The Impact of the World Financial Crisis on the Palestinian Economy

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For more than 40 years, the functioning of the Palestinian economy has been subject to the interests, measures and policies of the Israeli occupation. Accordingly, breaking up the unfair economic and trade ties between the Occupied Palestinian Territories (OPT) and Israel was a necessary precondition to securing economic independence and growth. In the absence of any political and economic settlements, the performance of the Palestinian economy has been on the decline, and Israel's economic shock policies and measures have created challenges and impediments to any improvement (El-Jafari, 2007). For example, twin deficits – the budget deficit and the trade deficit – tend to move jointly, both having increased rapidly over the last three years. Together, they have created a savings and investment gap, in which demand for investments is high but there are no savings. Consequently the gap between savings and investments has also tended to increase over time. The proportion of imports to the GDP has increased as well, from 40% in 2000 to more than 60% in 2008 (El-Jafari 2002; Naqib, 2003).

Remittances ranged between 20 to 35% of gross domestic product (GDP) in the period between 1968 and 2008. In the mid 1980s, as the level of remittances approached 35% of the GDP, they came to be seen as the "engine" of the economy and generated stable levels of consumption, leading to an income economy rather than a productive economy.

Remittance flows were greater than those of foreign exchanges in services, exports and foreign aids. External revenues, including donor grants, had quadrupled between 1999 and 2008 to nearly $2 billion, 90% of which went to financing the current budget. Those revenues accounted for 40% of GDP (El-Jafari, 2010).

The rise in labour and capital employment was not accompanied by any movement in productivity, whether in the private sector or the public sector, and intensive labour sub-sectors, such as services, witnessed significant increases in employment. Production factors are mainly imported from Israel, and the importation of technology remains at a low level (IMF, 2009; 2010).

Eventually, the choice in the future will be how to move from engagement with the Israeli economy to integration into regional and international markets by raising merchandise exports. At present, external support is needed to activate the national economy. For example, 20 days following the Israeli war against Gaza in the early days of January 2009, the European Union needed flowers; it therefore forced Israel to allow the export of flowers from Gaza, which demonstrated that this could be done for other merchandise. To show the impact of Israeli practices, it was found that the GDP of the West Bank and Gaza Strip (WBGS) in 2009 was below its 1999 level. During that period, the real GDP of the WBGS did not exceed $4.5 billion. This could be attributed to the shock policies adopted by Israel for the Palestinian economy over the past four decades. It has been estimated that the potential capacity of the Palestinian economy in 2008 could have been three times greater than its actual level if the economy had continued performing as it had between 1970 and 1985 (UNCTAD, 2009).

Consequences of the World Financial Crisis on the Palestinian Economy

Over the past two years, the negative consequences of the world financial crisis have been extensively discussed in literature (Khallouli and Nabi, 2010). In fact, the impact of the financial crisis has been transmitted from developed countries to less developed countries through economic relations and international banking channels. However, due to poor linkages between the emerging, regional and international markets, in terms of investment or capital markets, variations in the stock markets are seen to be very limited.

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The Palestinian financial market, for example, is linked to the financial crisis through its transmission effects from the Israeli economy. In fact, the containment of the Palestinian economy by the Israeli economy has led the performance of the Palestinian economy to be subject to that of the Israeli economy. The influence of the financial crisis on the Palestinian economy is transmitted through the following channels:

(i) Palestinian trade with Israel.
(ii) International financial flows from the donor countries.
(iii) The banking system

The impact and consequences of each channel are discussed below.

Palestinian Trade with Israel

Over the past four decades, Israel has been considered the major trade partner with the WBGS. More than 90% of Palestinian merchandise exports are allocated to the Israeli markets; nevertheless, around 80% of the Palestinian imports originally come from Israel. Therefore, any changes in the Israeli macroeconomic forces would have a direct and significant impact on trade levels between Israel and the WBGS. On the other hand, Palestinian merchandise imports were estimated at more than 70% of the WBGS GDP (El-Jafari, 2010). Trade with Israel has expanded over time due to the following reasons:

