

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**PROSPECTS FOR SUSTAINED
DEVELOPMENT OF THE
PALESTINIAN ECONOMY:
STRATEGIES AND POLICIES FOR
RECONSTRUCTION AND
DEVELOPMENT**



UNITED NATIONS

Distr.
GENERAL

UNCTAD/ECDC/SEU/12
21 August 1996

ENGLISH ONLY

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DEVELOPMENT***

* This study has been prepared by the UNCTAD secretariat drawing mainly on a contribution by UNCTAD consultant Prof. Fadle Naqib (University of Waterloo, Canada) within the framework of the intersectoral research project of the UNCTAD secretariat on "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip". The designations employed and the presentation of the material in this document do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or

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GE.96-51490 (E)

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ABBREVIATIONS

APB	Agriculture Planning Board
DoP	Declaration of Principles
GDP	Gross domestic product
GNP	Gross national product
JD	Jordanian Dinar
IS	Israeli Shekel
NIS	New Israeli Shekel
PADICO	The Palestinian Development and Investment Company
PECDAR	Palestinian Economic Council for Development and Reconstruction
PLO	Palestine Liberation Organization
PMA	Palestinian Monetary Authority
VAT	Value added tax

Preface

As part of its work programme and pursuant to resolution 239 (XXIII) of the Trade and Development Board and resolution 44/174 of the General Assembly, the UNCTAD secretariat initiated, in 1990/91, the preparation of an in-depth intersectoral project on development prospects for the Palestinian economy in the West Bank and Gaza Strip. Part One of the project deals with a comprehensive assessment of the economic and social situation in the West Bank and Gaza Strip, the main impediments to sustained growth and development, pressing needs, and corresponding measures for immediate action to promote recovery. Part Two of the project constitutes an in-depth analysis of prospects under different scenarios for the future development of the Palestinian economy. Part Three of the project is intended to provide both a strategy framework and policy guidelines for the revival and sustained future development of the Palestinian economy in the West Bank and Gaza Strip.

For the implementation of the project, a total of 25 in-depth studies were initiated at the field level covering economic and social sectors and issues. Concurrently, and in order to facilitate an intersectoral approach to the technical aspects of work on Parts Two and Three, the UNCTAD secretariat also prepared an in-depth study of a quantitative framework examining future options and prospects under several scenarios. The summary findings of the first parts of the field studies, in particular an identification of pressing needs and corresponding feasible measures for immediate action, were presented for further consideration by an expert group meeting (held in May 1992). The report of that meeting was published separately (UNCTAD/DSD/SEU/2). The secretariat's study of a quantitative framework for analysing future prospects was published as UNCTAD/ECDC/SEU/6 and UNCTAD/ECDC/SEU/6/Add.1. In order to provide more detailed substantive background to the findings and recommendations of the expert group meeting, and to enable donors to further develop their programmes of assistance to the Palestinian people, the first parts of a selected number of the field studies commissioned within the scope of this project have been published in a special study series on Palestinian economic and social development.

Positive developments in the region since 1993 and subsequent peace accords between Israel and Palestine and the new opportunities these have offered for development of the Palestinian economy rendered the findings of the UNCTAD intersectoral research project all the more relevant and timely. Indeed, the completion of substantive research under the intersectoral project coincided with the positive political developments in the Palestinian territory since 1993. These have provided the basis for the preparation by the UNCTAD secretariat, in consultation with the Palestinian Authority, of an integrated Programme of Technical Cooperation Activities in Support of Palestinian Trade, Finance and Related Services (published as document UNCTAD/ECDC/SEU/11). In response to specific requests by the Palestinian Authority, the secretariat has already provided advisory services within the context of this programme, and prepared a number of project proposals ready for immediate implementation.

The second and third parts of the field studies prepared, corresponding to the respective parts of the intersectoral project, have been consolidated by the UNCTAD secretariat under the present study on prospects for the future development of the Palestinian economy. The study constitutes a comprehensive analysis of prospects along with appropriate strategies and corresponding

policies to guide the reconstruction and sustained development of the Palestinian economy in an era of peace and cooperation with regional and global partners. This study, which constitutes the final document to emanate from the intersectoral project, is intended to serve as a concrete contribution to the growing policy debate regarding the prospects and options for Palestinian economic development in the coming years.

Acknowledgements

In the course of the implementation of the intersectoral research project, including the preparation of this study, the UNCTAD secretariat benefited from the valuable observations and inputs provided by a number of distinguished experts, in particular Dr. George Abed, Ms. Randa Alami, Dr. Graham Dyer, Prof. Laurence Harris, Prof. Fadle Naqib, Prof. Jeffrey Nugent and Dr. Sara Roy. The sectoral investigations carried out at the field level, which served as essential inputs to the project, were prepared by a group of Palestinian experts based in the West Bank and Gaza Strip: Mr. Rami Abdel Hadi, Dr. Sameer Abu Eishah, Dr. Abdelfattah Abu Shukor, Dr. Atef Alawneh, Mr. Abdel Rahman Awad, Dr. Hisham Awartani, Mr. Ibrahim Dakkak, Dr. Mahmoud El-Jafary, Dr. Wa'el Ennab, Dr. Said Haifa, Dr. Sameer Hazboun, Dr. Rita Giacaman, Dr. Hisham Jabr, Dr. Qasem Judeh, Dr. Rasim Khamaise, Dr. Riad Malki, Dr. Nidal Sabri, Dr. Nasr Said, Dr. Hind Salman, Dr. Ramzi Sansur, Dr. Usama Shahwan, Dr. Khawla Shakhshir and Dr. Salim Tamari.

It should be noted that the preparation of a number of the sectoral studies was made possible through extra-budgetary contributions of the Arab Industrial and Mining Organization (AIDMO), the League of Arab States (LAS) General Secretariat for Economic Affairs and the OPEC Fund for International Development. The implementation of research at the field level, which was rendered especially difficult in the 1990-1993 period, could not have been successfully completed without the indispensable support services and facilities provided by the Jerusalem office of the United Nations Development Programme (UNDP) - Programme of Assistance to the Palestinian People (PAPP).

Chapter I

SUMMARY AND OVERVIEW

When the Palestinian Authority began to exercise its functions in May 1994, the economic situation reflected disequilibria and fragmentation in all markets, coupled with a virtual paralysis of the public sector. The empowerment of the Palestinian people and the establishment of Palestinian self-government promise a new beginning for the economy. Three elements are involved: establishment of a Palestinian Authority committed to economic reconstruction and management according to national priorities; ensuring the integration of the Palestinian economy into the region; and the assurance of the international community regarding increased finance. Bearing in mind the interplay of these elements, the UNCTAD secretariat intersectoral research project has investigated the prospects for sustained development of the Palestinian economy over the period 1990-2010. This chapter presents the major findings emerging at the macroeconomic and intersectoral levels, in particular the macroeconomic imbalances and sectoral disarticulation, as well as the policies required to correct them.

A. The tasks of independent Palestinian economic development

Since 1994, and until the end of 1998, all economic activities in the West Bank and Gaza Strip will be governed by the "Protocol of Economic Relations" signed by Israel and Palestine in Paris on 29 April 1994. The achievements of the Middle East peace process including the Paris Protocol have emerged as the only concrete, workable and mutually agreed basis on which to rebuild the Palestinian economy within a framework of peaceful cooperation with Israel and with Arab neighbours. Meanwhile, accords between Jordan and Palestine have added new dimensions and opportunities to the process of Palestinian economic recovery and development.

At present, the Palestinian Authority faces two challenges that have implications for the success of long-term development efforts and that require immediate action, i.e. building new institutions for Palestinian government administration and rejuvenating the existing ones; and, dealing with unemployment. In tackling these two tasks, the Palestinian Authority is expected to resist the temptation to which many newly independent countries have succumbed, namely to embark on a programme of creating institutions aimed primarily at employing people directly. Instead, the two problems should be dealt with in terms of the imperatives inherent in the reconstruction programme. Institution-building and alleviating unemployment should be directed towards expanding the capacity of the private productive sectors. Priority should be given to activities that satisfy the double requirement of generating productive employment, while expanding the infrastructure that supports the private sector.

Accordingly, among the most important projects will be those which increase agricultural resources. These include programmes of land reclamation aimed at augmenting the area suitable for cultivation, increasing the supply of water by renovating artesian wells, drilling new wells and constructing reservoirs. Meanwhile, stimulating industrial activities requires increasing the supply of electricity, improving transport facilities and making large

investments to enhance communications. Finally, improving and modernizing the education and health systems will have a direct bearing on social development and economic performance in the medium and longer term.

B. Macroeconomic issues of sustainable growth

The UNCTAD intersectoral project has further investigated the prospects for placing the Palestinian economy on a path of rapid, sustained and independent economic development. This has been carried out at two levels. First, technical analysis provides rough estimates of the amount of external resources, and the time-span, required to place the economy on the road to sustainable growth. Secondly, policy proposals to reform the fiscal, financial and trade systems are evaluated in terms of the supportive environment they create with regard to making the technical results possible.

