, before a significant restructuring of the economy away from the pre-1994 trends which still dominate, runs the risk of locking the Palestinian economy into sub-optimal dependence.

These points imply that future Israeli-Palestinian trade relations need not be subject to an overly rigid agreement. They can evolve over time, in line with the dismantling of the occupation legacy. In this regard, from both an economic and a political viewpoint, the PA increasingly considers that the Palestinian interest may not be best served by negotiating a new trade relationship with Israel based on the current customs union (CU). Renewing the Israeli-Palestinian CU arrangement as currently structured could lead to no more than an “association agreement” through which the Palestinian economy would adopt, and adapt to, most of the elements of the current Israeli foreign trade regime, without any reciprocal adjustments by the Israeli partner. This could perpetuate a regime that is not conducive to Palestinian development objectives, given the great disparity between the two economies.

On the other hand, a complete free trade area (FTA) between the two parties may not be optimal at the present time especially if Palestinian labour cannot benefit from such an arrangement. In addition, some of the Palestinian industries that could not develop during the occupation era are in need of some degree of support over a limited period of time so as to upgrade and to compete with the productivity advantages of Israeli and other foreign competition. Most Palestinian industrial experts and sector representatives continue to strongly urge industrial support policies for those branches recommended by detailed cost-benefit studies, and for a stipulated period of time. These concerns need to be addressed.

On another level, integrating the Palestinian economy into the regional economy and the rest of the world cannot be accomplished under the present conditions of infrastructure, institutional framework and supply constraints. Nor can the integration of the Palestinian

economy into world markets be achieved through intermediaries and partners. The Palestinian economy should be able to realize its potential for dealing directly with regional and global trade and investment partners, according to its development needs and policies. Whatever arrangements do ultimately emerge, they need to address the political and economic imperatives for a degree of independent action for Palestinian trade policy-makers.

While regional economic cooperation in a future era of peace could have tangible benefits for the Palestinian economy in terms of economies of scale, market size and shared resources and infrastructure, medium-term priorities should emphasize developing distinctly Palestinian facilities, institutions and infrastructures. This should not be conceived as reflecting a “separation” policy towards Israel, but rather as part of efforts at improved utilization of Palestinian human, financial and natural resources, greater market diversification and promotion of a competitive, and thus ultimately more efficient, economic environment.

Regardless of the thrust of future trade policy, the Palestinian external trade sector has to be equipped with the means to interact more vigorously with bilateral and other markets. However, as many recent studies have demonstrated, there is a pressing need for development of trade-related infrastructure and services, as well as the requisite institutions. Basic facilities such as a seaport and expanded airport facilities are essential for establishing normal trade relations with the rest of the world.⁵² Overland trade with neighbouring countries is inhibited by the poor condition of the road network and the trucking fleet, both of which are in urgent need of rehabilitation and expansion. Trade procedures and operations at PA borders with Jordan, Egypt and Israel require a complete overhaul, as revealed in the findings of the recent UNCTAD technical assistance project in this field.⁵³ Legislation related to customs, transport information technology and electronic commerce, in addition to other trade facilitation issues, remains pending.

Furthermore, it is widely recognized that the Palestinian economy will not be able to reap the benefits of integration into world markets as long as the present supply-side constraints continue to prevail. These include a weak technological capacity, diffuse and untapped entrepreneurial and marketing skills and the absence of specialized institutions for agriculture and industrial products. Also, a major improvement in quality control, grading, packing and labelling is needed to make Palestinian exports competitive internationally.⁵⁴ Clearly, the interests of the Palestinian economy are best served by its designing its own set of standards reflecting its current conditions and development choices. Private and public sector institutions are already making important efforts to upgrade industries, while the development of a Palestinian Standards Institute is in its early stages. As regional and global economic integration is pursued, the domestic economy will have increasingly to conform to international standards governing quality, health and safety and intellectual property. Sustained efforts in this direction are not merely unavoidable in the light of global trends, but will also provide long-term benefits for Palestinian producers and consumers and enable the Palestinian economy to compete favourably in world markets.