- Importing from Israel has been considered a major source of revenue to finance the budget. It is therefore logical that financing the budget deficit by creating a trade deficit is an attainable option for the Palestinian National Authority (PNA). Since 1994, and according to the Paris Protocol signed by the Palestinian Liberation Organization (PLO) and the Government of Israel, trade tariff revenues generated from Palestinian merchandise imports are generated by the Israeli government and then transferred to the PNA. In recent years, Israel has frozen tariff revenues generated from imports for several months before transferring them to Palestine; particularly the case in 2006. Since then, Israel, the USA and other donor countries imposed several economic measures and sanctions on the Palestinian government to meet a number of basic political conditions. Thus, withholding tariff and tax revenues collected by Israel on Palestinian merchandise and services imports from or via Israel destined to the WBGS has become one of the most effective punishment measures adopted by Israel to suppress the Palestinian resistance against the Israeli Occupation (El-Jafari and Daoud, 2010).
- The rise in the merchandise import bill has been attributed to global price increases. In 2008, prices of food products, fuel and raw materials increased sharply, consequently increasing the value of imports. Price increases of those commodities have been transmitted to the Palestinian markets through the Israeli markets. On the other hand, global price increases made Palestinian products much cheaper in the Israeli markets. Eventually, Israeli importers turned to the Palestinian markets to meet the demand in local markets (PMA, Annual Report, 2010).
- Palestinian workers' remittances have been viewed as the engine to the Palestinian economy. While remittances are considered an external income, they have increased the gap between gross national disposable income and GDP. It is evident that any increase in income would shift the demand for imports. However, an increase in remittances is a derived demand from the increase in the demand for labour in the Israeli

markets. Although Palestine is not a unique case, workers' remittances have pushed the WBGS from a productive economy to an income and artificial economy, which is contained by the Israeli economy (El-Jafari, 2010).

- The real exchange rate effect of the Israeli currency (NIS) seems to increase Palestinian imports from Israel. It becomes cheaper to import from Israel than from abroad. The impact of real exchange rates has been found to be significant for all import groups particularly in manufactured goods. On the other hand, real exchange rates remain one of the main factors behind merchandise trade flows between the WBGS and the Israeli markets. Therefore, an increase in the value of the US currency with respect to the Israeli and Jordanian currencies would increase merchandise trade flows from the WBGS to the Israeli and Jordanian markets. To avoid a devaluation of the local currency against the US dollar, Palestinian exporters are paid in local currencies (New Israeli Shekel or Jordanian Dinar). Therefore, it becomes cheaper and preferable to the Israeli importer to buy Palestinian goods in Israeli shekel rather than in US dollars (El-Jafari, 2010). In the years 2008-2009, Israeli economic policies were directed toward price adjustments and stabilisation. Consequently, import and domestic prices in the WBGS showed very modest variations over this period. While inflation rates averaged 4-5% in Israel, they did not exceed 5% in either year in the WBGS. While Israel responded to the financial crises through price adjustments to increase aggregate demand, domestic prices in the WBGS were stabilised through imports from Israel, which account for more than 60% of consumption demand in the WBGS (Madar, 2010, Strategic Report; El-Jafari and Daoud, 2010).

International Financial Flows from Donor Dountries

Instead of labour export revenues being replaced with merchandise exports, particularly since 2000, foreign aid has become the main financial source to cover the deficit of the current PNA budget. Over the past decade, the contribution of the productive sector has tended to decline. The influence of the financial crisis on the Palestinian economy has been transmitted through trade flows, mainly with Israel, and transfer payments from donor countries. External revenues such as grants from donors quadrupled from 1999-2009. They increased from $497 million in 1999 to $1.953 billion in 2008; 90% was allocated to finance the current budget .This accounts for 40% of the GDP. Transfer payments are the major source of foreign exchange. They are employed to finance both the current budget and the trade deficit. Wages and salaries account for 55% of total public expenditures. In recent years, mainly since 2006, PNA domestic revenues have become insufficient to cover even the wage and salary bill of the public sector (Palestinian Monetary Authority, Annual Report, 2009; IMF, 2009; 2010).