On the first level, a scenario analysis was employed to assess future alternatives, the findings of which were published in a study by the secretariat entitled "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip, 1990-2010: a quantitative framework".¹ The framework is based on a parametric exercise and projected trends of key demographic, labour and macroeconomic variables for the period 1991-2010 under a baseline scenario and several alternative scenarios. In one alternative scenario, a programme of deliberate policy of reconstruction has been assumed. The policy components are focused on accelerating private investment, promoting exports, rationalizing imports by substitution rather than by compression, switching demand from consumption towards investment and expanding government consumption and capital expenditures. As a result of this programme, unemployment is expected to decline significantly over the projection period and improvements are achieved in the resource gaps. External aid and investments are crucial to these achievements, though with a declining trend over time. To ensure that the economy will, in fact, show this kind of positive response to growth-enhancing activities, macroeconomic policy changes are called for, including reforms in fiscal, financial and trade policies.

The success of this programme for the revival of the Palestinian economy is dependent on external aid, as national savings are currently not large enough to finance infrastructure rehabilitation, and exports are not sufficient to supply adequate foreign exchange for needed import. On the other hand, external aid is by its very nature a temporary remedy, and its success can be measured by the extent to which the economy is stimulated to grow and create its own replacement by increasing national savings and exports. As such, part of the growing income must be saved, part of the growing output must be exported and the rates at which investment and exports grow must outpace those of consumption and imports. Consequently, there is a need for two sets of macroeconomic policies. First are the policies related to the supply side, to create the incentives to increase savings and ensure their optimal allocation among different investments. Secondly, are the policies on the demand side, operating to constrain both inflation and increasing prices of non-tradables relative to tradables.

Until recently, the public finance system has been characterized by over-taxation and under-spending. Palestinians have been paying too many taxes and too much in taxation, while the share of GNP devoted to public expenditure represented a low level of government activity. The difference between taxes

and expenditures implied a "budget surplus", with an adverse impact on aggregate demand and economic growth. Furthermore, the structure of the tax system has not been suitable for the Palestinian economy: direct tax rates on personal incomes and corporate profits have been similar to those in Israel, and the indirect tax rates (VAT) have been identical, despite the differences between the two economies with regard to size, structure and, more importantly, stages of development.

There is, therefore, an urgent need to restructure the system in accordance with the present stage of development and the needs of the Palestinian economy. Broadly, reform should concentrate on reducing the number of taxes, shifting reliance away from income and foreign trade taxes and increasing the importance of consumption-based taxation, with most taxes having flatter rates and much wider bases than at present. As for the public expenditure system, the Palestinian Authority needs to specify how the budget is to be formed, implemented, and controlled, in both the executive and the legislative branches of Government. In the meantime, it is important to allocate expenditures according to the needs of the reconstruction programme.

There are now clear indications that the banking sector will be able to perform the dual role of supplying services needed in other economic activities, and of creating some growth-enhancing activities internally. During the transitional period, two currencies are to be used as legal tender - the new (Israeli) Shekel (NIS) and the Jordanian Dinar (JD) - and the Palestinian Monetary Authority (PMA) will be the national institution responsible for supervising monetary and financial activities. The PMA has many functions typical of a central bank, including the supervision of all financial institutions, acting as banker and sole financial agent of the Palestinian Authority and constituting lender of last resort to commercial banks. This latter function is, however, constrained by the absence of a national currency, which limits the capacity of the PMA to satisfy the public's demand for currency and the commercial banks' demand for reserves and liquidity.

While the monetary arrangements during the interim period represent an improvement over those of the past, they are not optimal. Indeed, the arrangements combine some of the less desirable aspects of two polar-type exchange-rate regimes. The absence of a national currency renders monetary policy ineffective, as in a fixed exchange-rate regime. The existence of a two-currency standard has the potential for increasing those costs associated with fluctuations in exchange rates typical of a flexible exchange-rate regime. In addition, a dual currency tends to reduce commercial banks' ability to perform their function of transforming debt maturities, because of the problem of currency mismatching inherent in their portfolios. This could discourage them from extending long-term loans, which are essential for investment and growth.

Regarding future monetary arrangements, five alternatives are considered: an independent Palestinian currency; the JD; a Palestinian currency in union with the JD; a Palestinian currency in union with the NIS; or a Palestinian currency in union with the JD and the NIS. Given the structures of the three economies, the potential for factor mobility between them and the macro-shocks they may face, the Palestinian and Jordanian economies are shown to constitute the optimal currency area. Accordingly, it is demonstrated that, short of

overriding political considerations, the Palestinian economy may be best served by adopting a Palestinian currency that is linked to the JD.

Parallel to reforming the public finance and monetary sectors, of equal importance is the need to revitalize, reorient and strengthen the trade sector. At present, the performance of external trade is deteriorating and relations with trade partners are skewed, as a result of the interplay between restrictions on production and barriers to trade. On the one hand, restrictions affecting production reduce the competitiveness of Palestinian products, and this limits trade. On the other hand, restrictions affecting the entry of Palestinian products into neighbouring markets reduce the demand for these products, thus constraining investment, production and employment. Reversing this vicious spiral in a way that favours growth in trade and production requires substantial changes on three fronts: removing restrictions on the use of natural resources; increasing the ability of Palestinian producers to import raw materials, intermediate goods, and capital goods at competitive prices; and opening neighbouring markets to Palestinian products.

Since substantial improvements on all three fronts will require time, it would be misleading to refer to the optimality of any trade arrangements between the Palestinian economy and its neighbours irrespective of the time factor. Instead, trade arrangements should follow a sequential pattern, reflecting the degree to which the Palestinian economy has overcome the heritage of restrictions and distortions. In the long run, the optimal trade arrangement for such a small economy is likely to be close to free trade, but free trade now implies locking in some negative aspects of the present situation. The goal for Palestinian external trade in the medium term therefore should be to revive and restructure the trade sector, with the long-term goal of free trade with its neighbours.

A free-trade arrangement is desirable in the long run in so far as it enables the Palestinian economy to pursue an export-oriented growth strategy, and to free itself from external dependence. Satisfying these two goals requires a gradual change in the current pattern of trade in the region. This should include increased trade between the Palestinian economy and its Arab neighbours, while at the same time endowing the Palestinian economy with the capacity to export to Israel some high-skilled products in addition to current exports. This transformation in regional trading partners in turn requires a change towards intra-industry trade based on specialization and economies of scale. This stage cannot be reached solely by removal of tariffs, but requires in addition the removal of non-tariff barriers.

C. Major sectoral issues of structural transformation

The study's review of major macroeconomic considerations leads to a focus on the sectoral issues involved in the reconstruction programme. In particular, the secretariat's research project has analysed the measures and policies required in the main sectors - agriculture, industry, construction, services and public utilities - so that the reconstruction effort advances smoothly, without the crippling effects of bottlenecks and rigidities, and results in the removal of the sectoral disarticulation that currently exists.

Given the current conditions, and guided by the experience of other comparable economies, improving intersectoral articulation entails enhancing

the role of manufacturing in the economy. Two stages can be distinguished in the movement towards this goal, in both of which the agricultural sector plays a pivotal role. In the first stage, growth-enhancing activities may be concentrated mainly in the construction of infrastructure and in establishing new government institutions and public services. In this stage, a set of interrelated policies are called for to expand agricultural production for two reasons. First, given the relatively high proportion of expenditures devoted to food in the Palestinian family budget, a relatively high income elasticity of demand for food, and the expected natural increase in population coupled with the flow of Palestinian returnees, demand for food will increase substantially. This has to be met by an increase in domestic supply, so that no pressure is put on the limited supply of foreign exchange and on the real wage. Secondly, given that activities for the construction of infrastructures and the establishment of public institutions cannot absorb the majority of the unemployed, it is left to the agricultural sector to play an important role, through re-employing those who had worked in Israeli agriculture and who lack non-agricultural skills. Agricultural expansion (output and employment) can be accomplished relatively quickly because it usually requires less capital than other sectors.

A successful completion of the first stage, with most of the basic infrastructure and public services built, means that growth in the second stage will come from expansion in the manufacturing and service sectors, which in turn exerts heavy pressure on the agricultural sector. From the supply-side, expansion of industrial production requires an increase in employment with relatively stable real wage rates. Both cannot be achieved simultaneously unless the productivity of agriculture increases concurrently, so as to release labour to the urban sectors and, at the same time, to increase agricultural production and maintain stability of food prices. On the demand side, given external market constraints in the short run, industrial expansion will have to depend for some time on rural demand. Thus, an increase in agricultural productivity is essential to increase rural income and, in turn, the demand for industrial products. Whereas in the first stage, therefore, it is crucial to expand the agricultural sector along current lines, at a later stage it becomes necessary to modernize agriculture along new lines.