In short, once Palestinian trade policy can be designed and implemented in accordance with national development needs and priorities, and the Palestinian economy is able to interact as an independent partner in international trade, it will be able to cooperate with neighbours in the region within an equitable and interdependent framework. Palestinian policy-makers and businessmen alike are aware of the realities on the ground and the degree to which the Israeli and Palestinian economies have become intertwined, in even more ways since 1994 than before. However, the Palestinian economy continues to cooperate with its neighbours, including its few non-Israeli trade and investment partners, as the weaker and less proactive partner. As long as this imbalance is maintained, prevailing mutual Israeli and Palestinian business and political interests could very well favour perpetuating the interim-period economic status quo in one form or another, without adequately addressing its shortcomings.

Chapter IV

CONCLUDING REMARKS: ENVISIONING PALESTINIAN DEVELOPMENT

The previous chapters have demonstrated that while the PA is making a serious effort to reconstruct the Palestinian economy along a path leading to sustainable growth, obstacles in both the political and economic domains still retard that effort and frustrate its achievements. Overcoming some of these obstacles may still be beyond the immediate reach of the PA, but this does not obviate the need for a comprehensive strategy to guide PA action in those domains in which it has authority and can effect change.

While some efforts in this direction have been initiated, they have lacked coherence, continuity and clear purpose. In the post-interim period, with major political issues resolved, the PA should be able to address this requirement in a more comprehensive manner than has so far been possible. Future efforts could usefully take as their starting point the ground already covered and the issues identified by various sources as pertinent to the immediate and longer-term tasks of developing the Palestinian economy. A range of considerations that could be relevant to designing an appropriate development policy and strategy are currently under thorough examination by the PA.⁵⁵

Since the beginning of the Middle East peace process, and especially since 1993, Palestinian and international sources have initiated research, workshops and conferences to attempt to address some of the key long-term development prospects and options facing the PA. The first Palestinian statement in this regard was the “Programme for Development of the Palestinian National Economy 1994-2000”, prepared by Palestine prior to 1993 and quickly overtaken by events. In 1996 a conference was held at Bir Zeit University on the theme “The Palestinian economy: towards a vision”, but did not produce concrete results in terms of follow-up by the PA. As the PA’s only published development strategy document, the Palestinian Development Plan (PDP) served primarily as a framework to guide donor assistance on a three-year, rolling basis.⁵⁶ Most recently international assessments of the PA institution-building process have prompted some remedial steps to improve PA economic policy-making and financial management.

While these activities have yielded useful and thought-provoking ideas, it has not been possible to consolidate these elements of a Palestinian development vision into a comprehensive, coherent and realistic “mission statement”, fully owned by the PA. A number of reasons may be cited to account for the shortcomings of these efforts:

- Many studies were conducted under the auspices of foreign organizations or were constrained by political considerations reflecting the immediate concerns of the peace process, rather than the long-term interests of the Palestinian economy.
- Development plans designed by various PA ministries and departments were, of necessity, drawn up as investment-driven programmes motivated by the exigencies of the time and not intended to produce a comprehensive strategy for the future.

- Many plans and schemes were produced by professionals and technicians, representing the views of a certain ministry, department or sector. None has been the outcome of public debate or endorsed by the PA and the private sector.

It is now widely accepted that, as the PA prepares to assume national government responsibilities, a far-reaching policy statement is needed. This would help shape institution-building efforts, reform measures and reconstruction programmes and guide strategic development policy elaboration. It would also equip policy-makers with studied and quantifiable assessments of the long-term economic and financial costs and benefits of pursuing an alternative development path. Furthermore, it would be indispensable as a reference tool for economic negotiations at bilateral, regional or global level.

In future efforts to envision a Palestinian development policy, a conceptual framework will be needed to delineate the terms in which Palestinian economic priorities can be spelt out. Such a framework needs to recognize the objective conditions of the Palestinian economy, reflect the imperatives of Palestinian political aspirations and draw on lessons acquired from the development experience of other countries. Furthermore, policy makers need to consider sequential stages through which policy goals can be achieved in a gradual manner. Aspects of international development experience, some of which have emerged as fundamentals in terms of which development perceptions may be articulated, are relevant to the Palestinian case and should be thoroughly examined.

