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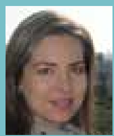
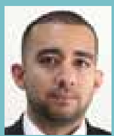
Growth in the Palestinian Economy
Drivers, Restrictions, and the Way Forward

Photo courtesy of Al Shabaka.org.

By Nur Nasser Eddin and Abdalwahab Khatib





Graphing growth rates of the Palestinian economy over the past twenty years would be like sketching a roller-coaster ride. The trend becomes even more erratic if growth rates for Gaza and the West Bank are plotted separately. Understanding this volatile economic behaviour requires taking a careful look at the main factors that have been driving growth, in addition to the key impediments that are faced by economic agents. Only then can a full rounded understanding of how the Palestinian economy works and what can be done to help it reach its potential be developed.

With the advent of the Oslo Peace Process and the establishment of the Palestinian Authority in 1994, the Palestinian economy experienced rapid growth that was enabled by the return of Palestinian refugees, restoration of livelihoods, and large inflows of public and private capital. Thus between 1994 and1999, growth averaged 9 percent and unemployment declined to below 9 percent.

After the outbreak of the second Intifada in 2000, however, this trend was quickly reversed. The peace process stalled, violence increased, and the government of Israel imposed a multi-layered system of physical, institutional, and administrative restrictions that fragmented the territory into small enclaves that lacked most forms of economic cohesion. This exacted a significant toll on the economy and constrained private investment and productivity. The real rate of growth quickly deteriorated to -9 percent and unemployment surged to 28 percent by the end of 2000.

Following the internal divide in mid-2007, a new PA caretaker government was sworn in, and it pursued recovery and fiscal stabilisation. Reforms carried out by the caretaker government were widely endorsed by the international community, which supported these efforts through providing large amounts of aid. Donor aid fuelled public and private consumption that, in addition to some easing of Israeli movement restrictions and PA-led reforms, enabled the Palestinian economy to recover. In fact, growth rates averaged 9 percent between 2008 and 2011, and standards of living improved as GDP per capita reached US$ 2,665 by the end of this period.

Nevertheless, the economy has been struggling ever since. The downturn started in 2012 when growth decelerated to about 6 percent as a result of a steep drop in foreign aid. This immediate response to the decline in aid reveals an inherent structural weakness in the Palestinian economy, which is lacking a competitive and dynamic private sector that can fuel growth and employment. The economic decline continued throughout 2013, and the economy actually slipped into recession in 2014, even prior to the start of the latest Gaza war. Recent estimates indicate that full-year growth in 2014 would amount to about -4 percent. With the unfolding recession, unemployment has reached a new high, particularly in Gaza where it stood at about 45 percent before the war (latest available data). Since poverty is highly correlated with labour-market outcomes, it is not surprising that a quarter of the Palestinian population has been living in poverty, and it is expected that the recent Gaza war has pushed many others below the poverty line (latest available data is for 2012).

Decomposing recent growth trends provides a very important insight into how the structure of the Palestinian economy has deteriorated in recent years, making it less competitive. For instance, most economic growth witnessed over the last years was in the public and non-tradable sectors whose share in the economy increased from 19 percent in 1994 to over 30 percent today. This has been positively reflected in the quality and quantity of public services provided by the government.

> Following political instability, the second largest obstacle to business, as perceived by enterprises, is the lack of reliable supply of electricity, particularly in Gaza.

Olive picking. Photo courtesy of ncpr.org.

But growth in the public sector has not been accompanied by an expansion of sectors that can generate public revenues to continue the provision of those services over the medium and long term. For instance, the size of the manufacturing sector, typically the key driver of export-led growth, halved between 1994 and today, which led to a deindustrialisation of the Palestinian economy. Developments in agriculture are very similar to those in manufacturing, with the size of the sector shrinking from 13 percent in 1994 to 6 percent today, and sector productivity halved. With the decline of both the agriculture and manufacturing sectors, the Palestinian economy's capacity to export and compete in foreign markets has significantly declined.

Furthermore, private investment, which is essential for maintaining competitiveness, has been around 15 percent of the GDP over the last decade. This rate is very low compared to other comparator countries. A recent Investment Climate Assessment conducted by the World Bank in 2014 shows that the main reason Palestinian enterprises are not investing enough to maintain their competitiveness is because of political instability and the restriction system imposed by the government of Israel on trade, movement, and access. These restrictions result in high risks, increased costs, and a fragmented Palestinian economic space.

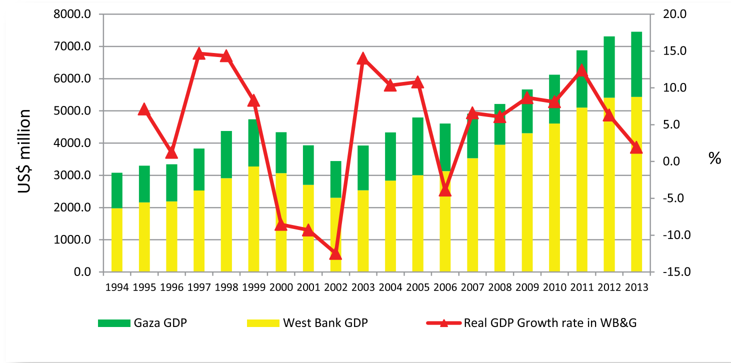
In particular, restrictions on access to Area C are among the most detrimental to economic growth and investment. Area C represents 61 percent of the West Bank, and it is the most resource abundant space in the country. It is also the only contiguous land in the West Bank that connects 227 separate geographical areas classified as A and B. A World Bank study published in 2014 entitled "Area C and the Future of the Palestinian Economy" revealed that lifting restrictions on Area C could increase the size of the Palestinian economy by 35 percent, which would have a significant positive effect on living standards of Palestinians.