Underlying the slow development of the agricultural sector and shifts in production patterns over past years is a set of interrelated constraints. The most important of these are: a declining resource base; underdeveloped marketing facilities; poor infrastructure; lack of institutional services; an inadequate financial system; and, barriers to trade. The gradual removal of these constraints is essential to revive the agricultural sector and to allow it to perform its role in the two stages of the reconstruction programme. The major changes called for include: agriculture planning, policy and institutions to establish facilities in the marketing, extension and supporting systems, and to plan for the future; land-management policy for both irrigated and rain-fed land including reclamations, agricultural roads, land fragmentation and other policies; water-management policy to increase the supply and efficient use of water, covering artesian wells, springs and reservoirs; improved agricultural marketing facilities and coordination comprising public-private sector cooperation; development of human resources, especially entrepreneurial and managerial; and agricultural education in colleges and in centres of agricultural research.

Together with agricultural reform, it can be expected that the removal of restrictions affecting the manufacturing sector, and the revival of the financial sector, supplying both financial intermediation and risk management, will stimulate increasing industrial activity. However, a major transformation, whereby its contribution to GDP, trade, and employment increases substantially, will require an active role for the public sector, including: building the necessary infrastructure in transportation, communications and electricity, and supervising the establishment of industrial zones; improving human resources by allocating more finance to technical and vocational institutions; developing the legal and institutional framework within which foreign investment is encouraged, and induced to transfer technology, train local labour and increase industrial exports; encouraging the creation of a support system that can supply industrial enterprises with long-term credit for investments, information regarding foreign markets and technical advice.

The poor natural resource base and the small size of the Palestinian economy make export-oriented activities the appropriate medium for the long-term development of the industrial sector. In the short run, however, there is an important role for import-substitution. These activities should be encouraged in precisely those areas where domestic production could replace imports without protection and could become competitive as a result of removing prevailing restrictions and of the emergence of a public support system. These activities will be mainly in agro-industry products and will have a stimulative impact on growth and employment of the whole economy owing to their strong link with agriculture and their labour-intensiveness. In general, it is envisaged that industrial sector expansion will follow two stages. In the first, emphasis will be mainly on the expansion of light consumer industries, so as to maximize the use of domestic inputs. A successful expansion of these industries will create both increased demand for intermediate and capital goods and an increase in domestic savings that can be invested in heavier industries with domestic and export potential.

The current situation in the housing market arises from a severely restricted supply coupled with a continuous increased demand. To meet the expected growth in demand for housing in coming years through increased supply rather than prices, there is an urgent need to formulate a housing strategy, with the aim of correcting existing distortions, as well as providing an adequate delivery system with a more equitable distribution of resources and benefits. The formulation and execution of the housing strategy will be a formidable task owing to the fact that housing in the territory has had no public role during the last (28) years. It should include the following elements: adopting a plan of urban expansion, taking into account the prevailing population densities in different regions, their potential economic expansion and their need for residential infrastructure; removal of the market distortions in building materials, by encouraging domestic production and importation at competitive prices; reviewing all laws related to property rights and rent control; and, establishing a finance system for housing, covering all social categories.

The Palestinian services sector will play a dual role in the reconstruction programme. It will generate much growth, tapping the potentials in many branches, including finance, tourism and the range of producer and distributive services of the private sector. Equally important is the role of

services in facilitating growth in other sectors. Communications, transportation, retail trade, banking and insurance services are essential to the growth of agricultural and industrial production, trade and foreign investments. Given the historical and religious significance of Palestine, tourism has the potential for substantial growth. The transformation of tourism into a modern industry, however, requires major improvements in transportation, hotels, restaurants, human resources, and tourist-related industries. Meanwhile, development finance, communications, transportation and retail trade require an educated labour force. Essential to the reconstruction of the four main sectors is a substantial improvement in public utilities. Investment priorities may be identified in the following branches: water, energy, sanitation, public markets and public safety.

The preceding paragraphs reflect briefly the sectoral priorities identified in this study, along with policy guidelines for action which are intended to help in the elaboration and achievement of the objectives of Palestinian reconstruction and development. This should aim at developing the Palestinian economy in a manner which employs the labour force, diversifies trade and achieves an adequate rate of growth in per capita income. It would be coupled with a more equitable distribution of the benefits of growth and development among regions and individuals, within the context of eliminating external economic dependency through building close relations with all neighbours. Achieving these objectives requires articulating the reconstruction programme through a comprehensive set of economic policies, and changing the legal system that governs economic activities; creating many new public institutions to regulate, and supply support services to, the private sector; building the requisite infrastructures; and, embarking on a programme to improve productivity. These broad objectives constitute an intersectoral framework for action and reform, outlined at the end of this study (cf. chap. V).

Chapter II

THE TASKS OF INDEPENDENT DEVELOPMENT

The economic environment prevailing in the West Bank and Gaza Strip before 1994 most notably affected issues such as access to natural resources,² financial and business activities,³ the composition and direction of international trade,⁴ the mobilization and allocation of resources in the economy,⁵ as well as physical and social infrastructures. The cumulative impact of developments in these areas influenced the development of the major productive sectors of the Palestinian economy, as well as the growth of domestic and external labour markets.⁶ This, in turn, had important consequences for the level and orientation of capital accumulation,⁷ as well as for entrepreneurial and business activities.⁸

Unemployment in the Gaza Strip had reached a high level of up to 40 per cent, and had contributed to increased poverty among the population.⁹ At the same time, most public services had been functioning at low capacity, making both daily life and business activities very difficult.¹⁰ Shortages of electricity and water had been typical in many areas, which remained without sanitation and basic hygienic facilities. This situation has been the result of both disequilibria and fragmentation in all sectors coupled with a virtual collapse in the supply of public goods and services, especially aggravated during the period following the Palestinian intifada and the 1990-1991 Gulf war.

The general pattern in the reallocation of factors of production, combined with the high market concentration of trade flows, resulted in a major structural transformation of the Palestinian economy characterized by several disequilibria:¹¹ a resource gap and labour and sectoral imbalances. These are depicted in Tables II-1, II-2 and II-3, respectively. This has been accompanied by a growing dependence on external sources of income.¹² Analysis of prospects and scenarios for the future development of the Palestinian economy¹³ reveals the difficult economic situation that would have ensued from a continuation of pre-1994 trends (see Tables II-4 and II-5). However, the gradual emergence of a new economic environment since then has improved the prospects for sustained development of the Palestinian economy.

On 18 May 1994, the Palestinian Authority took formal control over the Gaza Strip and Jericho. Initiated by the Israel-PLO agreement, this transfer of authority was the first step in creating self-government arrangements for the Palestinian people in the West Bank and Gaza Strip.¹⁴ The challenges that faced the Palestinian Authority were enormous. In addition to the problem of reconstructing government administrations, it faces the equally urgent task of reviving the economy. To deal with these challenges in a manner that addresses the causes of the difficulties, rather than their symptoms, ad hoc approaches and piecemeal policies must be avoided. The situation calls for the formulation of a comprehensive programme for the rehabilitation and reconstruction of the economy. Like any programme for economic revival and reconstruction it needs to include three elements: a set of well-defined objectives, a concise evaluation of relevant constraints and opportunities, and a coordinated set of policies and strategies that could be adopted to deal with the constraints, exploit opportunities and achieve the

objectives envisaged. This chapter is devoted to identifying elements of the constraints, opportunities, and the objectives of such a programme. This will set the stage for elaborating in subsequent chapters the various tasks involved in the rehabilitation, reconstruction and development of the economy.

A. The emergence of a new economic environment

The signing of the Declaration of Principles (DoP) between the Palestine Liberation Organization and Israel, on 13 September 1993, was followed by many important developments. On 1 October 1993, an international conference was convened in Washington D.C., and the participants pledged to devote some \$2.5 billion, over the period 1994-1998, as aid for the reconstruction of the Palestinian economy in the West Bank and Gaza Strip.¹⁵ The World Bank was designated to provide the general framework and the assistance needed to ensure the effective use of these resources. Subsequently, in November 1993, the Palestinian Authority announced the formation of the Palestinian Economic Council for Development and Reconstruction (PECDAR). The Council was envisaged as an agency to channel and manage external aid from multilateral donor sources, setting priorities for development projects, and directing their implementation on the basis of the principles of transparency, clarity, and competence. Its board of directors comprises 14 members, including the President of the Palestinian Authority as the chairman. PECDAR was one of the first agencies of the nascent Palestinian Authority to become operative, and in early 1994 it commenced its task of aid coordination and management.

Immediately after the signing of the DoP, the Palestinian leadership was engaged in an intensive negotiation with its Israeli counterpart in order to reach agreement on the implementation of the first part of the accord. Accordingly, agreement was reached in April 1994 on the "Protocol on economic relations between the Government of Israel and the Palestine Liberation Organization, representing the Palestinian people", henceforth referred to as the Protocol.¹⁶ This 60-page document "establishes the contractual agreement which will govern economic relations between the two sides, and which will cover the West Bank and Gaza Strip during the interim period", specified as five years starting from 4 May 1994. This was followed in May 1994, by the withdrawal of the Israeli army from the Gaza Strip and Jericho and the establishment of the Palestinian Authority.

The Protocol, in effect, defines the main features of the economic policy environment during the transition period within which the Palestinian Authority will carry out its responsibilities. Most of the document's relevant articles will be alluded to in detail in the rest of this study. The general aim is to pinpoint the areas in which the Protocol presents a radical departure away from the economic environment prevailing until 1994 and the areas in which it still retains the restrictive elements of that environment.