In looking forward to the task of strategic development policy-making, the following points flag some of the issues that have special relevance in the Palestinian context:

- *The impact of the external environment.* An accurate appraisal is required of the extent to which trends that emerged under the occupation can continue to shape economic and social trends after independence has been obtained.⁵⁷ Accordingly, the impact of prolonged occupation and the interim self-government period must be carefully considered in order to understand the nature of the “adverse path dependence” confronting the Palestinian economy, and the challenges faced in moving towards a new “positive path dependence”.
- *Internal determinants of growth.* Bearing in mind recent international research on the determinants of economic growth, especially with regard to incorporating the process of accumulation of human capital and technical innovation,⁵⁸ an appreciation of the developmental impact of human capital enhancement is important to the successful design of future Palestinian development policies and plans. Policy makers can benefit from a better understanding of how institutions, government policies and the legal framework affect long-term growth through their impact on incentives to accumulate human capital and engage in technical innovation.⁵⁹

- *Institutional reform to bolster the role of the market.* Successful development experiences in past decades have highlighted the need to identify the most effective mix of the role of the State and that of the market. Institutional reforms should be designed so as to allow firms to expand and promote productive entrepreneurship rather than rent-seeking activities. The PA could derive useful lessons from a closer examination of international experience in this regard.
- *The imperatives of structural transformation.* While the initial impulse towards reviving the role of the productive sectors of the Palestinian economy can most easily come from an increase in industrial production, especially agro-industries, this stage of import substitution has its natural limits as a generator of growth and development. Once most of the potentially viable non-durable consumer goods imports have been replaced by competitive domestic production, the PA will need to address the question of what can be done to ensure sustained industrialization and growth. One strategy that has been successfully pursued elsewhere is to move towards export orientation. Given the small size of the Palestinian market and the small number of firms in each industry, the ability to compete in foreign markets requires an early and determined effort to assist in facilitating higher-quality exports.
- *Technological learning and creating capacities.* Producing new goods and services need not require either the commitment of large amounts of capital or an abundance of natural resources. Equally important is the ability to accumulate human capital, effectively absorb scientific innovation, learn new techniques and adopt modern organizational methods of production.⁶⁰ Such knowledge-based assets can be acquired, provided that human resources are utilized and expanded along a well-defined strategy of technological development. The Palestinian economy needs to gain access to this knowledge base through training and adaptation of new technologies so as not to lag behind. The acquisition of technology needs to be carefully considered in the context of future Palestinian trade and economic relations with Israel and regional partners.
- *The role of government.* Given that the Palestinian private sector is still evolving, the public sector is likely to maintain its leading role in encouraging firms to tackle new production challenges in areas deemed to be of high priority, while supporting research facilities to undertake scientific activities that are complementary to new industries. Carrying out these activities in a manner that ensures that the growth of the public sector becomes an asset to the private sector is a major undertaking related to the important question of the role of the State in development.⁶¹ Institutional and attitudinal changes have begun to take shape as PA policy makers tackle the complex problems facing the emergence of the Palestinian economy at the regional and global levels. This should be further encouraged if the Palestinian public sector is to be successful in promoting sustained development.

Notes

¹ In accordance with the relevant United Nations General Assembly resolutions and decisions, references in this study to “the occupied Palestinian territory” pertain to the Gaza Strip and West Bank, including east Jerusalem. For the sake of brevity, the term “the Palestinian territory” is also used as appropriate. In accordance with the relevant General Assembly resolution, the term “Palestine” in this study refers to the Palestine Liberation Organization, which established the Palestinian Authority (PA), pursuant to the 1993-1994 accords with Israel.

² The role of the PA in the economic sphere is defined by the agreement signed in April 1994 entitled “Protocol on Economic Relations between the Government of the State of Israel and the Palestine Liberation Organization, representing the Palestinian people”, known as the Paris Protocol. The full text is published as United Nations document A/49/180; S/1994/727, 20 June 1994.