With the acknowledgment that political instability and restrictions top the list of major obstacles faced by the Palestinian private sector, it then follows that any lasting transformative steps towards reversing the current economic downturn must first address the political instability emanating from the conflict. While this often tops the list of high priority actions to generate positive impact on the Palestinian economy, it is also undoubtedly the most challenging.

In the absence of the political enablers necessary to reverse the distortionary effects of the political realities, several actions can be taken to mitigate the effects of political instability and to marginally facilitate growth – albeit limited – within the private sector.

While it is uncommon for global institutional investors to undertake investments in the Palestinian economy, several successful cases of multinational companies doing business here do exist. Additional investments in targeted sectors can be encouraged through more effective investment promotion activities. Official investment promotion agencies such as PIPA should play an increasingly prominent role in attracting FDI through regional campaigns and policy reforms; however, grassroots campaigns at the level of industry associations must also be nurtured and supported. To further encourage first movers considering new investments in the Palestinian market, the availability of risk mitigating mechanisms is key. Political risk insurance offered by the Multilateral Investment Guarantee Agency (MIGA), for example, has been actively deployed for several years, and the current programme is close to reaching its capacity. Efforts should be made by international institutions and development agencies to ensure that additional funding is made available to underwrite political risk coverage for potential future investments.

Work also needs to be done to enhance the legal and regulatory environment



Source: Palestine Central Bureau of Statistics (PCBS)

in the Palestinian territories that is currently deemed inadequate to attract the needed foreign and domestic investment. The current system of laws stems from various periods of Palestinian history and consists of layers of Ottoman, British Mandate, Jordanian, Egyptian, and Palestinian laws as well as Israeli military orders. This disparate group of laws leaves significant gaps and contains many internal inconsistencies. Thus, reforming the current collection of legislation governing business is critical to improving the investment climate.

While access to land in Area C may be subject to developments on the political front, current steps can be taken to facilitate a more efficient utilisation of resources in areas A and B. A dedicated government agency does exist to manage the land registration process; however, at the current rate of dispute resolution and registration procedure, it would take approximately 80 years to completely register all unregistered land in the West Bank. A more streamlined and less costly process for land surveying, dispute resolution, and registration in areas A and B would release significant assets and resources into the economic space, with related benefits to the financial sector through collateralised lending.

Access to finance is often dubbed as the lubricant for economic growth. Yet evidence shows some room for improvement on the issue of MSME access to finance in the Palestinian market, including the informal sector. As the main source of financing, the Palestinian banking sector is regarded as both stable and conservative, with the majority of its lending done through salary-backed personal loans rather than small business loans. In particular, small and informal firms appear to be significantly more constrained in obtaining credit when they need it compared to large firms. A recent enterprise survey indicates that 40 percent of large firms have a loan or access to a line of credit, compared to only 4 percent among small firms, many of which report collateral requirements set for them at 200 percent of loan value. Greater access to finance for such firms should begin with supporting financial inclusion. Concrete steps may include greater support and development for non-bank financial institutions (e.g., leasing, insurance), the microfinance market, and addressing the collateral constraints, which seems to be the stumbling block for many micro and small businesses.

Reforming the education system so that it produces graduates well equipped with skills required by the private sector is also critical to increasing the productivity and competitiveness of Palestinian businesses. The Palestinian private sector consistently reports that it is unable to find workers with the skills that it needs. This is particularly a problem for exporters of high value added goods and services. If the Palestinian economy is going to integrate into world supply chains, it is critical that the education system prepare students for the modern workplace. Education must go beyond basic literacy and provide students with the high-level cognitive skills (such as analysis, problem solving, and communication) and behavioural skills required by competitive industries. This will require the PA to accelerate education reforms in the Palestinian territories.

In sum, removing restrictions currently imposed by the government of Israel on movement, access, and trade is considered a necessary condition for growing the Palestinian economy because it is the only way to reduce the current aid dependence and enable the private sector to become the real engine of sustainable growth. However, it is important to note that despite being necessary, the removal of restrictions will not be sufficient. Efforts also need to be conducted by the Palestinian Authority on multiple fronts such as enhancing investment-promotion activities, accelerating the process of land registration, improving access to finance, and implementing policies for aligning education and workforce development with economic development.

Nur Nasser Eddin is an economist at the World Bank. Prior to joining the bank, she held several positions in the private sector, the last of which was as head of the Investor Relations Unit at PADICO Holding. Nur holds a master's degree from the London School of Economics and Political Science.

Abdalwahab Khatib is a private-sector development specialist at the World Bank. Previously, he held the position of investment manager at Palestine Investment Fund. Abdalwahab holds a master's degree from the University of Chicago.

An-Najah University, media room.