The chief characteristics of that environment, as stated under Section A above, were constraints on the use of natural resources, production orientation, mobilization and allocation of financial resources, and composition and direction of trade activities. The following sections briefly describe how the Protocol deals with each of these elements.

1. Natural resources

The Protocol does not address this issue at all. It was agreed that there will be no change in sovereignty over land, water, and settlements in the transitional period. These issues are to be addressed as part of the final

status negotiations, due to commence in mid-1996. Consequently, the restrictions prevailing on Palestinian control over land and water remain in place, notwithstanding a transnational agreement to increase water quotas allocated to the areas under the Palestinian Authority. Prevailing restrictions on the use of irrigation water in the West Bank and Gaza Strip will continue to constrain development of modern Palestinian agriculture, and prevent any substantial progress towards expanding and diversifying crops. Similarly, the fact that over 60 per cent of the land area in the West Bank and Gaza Strip is outside direct Palestinian Authority jurisdiction will place severe impediments on the expansion of agriculture and industry and, to a lesser extent on residential construction.

2. Business activities

The transfer of power to the Palestinian Authority over economic affairs removes direct restrictions on business activities. Palestinian firms can now function without the deterrent effects of permits and licences previously required by the Civil Administration. Notwithstanding the importance of such a development, it should be mentioned that some of the indirect restrictions affecting private sector development are retained under the Protocol. These include the treatment of indirect taxes whereby the VAT role is effectively identical to that in Israel, notwithstanding the wide divergences in economic structure and scale and the tariffs on consumer durables imported from neighbouring Arab countries (which exempt only a limited list of goods from the Palestinian-Israeli Customs Union).

3. Trade and finance

The asymmetric customs union regime, which characterized economic relationship between Israel and the occupied territory, has been changed in two directions by the Protocol. First, many elements in the asymmetry are removed. In principle, Palestinian goods will receive the same treatment in Israel that Israeli goods receive in the Palestinian territory.¹⁷ Second, some elements of a Free Trade Area regime are introduced. The Palestinian Authority will be able to choose its own tariff rates on two lists of goods. One list refers to certain goods produced locally in Jordan, Egypt, and other Arab countries. The second list comprises certain foodstuffs imported from Arab countries in quantities reflecting the Palestinian consumption needs.

The Protocol gives the Palestinian Authority the right to determine the rates of tariffs and other levies on some capital goods needed in the reconstruction effort. The Palestinian Authority also may introduce its own customs duties on motor vehicle imports, and on petroleum products.¹⁸ This limited opening to trade with Arab countries is considered by some observers as a first step towards the diversification of Palestinian trade flows, and to the reintegration of the Palestinian economy in the wider regional context.¹⁹ It has been noted, however, that Jordan and Egypt have received special treatment in this regard. Bearing in mind that the two are the only Arab countries having peace treaties with Israel, this has been considered to be an indication that the development of future relations between the Palestinian economy and the Arab countries will proceed in tandem with improvement in Israel's economic relations with its neighbours.²⁰

As regards the movement of labour, the Protocol gives each side the right

to determine the extent and conditions of any labour flows into its territory. Thus, there was no commitment to free labour movement; the Protocol gives each side the right to prevent the labour of the other from working in its territory. Similarly, there was no agreement on reductions in non-tariff barriers (NTB) to trade. The Shekel will be used as legal tender in the West Bank and Gaza Strip, and monetary affairs will be under the authority of the Palestinian Monetary Authority (PMA), which has some functions of a Central Bank but not yet having the right to issue a national currency.

4. Transfer of resources

The Protocol specifies the nature of resource transfers associated with direct and indirect taxes imposed by Israel. The agreement states that Israel will transfer to the Palestinian Authority 75 per cent of the income tax revenues collected from Palestinians who come from the Gaza Strip and Jericho to work in Israel, and 100 per cent of income tax collected from those Palestinians working in Israeli settlements. As far as the value-added tax (VAT) is concerned, revenues from this tax will accrue to the territory in which the business is registered. Thus, Israel transfers to the Palestinian Authority all revenues collected from VAT on goods purchased in Israel by Palestinian entities, less the VAT collected by the Palestinian Authority on goods purchased in the Palestinian territory by Israeli entities (important aspects of the agreement related to the fiscal, monetary, and trade sectors are discussed in the next chapter). However, Palestinian imports from the rest of the world, which must pass through Israel, still generate revenues equal to the customs duties paid to Israel and charged to Palestinians as part of the price of these imports. These revenues are not transferred to the Palestinian Authority. According to a recent study, revenues forgone from this area are estimated between \$88 million and \$195 million for 1992. ²¹

Another important development promising change in the economic environment is the agreement between the Palestinian Authority and Jordan. This agreement, signed in Amman on 26 January 1995, emphasizes the commitment of the two sides to strengthen the special relationship between the two parties, by coordinating all economic and development policies. The agreement has seven parts covering trade and commerce, money and banking, education, information and culture, posts and communication, transportation and administrative affairs.

In the section on trade, the two sides agreed that future trade between them (including trade in agricultural products) will be completely free. However, the movement towards free trade will be gradual, and a committee will meet biannually to negotiate the list of goods to be exempted from tariffs. A list comprising some 75 Jordanian manufactured and processed exports has been identified for exemption from Palestinian customs duties; another two lists exempt over 40 Palestinian manufactured exports from Jordanian customs duties and (in 27 cases) imposes only levies and taxes. ²² The agreement falls short of specifying a timetable for reaching the final goal of free trade.

Because of the importance of agricultural trade (which is free of all duties) a separate committee will be responsible for establishing the seasonal entry arrangements and quotas.

In the money and banking area, it has been agreed to use the Jordanian Dinar as a legal tender in the Palestinian territory and to enter into early negotiations, so as to facilitate a smooth and orderly transition to a

Palestinian currency if and when the Palestinian Authority decides to create its own national currency. In the meantime, the Palestinian Authority committed itself to maximize its use of the JD in its own financial dealings. The agreement also emphasized the importance of coordination between the PMA and the Jordanian Central Bank regarding all aspects related to the operation of financial institutions using the Dinar in the Palestinian territory. The other five parts of the agreement stressed the need for consultation and coordination in their respective fields, and the commitment of Jordan to help in building the new institutions needed by the Palestinian Authority.

On 28 September 1995, the Palestinian Authority and Israel signed an agreement in Washington to broaden Palestinian self-rule in the West Bank. The agreement comprises some 400 pages and specifies the details of the redeployment of the Israeli Army from the populated areas of the West Bank and the transfer of power to the Palestinian Authority, leading to the election of the self-governing authority, the Palestinian Council. The agreement is divided into sections related with security arrangements, elections, civil affairs (transfer of powers), legal matters, economic relations, and Israeli-Palestine cooperation. The agreement establishes the 1994 Protocol as the relevant frame of reference for economic relations for the remainder of the interim period. An examination of the agreement suggests that the most important new item in the economic section is related to water. The agreement contains an undertaking on the part of Israel to increase the amount of water allocated to the Palestinians by 28 million cubic metres. Any further addition to either side will be based on an increase in the available water resources to be developed through international funding and channels, among them the tripartite American-Palestinian-Israeli forum which will hold its first meeting after the signing of the Interim Agreement. The agreement provides for the establishment of a joint water committee that will manage water resources and enforce water policies, protecting interests of both parties by the prevention of uncontrolled drilling and by enforcing standards, and other measures.²³ Although the agreement will increase Palestinian control over the use of water resources, it does not represent an appreciable increase. The 28 million cubic metres allotted to the Palestinians allows them the use of around 32 per cent of available water as compared to 28 per cent available in the past.

B. The tasks of independent development

The new environment emerging with the establishment of Palestinian self-government in Jericho and Gaza Strip, and later in the rest of the West Bank, promises a new beginning for the Palestinian economy. The redressing of the asymmetric integration into the Israeli economy, the establishment of Palestinian Authority committed to rebuilding and managing the economy according to national priorities, and the assurance of the international community regarding financial support are three vital elements promising a new era of movement toward Palestinian self-reliance.

Obviously, the realization of this goal together with its economic implications, will depend on the behaviour of the three parties - Israel, the Palestinian Authority, and the international community - regarding their respective commitments. The economic tasks facing the Palestinian Authority are vast in scope and complex in nature, requiring competent, skilful, and experienced management. In particular, the Palestinian Authority will have to deal with the following two major problems.

First, the present orientation of the Palestinian economy is very peculiar; the main thrust of its activity is one of exporting labour and importing goods. This reflects the fact that the economy has developed distorted markets and an abnormal sectoral structure. There is a disarticulation between supply and demand, both in the factor markets, and in the markets for goods and services. The cumulative effect of these distortions has resulted in a continuous shrinking of the productive base of the economy, and its increasing dependence on outside sources of income. These sources have declined sharply due to the Gulf war and the repeated closures of the territory since March 1993, which dramatically increased the vulnerability of the economy. Unemployment has reached high levels, reflecting a fundamental disequilibrium in the labour market. Understandably, then, the immediate and urgent challenge facing the Palestinian Authority is to deal with the unemployment problem, which entails creating jobs for some, and instituting relief programmes for others.