³ In 1995, the PA adopted the Law on the Encouragement of Investment (updated in 1997), which provides specific tax exemptions for private investments. The exemptions are related to the amount of capital committed, the level of employment generated and the anticipated duration of the project.

⁴ For a detailed analysis of the development of the banking system in the West Bank and Gaza Strip, see Hamed O, *The Palestinian Banking System: Reality and Potential*. Ramallah, Palestine Economic Policy Research Institute (MAS), 1996.

⁵ See Palestinian Authority, A preliminary statement on Palestinian development strategy, presented to the Conference on Assistance to the Palestinians, Paris, 9 January 1996. Gaza, 27 December 1995.

⁶ See Palestinian Authority, *Palestinian Development Plan 1999-2003*. Gaza, January 1999.

⁷ The formal agreements between Palestine and Israel did not explicitly impose a freeze on Israeli confiscation of land and building and expansion of settlements. The Palestinian side, however, maintains that such a freeze is implicit in the clause that prohibits both sides from engaging in unilateral activities that prejudice permanent status negotiations.

⁸ According to survey studies conducted by the Palestinian Central Bureau of Statistics (PCBS), real per capita average expenditures in the 1995-1996 survey period were about 15 per cent below the average for 1992-1993. See *Expenditure and Consumption Surveys*, Ramallah, PCBS, October-September 1996 and April-May 1996.

⁹ It has been estimated that the short-term cost of the closures for the West Bank in 1995 and 1996 was 15 and 18 per cent of GDP respectively, while the loss for the Gaza Strip was 35 and 40 per cent of GDP for the same two years. See Diwan I and Shaban R, eds., *Development under Adversity: The Palestinian Economy in Transition*. Ramallah, Palestine Economic Policy Research Institute (MAS) and World Bank, 1999.

¹⁰ According to Palestinian sources, confiscation of land continued in the post-Oslo period. These sources estimate that Israel confiscated 5,119 dunums in 1994, 24,867 dunums in 1995, 6,000 dunums in 1996 and 24,938 dunums in 1997 (1 dunum = 1,000 square metres). See Palestine Economic Policy Research Institute, *MAS Economic Monitor*, No. 3, December 1998.

¹¹ Palestinian and Israeli non-governmental organizations report that 16 new settlements were created during a period of five months after the Wye River Memorandum was signed at the White House. See *New York Times*, 3 March 1999.

¹² UNCTAD, *The Palestinian economy and prospects for regional cooperation*. UNCTAD/GDS/SEU/2, Geneva, 1998.

¹³ The UNCTAD secretariat has developed a Palestinian Macroeconomic Simulation Framework (MSF), which demonstrates the capacity of the economy to break out of the current adverse path dependence, reduce major macro distortions (trade deficit, savings investment gap and chronic unemployment) and productively absorb a large returnee population over 10 years. This is to be achieved through a combination of policies to enhance domestic savings and investment, expand and diversify exports and better allocate significant flows of external resources.

¹⁴ Population and labour force data for 1997 and 1998 are all from PCBS, as presented in Office of the United Nations Special Coordinator in the Occupied Territories (UNSCO), *Report on Economic and Social Conditions in the West Bank and Gaza Strip*. Gaza, 1999.

¹⁵ These figures relate to employment in the second quarter of 1998 as compared with the second quarter of 1997. See *MAS Economic Monitor*, No. 3, December 1998.

¹⁶ See UNSCO, *Report on Economic and Social Conditions in the West Bank and Gaza Strip*. Gaza, 2000.

¹⁷ Available published data and estimates on Palestinian economic performance all draw on three main sources - the Palestinian Central Bureau of Statistics, the PA Ministry of Finance and International Monetary Fund staff estimates, as follows:

- *MAS Economic Monitor*, No. 3, December 1998;
- Palestinian Authority and International Monetary Fund, *West Bank and Gaza Economic Policy Framework: Progress Report*, 31 May 2000;
- UNSCO, *Report on Economic and Social Conditions in the West Bank and Gaza Strip*, 1999 and 2000.