The influence of the financial crisis on the Palestinian economy has been transmitted through trade flows, mainly with Israel, and transfer payments from donor countries

In addition, since mid 2007, Israel, the US and other donor countries lifted certain economic measures and sanctions on the Palestinian government in the West Bank, particularly, after it met a number of basic political conditions. In 2008, the Palestinian economy was expected to feel the effects of the financial crisis through decreases in aid, especially from the Gulf States and Europe, due to the fall in the dollar and the losses suffered by Europe and America. It is clear that international aid is significant in financing development projects in the WBGS. The economic measures lifted by Israel and donor countries are outlined below:

1. Promotion of tariff and tax revenue flows to the PNA collected by Israel on Palestinian merchandise and services imports from or via Israel destined to the WBGS.
2. Restrictions imposed by Israel on Palestinian labour mobility to Israel were kept to a minimum between 2001-2007. Over the period 2007-2009, the proportion of Palestinian workers in Israel to that of workers in the WBGS accounted for only 10%.
3. By easing Israeli security checks with the WBGS, and thereby relaxing Palestinian trade with and

via Israel, Palestinian trade in 2006 became closer to its levels in 2002.

4. Foreign aid covers budget support and humanitarian and development aid. In 2008, foreign aid to the WBGS amounted to $2 billion, around 22% of GNDI.

However, the regular financial support received by the Palestinian National Authority (PNA) from the donor countries was expected to be reduced. It has been predicted that withholding international aid would be a disaster to the Palestinian economy. International aid channelled directly to the Ministry of Finance covers more than 60% of current expenditures. Any cuts in the PNA budget would directly reduce social services, health and even food to the people, and even drastically influence the running of some associations and institutions that receive 100% funding from abroad.

Banking System

It is understood that some of the Palestinian banking system resources are employed abroad in the form of deposits, short-term financial debt securities and certificates of deposit, which constitute nearly 50% of those resources. Only 2% are invested in US banks. However, the impact of the crisis was limited due to the small size of the deposits made by Palestinian residents in local and foreign banks abroad. In addition, there are limited deposits in foreign banks operating in the Palestinian territories.

In 2007, the Palestine Monetary Authority (PMA) declared a package of acts to regulate the banking system and minimise the risk of banks investing in deposits abroad (PMA, Annual Report2010). The PMA have put the following regulations in place to control the banking system:

(i) Approval should be obtained from the PMA when banks decide to invest in stocks, bonds and treasury bills abroad.

(ii) It is prohibited for any bank to invest in any country that imposes regulations on money transactions.

(iii) It is prohibited for any Palestinian bank to invest its deposits in a non-banking institution.

(iv) International Standard Credits of any country should be taken into account when any Palestinian decides to invest in that country.

(v) It is prohibited for any bank to provide loans for customers to invest in Palestinian securities.

(vi) Any bank that violates one of these regulations shall be subject to certain measures and penalties.

Unsurprisingly, therefore, Palestinian bank investments in stocks and bonds abroad amounted to around just 6% of total foreign investments. Consequently, the impact of recent developments in the global financial banking system on the PNA was minimal. On the other hand, data available from the PMA indicate that there was a stabilisation of deposits in the Palestinian banks. In other words, there was no withdrawal of deposits. On the contrary the data show a slight rise in the value of these deposits. They rose from $4.6 billion in 2007 to $5.8 billion in 2008. In the following year, 2009, they were up to $6.5 billion, an increase of 26% in 2008 and 41% in 2009 compared to their level in 2007 (PMA, Annual Report, 2010).

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This could be attributed to the limited connection between the Palestinian stock market and other markets. Thanks to measures taken by the Palestinian Security Exchange (PSE) severe restrictions are imposed to prevent any false transactions. While the PMA itself has a diversified investment portfolio in 22 banks abroad, the PSE also has a modest degree of exposure to the international financial system.

Policy Options Available to the PNA

The policy options available for the PNA to respond to the global financial crisis constitute a subset of policies available to it under the terms of the Paris Protocol, signed between the PLO and the Government of Israel in 1994. Therefore, any of the PNA's achievements in adjusting the performance and functioning of the Palestinian economy are the result of the impact of Israeli policies and practices on the global economy on the one hand, and on the Palestinian economy on the other.

As a result, the PMA has adopted conservative financial policies to protect 95% of the foreign assets of banks operating in the WBGS from the risk of being controlled by the financial markets. Variations in real interest rates and real exchange rates are out of control, despite the fact that the New Israeli Shekel, is the main currency circulating in the WBGS.

However, if the financial crisis continues and the donors reduce or cut their financial aid, how should the PNA respond?

- Building Palestinian institutions is a noble task, but economically unsustainable. In the long run it is a move that cannot survive; a form of invisible unemployment.
- Strengthening both the agricultural and the industrial sectors. Instead of increasing public sector employment, the PNA should subsidise these sectors.

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