Second, the political situation presents the Palestinian Authority with another immediate and difficult challenge. Self-government rule requires the building of new institutions for Palestinian civil administration, and the rejuvenation of existing ones. Some of these institutions are needed immediately to provide for security and the maintenance of law and order. Others are needed urgently to supply some other basic services essential to any civil society, including institutions which organize economic and social life.

It is important to understand that these two tasks are related to each other, and have to be tackled simultaneously. The capacity of the Palestinian Authority to create effective institutions depends to a great extent on their credibility, which in turn requires a fundamental improvement in the economic situation. On the other hand, improving economic conditions depends on increasing investment in the productive sectors, which, in turn, requires an institutional framework supplying a regulatory environment, the basic infrastructure, and essential public services. The interconnection of these two tasks, combined with the availability of foreign aid, might induce the Palestinian Authority to treat them as a single issue, and embark on a programme of creating institutions that employ people directly, so ensuring their loyalties. However, such an approach would address the symptoms of the economic problem and not its causes. In the long run, it threatens to make the Palestinian Authority the largest employer, with a huge bureaucracy that straddles the private and the public sectors, so blurring the distinction between them.

The Palestinian Authority needs to resist the temptation of such policy, and instead embark on a completely different programme resulting in a structural transformation, whereby the Palestinian economy substitutes exporting goods for exporting labour and gradually reduces its dependence on

foreign aid. In other words, the focus of efforts should be to expand the productive sectors of the economy, thereby generating enough production and trade activity to absorb the labour force.

In the early stages of this transformation, the private sector alone will not be capable of generating the savings needed to finance the investments required to reorient production and trade. External resources, both official and private, will have to play a leading role in augmenting national savings,

and in financing needed imports. Moreover, the Palestinian Authority will have to initiate some public works in order to stimulate the economy immediately, in addition to its role in building the necessary institutions and providing relief programmes during the difficult transition period. The public works activities should satisfy the double requirement of generating employment and expanding the infrastructure to support the private sector. These include programmes of land reclamation, aimed at augmenting the area suitable for cultivation, and increasing the supply of water by renovating artesian wells, drilling new wells, and constructing reservoirs. The building of agricultural feeder roads also meets the double requirement of being a labour-intensive project and of enhancing the output potential of the agricultural sector. Stimulating industrial activities requires an increase in the supply of electricity, the improvement of transport facilities, and large investments to modernize communications. Finally, projects aimed at improving the quality of human resources are important; improving and modernizing the education and health systems will have a direct bearing on economic performance in the medium and longer term.

The ultimate success of these public projects depends on the extent to which they facilitate economic growth in the private sector. The role of the private sector in employment generation could be enhanced by the formulation of policies (taxes and subsidies) designed to induce more labour-intensive activities. Success also requires the elimination or reform of many regulations and restrictions, which are responsible for distorting prices, mis-allocating resources, and creating rigidities and disequilibria. While the restrictions and regulations imposed under occupation stand out as the most harmful, others that date back to pre-1967, and Mandate periods, and beyond, need to be reformed to meet present and future needs. No amount of public expenditure, or foreign aid, will have an appreciable positive impact on the economy if the private sector is not free of distorting regulations, and capable of functioning in a socially productive manner. Thus, a comprehensive reform of the legal and institutional framework governing the private sector needs to become an immediate task of the Palestinian Authority.

The rehabilitation and reconstruction efforts of the Palestinian Authority during the transition period should be sharply distinguished from the permanent functions of the public sector once the economy achieves sustainable growth. At that point, the public sector should be confined to doing what it does best, which is supplying the public goods and services that constitute the proper environment within which it may conduct its business with the minimum cost and degree of risk. In addition, it will have a role in smoothing short-run fluctuations through fiscal and monetary policies, and in directing growth through its employment, commercial and industrial policies.

It should be emphasized, however, that the role of these economic policies will have a special urgency in the immediate future, because of the central role assigned to foreign aid in the process of rehabilitation and reconstruction. Readjustment policies will be needed to deal with some of the possible negative aspects of foreign aid, especially the tendency of the recipient to use aid not as a supplement to national saving but as a substitute for it. Thus, an appropriate mix of fiscal and monetary policies should be used to encourage private saving, and prevent the reduction of public

saving.

Macroeconomic policy measures are essential to counteract the adverse impact of aid on domestic prices. A considerable flow of aid into an economy having relatively limited absorptive capacity threatens to bring about a rise in the general level of prices (inflation), and a change in the relative price of tradables and non-tradables. Both effects have the harmful result of reducing the competitiveness of the export sector, and increasing the problem of import dependency.

Equally important to the success of the development effort is a balanced and well-targeted allocation of investment among the main sectors of the economy. Since external financial resources will be transferred in the form of project aid, there is a potential problem of coordinating the different projects, especially since they are financed by different bilateral and multilateral sources. This concern is often termed "the micro-macro paradox".²⁴ This has been evident from the experience of many third world countries that have used foreign aid in a major way to finance their development efforts. In many cases, foreign aid at the macrolevel has had no significant impact on growth despite the fact that at the microlevel the majority of the financed projects have shown profitable economic results. In other words, foreign aid transferred through separate projects has the potential of leading to a situation where the total is less than the sum of its parts. This paradox reflects the overlap among the projects, and the negative externalities not counted in microlevel valuations based on partial equilibrium methodology. Both problems are caused by the absence of coordination among the different projects. To avoid them it is most important that the Palestinian Authority adopts a comprehensive intersectoral development programme, and negotiates with the donor countries according to the priorities of the programme, which should reflect the sequencing of the different stages in structural transformation.²⁵

Chapter III

THE MACROECONOMICS OF SUSTAINABLE GROWTH

Two themes have so far dominated the analysis of the current structure of the Palestinian economy. The first concerns the detrimental economic impact of the occupation, which has had two considerable gaps in resource availabilities and uses, including an untenable labour market imbalance. The second focused on the emergence of a promising new economic environment, characterized by the establishment of an indigenous self-government authority, the removal of many of the restrictions associated with occupation and the declared readiness of the international community to extend assistance in the financing of part of the reconstruction effort. Thus, while the positive developments in the policy environment since 1993 pave the way for the reconstruction and development of the Palestinian economy, the legacy of over 28 years of occupation and the sustainable distortions caused in the economy continue to influence the pace and direction of economic recovery.

In this chapter these two themes form the backdrop against which the prospects for changing the direction of the Palestinian economy towards one of sustained growth will be investigated. The economic opportunities created by the new environment will constitute the context within which the potential for developing the economy in the direction of closing the resources gaps and correcting the labour market imbalance will be examined.

This investigation is carried out at two levels. First, the technical investigation which provides a rough estimate of the amount of external resources and the time-span required to place the economy on the road to sustainable growth. The second is a policy investigation, which will focus on the changes in the fiscal, financial and trade systems required to create the supportive environment making the technical results possible.

The technical aspect is illustrated by two scenarios for the Palestinian economy, assuming an intensive trade oriented investment strategy, with substantial external transfers from abroad over the next 15 years 1995-2010 (Alternative scenarios III and V in the Quantitative Framework).²⁶ Both suggest that the economy has an impressive capacity to respond to a policy oriented boost, combined with a relaxation of the restrictions imposed on production and trade. The growth in production will enable the economy to absorb the majority of its labour force by the end of the projected period and achieve a significant reduction in the trade gap and the savings/investment gap. The quantitative dimension of this picture will provide guidelines for the subsequent analysis of the required changes in the fiscal, financial, and the trade systems.

This chapter is divided into five sections, the first of which summarizes the results of the two scenarios. Issues involved in the fiscal, financial and trade sectors are outlined in the subsequent sections, followed by a general discussion of macroeconomic policies.

A. Prospects for future development

Currently, the Palestinian economy suffers from a chronic incapacity to create enough jobs to employ the labour force, generate enough saving to finance investment, and produce enough exports to pay for imports. Consequently, the development effort needs to be directed at creating an engine of growth encompassing activities which: absorb the increases in the labour force; generate income with part of it saved so as to close the investment-savings gap; and, export part of the increased output, so as to close the trade gap.

Undoubtedly, at present and in the near future, the problem in the labour market could be eased considerably by the availability of employment in the Israeli economy. Similarly, the shortages in savings and foreign exchange could be reduced substantially by external aid. In the long run, however, the economy should function without the support of these two sources. Employment in Israel cannot be sustained at the high historical levels of up to 100,000 workers, ²⁷ and external aid will certainly dry up, eventually. Indeed, even in the post-1993 circumstances, employment in Israel has rarely exceeded 60,000-70,000 workers, while the \$2.5 billion pledged by donors has been slow to materialize and in any case falls short of the sums envisaged by Palestinian and other sources to be necessary for reconstruction and sustained development. Accordingly, the development effort should utilize these two external sources in such a manner that ensures the creation of replacements. In other words, these two sources should be used to increase the capacity of the productive sectors, and enhance savings and exports, rather than to finance consumption and imports. External aid should be used as a complement to domestic saving, and not operate as a substitute.