¹⁸ Unless otherwise indicated, economic data presented here exclude east Jerusalem.

¹⁹ UNSCO, *Report on Economic and Social conditions in the West Bank and Gaza Strip*, 1999, p. 8.

²⁰ UNSCO, *Report on Economic and Social Conditions in the West Bank and Gaza Strip*, 2000.

²¹ The number of new companies declined by 27 per cent for companies with private limited liabilities, 50 per cent for companies with public limited liabilities and 75 per cent for foreign companies during 1997. The value of approved investment projects declined by 4 per cent for domestic investment and 65 per cent for foreign investment during the year. See UNSCO, *Report on Economic and Social Conditions in the West Bank and Gaza Strip*, 1999, p. 9.

²² UNSCO, *Report on Economic and Social Conditions in the West Bank and Gaza Strip*, 2000.

²³ *Ibid.*, p. 11.

²⁴ Palestinian balance-of-payments data are generally considered weak and contain serious errors, omissions and discrepancies, which might account for a part of this deficit in “net capital movements”, estimated at over \$700 million since 1999. Otherwise, this item reflects the effective external financing needs of the Palestinian economy.

²⁵ See Cooperation between the Palestinian Authority, Egypt and Jordan to enhance subregional trade-related services. UNCTAD/GDS/SEU/3, Geneva, February 2000.

²⁶ This report by the Council for Foreign Relations (CFR) is a prime example of newly emerging linkages between domestic and international considerations in setting the tone for PA reform. See CFR, *Strengthening Palestinian Public Institutions*. New York, 1999.

²⁷ For a detailed description of the infrastructure in the West Bank and Gaza, see Diwan and Shaban, chapter 13.

²⁸ The first power generation station, currently under construction with donor finance, is due to go on-line in 2001.

²⁹ See *MAS Economic Monitor*, No. 3, December 1998, p. 4.

³⁰ Palestinian Authority, *Palestinian Development Plan 1999-2003*. Gaza, January 1999.

³¹ *Ibid.*

³² In 1995 there were 12 doctors per 10,000 people in the Palestinian territory, whereas the ratio during the 1980s was 24 in Jordan and 28 in Israel. Similarly, in 1995 there were 1.3 hospital beds per 1,000 people in the West Bank and Gaza Strip compared with 1.8 in Jordan and 2.0 in Egypt. See Diwan and Shaban, chapter 12.

³³ Stiglitz J, in his introduction to Diwan and Shaban, chapter 13. See also Barrow RJ et al., *Economic Growth*. McGraw-Hill, 1995, chapter 12.

³⁴ For a detailed analysis of factors contributing to the low participation rate, see UNCTAD, *Prospects for sustained development of the Palestinian economy: strategies and policies for reconstruction and development*. UNCTAD/ECDC/SEU/12, Geneva, 1996, p. 96.

³⁵ See Diwan and Shaban, chapter 13 and chapter 10, table 10.2.

³⁶ See Naqib F, *A Preliminary Evaluation of the Tax System in the West Bank and Gaza Strip*. Ramallah, MAS, 1996.

³⁷ This understanding between the PA and the donor countries, originally reached in 1996, was again underlined at the meeting of the Consultative Group of Donors in December 1997. See World Bank press release, *International community reaffirms support for Palestinian development*, Paris, 15 December 1997. It has since been incorporated into the workplan of the Higher Council for Development (referred to in chapter I).

³⁸ Palestinian Authority and International Monetary Fund, *West Bank and Gaza Economic Policy Framework: Progress Report*, 31 May 2000.

³⁹ CFR, *Strengthening Palestinian Public Institutions*. New York, 1999.

⁴⁰ Palestinian Authority and International Monetary Fund, op. cit.

⁴¹ *MAS Economic Monitor*, No. 6, April 2000.

⁴² For example, the two sides agreed at the technical and senior ministerial levels in early 1998 on a significant increase in the number of imported goods in respect of which customs duties may be reduced by the PA or which may be exempted from such duties. The agreement was formalized only in June 2000, owing to a variety of factors related to the non-implementation of economic issues covered by the Wye River Memorandum.