Indeed, fiscal and monetary policies need to be designed so as to provide incentives for increased savings and investments, and to discourage unbridled consumption expenditures. In particular, the consumption of imported luxury goods could be curtailed. Employment in Israel needs to be treated as a temporary remedy, and, as the development effort advances it should be relegated to the status of a residual in the labour market, which could then be eliminated gradually.

Guided by these considerations, which define a national development strategy, the two scenarios constructed in the Quantitative Framework focus on the general aim of boosting the productive capacity of the economy, and its domestic demand, while preventing consumption, and hence imports, from increasing in importance. This general aim is translated into the following specific requirements: accelerating private investment, promoting exports, reducing imports by substitution rather than compression, switching demand from consumption towards investment, and expanding particular forms of government consumption and investment expenditures.

The first three specific requirements are combined in the framework by assuming that an additional portion of domestic resources (1 to 5 per cent of GDP) will be allocated to productive investment. Part of the resulting output gain is directed toward export promotion, and the rest to import substitution. The last two requirements are achieved by an increase of government expenditures, which is needed to finance increased provision of health, education, communications, housing, transport, and other supportive public services, without which the private sector cannot develop. The temporary

character of the external transfer is recognized by giving it a residual and declining role in the expansion process. This is done by calculating the gap between actual and potential aggregate demand resulting from the domestic policy package mentioned above. However, if the gap exceeds a desired level (equivalent to 10 per cent of unemployment), external transfers are called upon to match the difference.

Tables III-1 and III-2 show the outcome of the two scenarios regarding the resource gap and the labour market imbalance. The only significant difference between the two is related to the assumption concerning population. The first assumes that the current Palestinian population of the West Bank and Gaza Strip would constitute the future population of these areas, while the second allows in addition the gradual return over 15 years of up to one million Palestinians from outside.²⁸ This increase in population requires a commensurate expansion in employment opportunities in agriculture and industry, housing and urbanization, public services, and provision of needed infrastructure. Accordingly, the second scenario is designed with a more extensive investment programme (public and private), featuring faster expansion of productive activities and deeper structural transformation. It should be emphasized, however, that such an undertaking cannot be achieved unless the Palestinians in the West Bank and Gaza Strip attain full control over their land and water resources.

To appreciate the improvement expected in the performance of the economy as a result of the measures detailed above, table III-1 is compared with table II-5 of the previous chapter (the Baseline Variant scenario), since both have the same assumption concerning population. The improvement in the labour market situation is profound. Employment is able to rise rapidly to 399,000 by the year 2000, compared to 358,000 under the Baseline Variant. In other words, unemployment could be expected to stand at 26 per cent of the labour force in the year 2000 if the economy was left without the policy measures of intensive investment, but, as a result of these measures, unemployment will go down to 9 per cent. This large expansion in employment is made possible by the availability of an extra \$642 million in external aid for that year, which amounts to 30 per cent of GDP.

The role of this external aid is substantial. Over the period 1996-2007, some \$5.4 billion of additional net external transfers (i.e. over and above historic levels of remittances and other transfers to the territory from abroad) are required to help the economy attain sustained growth and development. The framework shows that without such aid the unemployment rate would have dropped to only 18 per cent of the labour force, instead of 9 per cent.²⁹ However, the long-term viability of the domestic policy package is demonstrated by its success in generating sufficient domestic savings, allowing the gradual replacement of external aid. Thus, the ratio of external aid to GDP declines from 30 per cent in the year 2000 to 19 per cent in 2005, and becomes just 4 per cent by the year 2010.

Improvements are noted also in the trade sector. At the end of the projected period the import surplus becomes 26 per cent of GDP, in contrast to 35 per cent in the baseline variant. Similarly, the investment surplus reaches 19 per cent of GNP, compared to 22 per cent under the baseline variant. Furthermore, the economy's dependence on external sources of income (employment in Israel) will decline substantially. This decline is demonstrated by the continuous increase of the ratio of GDP to GNP, from 84 per cent in 1995 to a

more reasonable proportion of 92 per cent in 2010.

These achievements are made possible by the following measures:

- Extra private investment, which amounts to 2.5 per cent of potential GDP in the Gaza Strip every year between 1996 and 2005, and 1 per cent in the rest of the period. The percentages for the West Bank were assumed to stand at 1.5 per cent for the period 1996-2000, and 1 per cent thereafter.
- 70 per cent of the extra investment is assumed to be allocated to export promotion activities, and 30 per cent is assumed to be allocated to import substitution.
- Government consumption expenditures are assumed to grow at an annual rate of 7 per cent in both the West Bank and Gaza Strip. Government investment expenditures are assumed to grow at a rate of 10 per cent in the West Bank and 8 per cent in Gaza Strip.
- Total external aid (aid at current levels plus the extra aid deemed necessary by the scenario) for the whole period (1996-2010) is estimated to be approximately \$9 billion. During this period, extra aid will range annually from as much as \$644 million in 2001 to as low as \$42 million in 2007.

Obviously, implementing these measures, and ensuring that they achieve the results noted above, as summarized in tables (III-1) and (III-2), require radical changes in fiscal, financial, and trade systems.

B. The public finance sector

The success of the development programme outlined in the previous section depends to a great extent on the ability of the Palestinian Authority to mobilize resources for both private and public sectors investments. Such a task requires the effective functioning of public finances. The present system of public finance is not suitable, and is in fact responsible for many of the illnesses that have afflicted the Palestinian economy in the past. Consequently, it will present a formidable obstacle to development if it is not reformed and restructured. The following features of the existing system are the most harmful:

1. The tax system is not suited to the Palestinian economy at the present stage of its revival and growth. The direct tax rates on personal incomes and corporate profits have been generally higher than those in Israel and Jordan, and the indirect tax rates (VAT) are identical to those in Israel, despite the great differences between the levels and stages of development of the two economies.³⁰ There is no justification for the Palestinian economy, whose GDP per capita is 14 times smaller than Israel's to have the same tax structure. Within the territory itself the tax laws have not been uniform as they date back to two different regimes prevailing in the West Bank and Gaza Strip up to 1967, i.e. the 1964 Jordanian Tax Law applicable in the West Bank and the 1947 British Mandate Tax Ordinance in the Gaza Strip, coupled with changes introduced by Egypt during the period 1948-1967. These features were further complicated by numerous amendments introduced by Israel during the period 1967-1993.

2. The existing system and especially the tax system, is associated in the minds of Palestinians with the occupation and its harsh and arbitrary rules. An important episode of the intifadah involved the mass refusal to pay taxes.³¹ These and other features of the tax system have had a discouraging effect on business activities and investments in general.
3. Under the existing system of public finance many public goods, which are usually supplied by the public sector in most countries, are provided by the private sector.³² This is a direct result of the unusually small and shrinking size of government expenditure. During the period 1968-1990, the share of GNP devoted to public expenditure fell from 15 per cent to 8 per cent in the West Bank and from 14 per cent to 10 per cent in the Gaza Strip. These percentages represent a very low level of government involvement in the economy, and explain the poor quality of physical infrastructures, urban services, education and provisions of welfare.³³
4. The harmful effects of the low level of public expenditures is aggravated by the extra taxes collected from Palestinians, which were channelled out of the domestic economy. The difference between taxes and expenditures amounted to an effective "budget surplus", with its adverse impact on aggregate demand and economic growth.³⁴ This depressing factor has been partly responsible for the chronic problem of unemployment.³⁵

The new fiscal system should rid itself of all these negative aspects, and at the same time acquire those positive qualities needed to make the public sector a leading force in promoting economic and social activities. The next section will therefore outline some of the features which the fiscal system should acquire. The subsequent sections will focus on the details of tax reform and public expenditures.

Before doing so, however, it is important to emphasize that reforming the fiscal system should be accompanied by a well designed information campaign. The Palestinian Authority would be well advised to explain to the Palestinian people the mechanics, functions, and objectives of the new system. Understanding the benefits that will flow, both collectively and individually, is a necessary condition for the smooth functioning of the system. It is a difficult but at the same time an unavoidable and necessary step to be taken toward ensuring the success of the implementation of the new system, with minimum compliance cost.³⁶

1. The objectives of the fiscal system

Reviewing the traditional functions of the public finance sector in any economy, and in developing economies in particular, leads to recognizing the sense of urgency associated with each function in the Palestinian context.

In the Palestinian context, the role of the public sector as the supplier of public goods assumes a greater importance because of the neglect of the physical infrastructures and social services over the last 27 years. A considerable improvement in these areas is essential for creating a supportive environment, within which the private sector can expand. This requires an effective and strong fiscal system. The role of fiscal policy, as a tool to support the development process, by stabilizing short-run fluctuations, and achieving growth-oriented adjustment, becomes critical in the Palestinian

context due to the fact that the tools of monetary policy will not be effectively operational for some time. This is so because of the absence of a national currency, and the need for enough time to elapse before the PMA can gain sufficient experience with the use of some tools of monetary policy.

The role of the public sector in redistributing income among individuals and regions is equally essential in the Palestinian territory in view of the marked disparity between the standard of living in the West Bank and Gaza Strip, and the general problem of poverty caused by high rates of unemployment, especially in the last few years. These redistribution functions require an appropriately reformed system. The reform of the tax system needs to be designed as to also promote both horizontal and vertical equity. Reducing the economic disparity among the different regions could also be achieved by adopting an equalization payment (revenue sharing) system, in which the central Government transfers funds through local authorities to different regions so as to equalize their ability to provide public services. Of equal importance is the need to reduce income inequality among groups and individuals. This objective necessitates the creation of a safety net by which the Government subsidizes certain basic necessities such as food, housing, education, health care, and energy for the lower income families, as well as offering assistance to the unemployed, aged and disabled persons with low income.

The proper functioning of the tax system is especially important in the present and immediate future, because taxes are likely to serve as the primary source of government revenue, aside from external resource transfers. Borrowing from the local market will tend to crowd out the fragile and embryonic private investment market, and impede the growth of the private sector. On the other hand, accumulating debts from the outside world is neither possible nor desirable at this stage. Taxes, therefore, have to play the double role of raising a reasonable amount of revenue, that increases with the growth of income, and encouraging private saving, which also grows with income. Only if the sum of private and public saving grows with income, and gradually finances a greater part of total investment, will the need for external aid be reduced.

2. Elements of tax reform

Guided by these considerations, and the standard criteria of efficiency, equity, and cost of administration, the tax structure should be changed in line with the following major criteria:

- (i) reducing the number of taxes;
- (ii) reducing the reliance on income and foreign trade taxes, and increasing the reliance on consumption-based taxation;
- (iii) in general, taxes should have less differentiated rates, and a much wider base than at present.

At present, the tax system includes 25 taxes of 16 different types. A single firm has to collect and/or pay 13 different types of taxes. This large number includes some low-yielding taxes, which do not justify their administrative cost. Furthermore, having a large number of taxes usually

increases the compliance cost, and may increase distortions, so reducing economic efficiency. Cutting the number of taxes, therefore, will reduce both administration and compliance costs, and will probably increase efficiency. Accordingly, it is suggested to have only the following 8 types of taxes.

Direct Taxes:

1. Personal income (payroll, self-employed).
2. Business income (private and public corporations and cooperatives).
3. Property.

Indirect Taxes:

4. Expenditures (VAT).
5. Excise.
6. Import duty.
7. Export tax.
8. Taxes on transactions, registration and licences.

The most important are the income tax and the VAT, both of which need complete restructuring. The income tax structure as it stands is very similar to that of Israel, whose per capita income is over 14 times greater than that of the Palestinian economy. Tables III-3 and III-4 present proposed schedules for the tax rates on personal and business income.³⁷ They feature pronounced changes in the direct tax structure which are designed to bring about two important interrelated improvements over the present system. The first is to simplify the way taxes are assessed, processed, and collected, so as to reduce both the cost of tax administration and tax evasion. The second is to bolster the objectives of efficiency, equity, and macroeconomic stability, so that the tax system becomes an effective instrument of economic growth and social harmony. The principal aspect of these changes is a shift towards a system of lower tax rates on broader income tax bases. A lower rate will foster efficiency by reducing the distortions in both work effort and saving decisions. Furthermore, it is essential to reduce tax evasion and the risk of capital flight. The experience of both developed and developing countries has shown that high marginal rates have not been enforceable due to a strong incentive to evade, and countries with top marginal rates higher than those prevailing in advanced industrialized countries often suffer from capital flight.³⁸ At present the top marginal rate in the Palestinian territories is 48 per cent as compared to 33 per cent in the United States.

It would be misleading to assume that this gain in efficiency will be at the expense of equity because the flatter rate renders the system less progressive. In fact the proposed schedule exhibits a more equitable treatment of taxpayers because it reduces the heavy tax burden on the lower income groups. For instance, under the present system a wage earner with a non-working wife and three children, and with an annual income of \$4,000, pays 4 per cent of his salary in income tax, whereas, he would pay no income tax under the proposed system.³⁹ Another important element of the reform is the simplification of the business tax system and a reduction in rates of taxation. These changes would integrate the two systems, and encourage investment while preventing tax arbitrage.

The second important change compared to the present system is in the structure of indirect taxes. Experience of developed and underdeveloped

economies have both testified to the attractiveness of VAT regarding its capacity to generate large amounts of revenue at a relatively low cost of administration. The rate should be chosen so as to foster its advantages without hampering other objectives of the tax system. At present the VAT rate is 17 per cent, and according to the Paris Protocol cannot be reduced below 15 per cent in the transition period. Fifteen per cent is a very high rate for the Palestinian economy in its present state of development. A much lower rate may be considered more appropriate from the viewpoint of equity and growth considerations. The equity issue is obvious bearing in mind that VAT is an expenditure tax, which is in turn equivalent to flat-rate income tax without exemptions.⁴⁰ Accordingly, the tax is not progressive, and usually this aspect of the tax is tolerated only so long as its rate is not very high. A moderate rate of VAT makes the tax a complement to a progressive income tax, by helping to reduce substantially the marginal income tax rate, and thus reduce distortions. On the other hand, a high VAT rate makes it regressive. Reducing the degree of regressivity necessitates exempting products that figure prominently in the family expenditures of the poor from the tax (or taxing them at lower rate). Another way of reducing the regressive nature of the tax is by imposing a surtax on luxuries. But different rates damage the attractive property of the tax; namely, its simplicity and uniformity. Also, achieving economic growth requires reorienting trade flows toward neighbouring Arab countries, and a high VAT rate will not help this effort. In other words, a high VAT rate might not be compatible with the trade regime deemed optimal for growth. (More on this point in the next section on the trade sector.)

It should also be noted that, up to 1993, VAT was in fact used more as a substitute for the income tax, rather than as a complement, because of its compatibility with the prevailing system in Israel.⁴¹ In an independent economy of Palestine, the tax should be used in a more appropriate form, with the regressive nature of the tax being reduced by cutting its rate. The rate reductions in both the personal tax and VAT would improve the enforceability of the tax system, thereby increasing its capacity to generate revenue. At the same time the change would reduce distortions and increase the incentive to save and invest. Coupled with a high sales tax on luxury goods and services, and sales tax exemption of food and health items, this would contribute to greater progressivity in the whole tax system.

In broad outline, these are the proposed changes in the structure of the tax system. Obviously, a comprehensive reform of the system requires more detailed studies dealing with issues of revenue yields, equity, and efficiency, which are constructed on more concrete assumptions regarding trade relations and tax harmonization with neighbours. In the immediate term and the short term, the existing system should be adjusted in line with the IMF

mission's recommendations; increasing the personal income tax deductions for the taxpayers and dependants, and addressing the regressivity of the existing high VAT rates through specific targeted assistance. ⁴²

Another important area that needs immediate attention is the fiscal leakage caused by the present treatment of Palestinian indirect imports by Israel through licensed Israeli traders. The Palestinian Authority should demand the acceptance of the principle of assigning revenues from customs duties on imports according to the point of consumption and negotiate a revenue-sharing formula based on total import flows.

3. Reconstruction of the expenditure system

The need to organize the expenditure side of public finances is no less urgent than the task of tax reform. In fact, in the transition period, with huge construction activities supervised by the Palestinian Authority, and with relatively large amounts of external aid, the accountability, transparency, and efficiency of the expenditure side acquires a critical political dimension, in addition to its economic importance.

Two primary tasks need the immediate attention of the Palestinian Authority in order to lay the foundation of an effective expenditure system. The first is organizational, and is most urgent. It involves the staffing by Palestinian employees as replacements for Israeli staff in the various departments of the Civil Administration. According to some estimates, this will involve hiring around 2,000 new employees, ⁴³ though actual developments since 1994 indicate an even greater increase in the public sector employment. This relatively large expansion reflects the fact that the new Palestinian administration will have to carry out the usual recurrent government activities, and the following new items:

- a relief programme to alleviate the high level of poverty caused by the recent increase in unemployment;
- an aid and compensation programme to families who suffered a loss, or disability, of members during the occupation;
- administer the expenditures of the new Palestinian police force, estimated to have reached at least 15,000 persons by the end of 1995; and,
- administer the expenditures of all aspects of the reconstruction effort, which includes the repairing of the physical infrastructure, revitalizing old and establishing new public services and social institutions.

The second task is political and essential to the success of the Palestinian Authority in rallying support of the inhabitants in the reconstruction process. This involves creating the Budget Law and the National Bureau of the Budget, which do not exist at present. As is known, prior to 1993, all matters related to government budget were the responsibility of the Israeli authorities. The preparation and implementation of the budget was carried out without consultation with the Palestinian people. The budget was presented annually in a separate section of the Israeli Government budget, and was not organized in any generally sensible

scheme of functional or economic classification. There is, therefore, an urgent need to create a new law specifying the details of the process of formulating, implementing, and controlling the budget, both at the executive and the legislative branches of the Palestinian Authority. This process will include the stages of initiation, preparation, and articulation at the executive branch, and the stages of reviewing, amending, approving, and authorizing at the legislative branch.