⁴³ See UNCTAD, *Cooperation between the Palestinian Authority ...*

⁴⁴ See Awartani H, *Palestinian-Jordanian Agriculture Relations*. Nablus, Centre for Palestinian Research and Studies, 1994; and Makhool B, *Competitiveness of Palestinian Industry vs Jordanian Industry*. Ramallah, Palestine Economic Policy Research Institute (MAS), 1996.

⁴⁵ Ibid.

⁴⁶ For a detailed analysis of monetary shocks facing the Palestinian economy during the interim period, see: Hamed O, *Monetary Policy in the Absence of a National Currency and under a Currency Board*. Ramallah, Palestine Economic Policy Research Institute (MAS), forthcoming.

- ⁴⁷ See *MAS Economic Monitor*, No. 3, December 1998, p. 5.
- ⁴⁸ Depreciation of the shekel tends to inflate prices in Israel through the large import component, which in turn inflates Palestinian prices.
- ⁴⁹ Monetary policy in those countries has not been independent of the Government, which has in effect relegated it to the role of accommodating lax fiscal policy, thus causing inflationary pressure and instability. This was the reason for the establishment of a Currency Board (CB) in Estonia (1992) and in Lithuania (1994).
- ⁵⁰ The successful management of a CB requires strong political commitment, rather than strong institutions: the recent revival of the CB institution in some developing and transition economies was motivated by a general distrust of monetary institutions and a desire to curtail their discretionary powers.
- ⁵¹ This section draws on an unpublished report prepared by an UNCTAD consultant, Luis Abugattas.
- ⁵² Gaza International Airport was opened at the end of 1998, but the West Bank needs its own airport.
- ⁵³ See UNCTAD, *Cooperation between the Palestinian Authority ...*
- ⁵⁴ For a detailed analysis of these issues, see UNCTAD, *The Palestinian economy and prospects for regional cooperation*, chapter III, section D; and UNCTAD, *Palestinian merchandise trade in the 1990s: opportunities and challenges*. UNCTAD/GDS/SEU/1, Geneva, 1998.
- ⁵⁵ The need to elaborate a Palestinian position and statement in this regard has recently been recognized by the PA, which has begun work on a Palestinian Strategic Development Plan, due for completion in 2001, to be prepared by the PA and affiliated research teams and drawing on assistance from international sources. The assessment in this chapter is intended as a contribution to this effort.
- ⁵⁶ See chapter II.
- ⁵⁷ See Alan MS, *Colonialism, decolonization and growth rates: theory and empirical evidence*. *Cambridge Journal of Economics*, 1994, 18: 235-257.
- ⁵⁸ See Gypher J and Dietz J, *The process of Economic Development*. London, Routledge, 1997, chapter 13, p. 404.
- ⁵⁹ George Abed made an important contribution to the debate on Palestinian growth and development prospects at the conference held at Bir Zeit University in 1996. He argued that “endogenous growth” theory, which incorporates knowledge-generating activity into the production function, provides a framework for exploring policy issues related to the choices

made by Governments. As for the growth prospects of the Palestinian economy, Abed believes that three critical factors determine the shape of the growth path: political arrangements, policy fundamentals and institutions (both political and economic). See Abed G, Prospects for long-run sustainable growth, paper presented to the Conference on “The Palestinian economy: towards a vision”, organized by the Arab Economists Association, Bir Zeit University, June 1996.

⁶⁰ Evenson RE and Westphal LE, Technological change and technology strategy. In: Behrman J and Srinivan TN, eds. *Handbook of Development Economies*, Vol. IIIA, Amsterdam Elsevier Science, 1995. See also Gypher and Dietz, chapter 13, p. 465.

⁶¹ For a recent analysis of the role of the State in development, see Evans P, *Embedded Autonomy*, Princeton, NJ, Princeton University Press, 1995. A considerable amount of attention has been paid by donors and Palestinian policy makers in the past few years to improving PA performance, especially at the executive level, in the hope that some of the widely acknowledged mistakes of other developing economies may be avoided.

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