In order to carry out the various tasks of budgeting at the executive branch, a specialized department, such as The National Bureau of the Budget, has to be created. The Bureau may be a department within the Ministry of Finance responsible for all matters related to the executive branch's role in the budget, and must work closely with the committee of the Palestinian Legislative Council responsible for budgetary affairs. The Bureau has to develop a new system of budgeting in accordance with the innovative methods currently used in many countries.

To complete the system, another department, independent of any government unit, is needed to function as a Bureau of Accountancy. It could be run by a board of directors responsible directly to the National Council. This independent body will have the important function of auditing all government units, at the central and the local level, including the tax authorities. It will submit an annual report to the Legislative Council detailing its auditing of all government activities and undertakings. It also will have the function of overseeing, accrediting, and controlling the auditing and the accounting system and procedures in the private sector.

4. Estimation of future revenue and expenditure

Prior to 1994, Palestinians were over-taxed by paying two kinds of taxes: one to the Civil Administration and the other to the treasury. The total of these taxes in the late 1980s and early 1990s has been estimated at around 18-24 per cent of GDP.⁴⁴ At the same time, the level of public expenditures was less than 15 per cent of GDP, which is very low compared to other countries,⁴⁵ and implies a net transfer to the treasury.

In the next few years, the Palestinian Authority has to increase public expenditures, with regard to current expenditures in order to facilitate the increase in public services, and also with respect to development expenditures, especially in such fields as education, health, and municipal services, in addition to initiating public investment in all areas of infrastructure. Against these rising commitments, revenues generated from taxes are expected to decline. This is mainly because the Palestinian Authority will have to eliminate the "over taxation" feature of the present tax system, and also as the task of establishing a national tax authority and undertaking a tax reform will need some time to fully become operational. Thus, if expenditures are raised to around normal level (say 20 per cent of GDP), it is expected that the government budget will exhibit some deficits in the next few years.

In the following paragraphs, an estimate of a consolidated central government budget structure for the next year is presented.⁴⁶ This is based on the following assumptions:

1. The growth of income and government expenditures are estimated along the lines of the Alternative Scenario (without population return) scenario

(Section A of this Chapter).

2. The breakdown of the budget into current and development items takes into consideration the present situation and the urgent needs of the public. Thus, 70 per cent of the budget is allocated to current expenditures, and 30 per cent to development expenditures.

The current expenditures are in turn distributed as follows: 30 per cent for general services; 48 per cent for social services; 10 per cent for economic services; 7 per cent for community services; and 5 per cent for contingencies.

The development budget is distributed as follows: 40 per cent for general expenditure on roads; 20 per cent for social infrastructure; 20 per cent for economic infrastructure; 15 per cent for community infrastructure; and 5 per cent for contingencies. ⁴⁷

Taking into consideration the present condition of the Palestinian economy, it was estimated that total revenue could be generated in the following way: indirect taxes providing 40 per cent of total revenues; direct taxes 25 per cent; government services and fees 30 per cent; and public sector 5 per cent of total revenues.

The Palestinian Authority, however, is not expected to be able to tap the full tax potential of the economy immediately. Given the exceptionally difficult circumstances in which authority transfer is taking place, revenue collection in 1996 is expected to be below potential for both political and economic reasons. However, this equally necessitates an increasing tax effort to top the full tax capacity in the economy. Guided by these considerations, the consolidated budget of the central government for 1996 is presented in table II-5.

On the expenditure side, allocations are made according to the present needs of the Palestinian economy and the launching of the reconstruction programme (based on the alternative scenario without population return). On the revenue side, two estimates are presented: the "potential" revenue signifies the full tax capacity of the economy, given the existing tax rates; the "probable" revenue is an estimate based on the actual tax revenue collected since the establishment of the Palestinian Authority (end of 1994 and early 1995). ⁴⁸

C. The monetary sector

Restructuring the fiscal sector and reviving trade flows depends on rejuvenating the monetary sector, which has suffered severely during the last 27 years.

It is hard to envision any success in reforming the tax and public expenditures systems without a major transformation in banking and other facilities for financial transactions. Nor can a successful reorientation and increase in trade activities be envisaged without a major improvement in the private sector's capacity to finance and insure transactions. More generally,

the whole reconstruction effort cannot be carried out without creating sound and vibrant markets and related institutions, which collectively perform the essential functions of supplying liquidity, encouraging savings and

investments, and facilitating the management of risk. Fortunately, activities in the private sector to build the banking and investment institutions have already begun, and there are some indications that the sector may well be able to play the dual role of supplying the complementary services needed by all other economic activities, and creating important growth enhancing activities themselves.

Assessing the potential of the sector within the context of the existing situation, and the changes expected in the near future, is the subject of this section. It commences with a brief review of the present conditions, which reflect the changes that have taken place since the establishment of the Palestinian Authority. This is followed by a detailed analysis of the prospects for change and growth within the context of the new monetary arrangement specified in the Protocol. A formal analysis of this monetary arrangement, which explores both the potential use of monetary policy by the Palestinian Monetary Authority, and the effectiveness of commercial banks in supplying funds for investments, is provided in Appendix (III-1). The final subsection is devoted to analysing monetary arrangements beyond the transition period.

1. Present conditions and future prospects of the monetary sector

The establishment of the Palestinian Authority followed by the gradual removal of some of the harmful restrictions of the past, has set in motion a number of activities in the financial sector. Indeed, the last year has witnessed the revival of many activities in the financial sector, through rejuvenating old financial institutions and establishing new ones. Three different strands can be distinguished. First, the return of the Arab banks to the West Bank and Gaza Strip has been accomplished. This is taking the form of Arab banks reopening their old branches that were closed in 1967, and new Arab banks opening branches for the first time. Included in this category is the reopening of branches of the Arab Bank and Bank of Jordan, and the opening of new branches of the Jordan-Gulf Bank, and the Egyptian Arab Real State Bank. Second, the recent period has witnessed the establishment of locally owned new banks and investment companies with their own capital. Residents of the West Bank and Gaza Strip have founded the Commercial Bank of Palestine and the Arab Investment Corporation. The former started business in Ramallah in July 1994, with a capital of JD 10 million. The latter was registered in April of the same year, and is expected to perform the much needed function of creating credit for investment purposes.⁴⁹ Third, the flow of both expatriate Palestinian capital, and Arab and international capital has intensified. Two institutions typifying this category have been licensed and are in the process of commencing business. The Palestinian Development and Investment Company (PADICO) was founded as an offshore firm by a group of Palestinians (mostly from outside the territory) and Jordanian businessmen. It has a paid up capital of \$200 million, and an authorized capital of one billion. The second is the Palestinian Arab Investment Bank (PAIB), which is a joint venture of international, Arab, and Palestinian capital. Half of the company's shares will be owned by the Arab Bank, 25 per cent by the International Finance Corporation (World Bank affiliate), 15 per cent by a German development institution, and 9 per cent by Palestinian investors.⁵⁰

As a result of these activities, the landscape of commercial banking in the West Bank and Gaza Strip has changed radically, whereas there were only

2 Arab banks with 13 branches operating at the end of 1993, 41 branches representing 10 banks were operating at the end of March 1995.⁵¹ The first three months of 1995 registered an increase of 41 per cent in total bank deposits, reflecting a shift in money holding from cash to bank deposits, and indicating that Palestinians have started to bring home their bank deposits in other countries.⁵² Total bank loans, however, have not yet responded to this increase in deposits. The ratio of loans to deposits is still very low at 46 per cent in Gaza and Jericho banks, and 25 per cent in banks in the rest of the West Bank.⁵³ The comparable ratios at the end of 1994 for Jordanian and Israeli banks were 80 per cent and 86 per cent, respectively. However, this small role of financial intermediation by the banks is expected to expand once they have enough time to acquaint themselves with market conditions, and when measures needed to protect deposits reduce risks of loans and investments are put to work.

Obviously, it is too early to assess the impact of these recent developments in the monetary sector and the extent they will be able to provide the economy with liquidity, financial intermediation, and the management of risk. Nevertheless, the slow channelling of local and external capital into financial institutions has begun signalling a very important first step toward reviving the sector. There seems no reason to believe that steady progress will be inhibited provided that political uncertainty is reduced. To guard against misplaced optimism, however, it is important to emphasize that while the activities noted above are essential to the process of building a sound and vibrant financial sector, their ultimate success depends in great part on the direction, coordination, and supervision of the Palestinian Monetary Authority (PMA). The following subsection will explore the potential power of this institution within the monetary arrangements of the transition period, as specified by the Protocol.

2. The PMA and monetary arrangements during the transition period

The Protocol has assigned many functions to the PMA that are the traditional responsibilities of a central bank, designating the PMA as the supervisor and controller of the financial system, and as banker to both the Palestinian Authority and the commercial banks. The PMA is thus entrusted with the job of licensing all banks operating in the West Bank and Gaza Strip, holding their reserves, and regulating their operations with regard to solvency, liquidity, and stability. More specifically, Article IV, Item 5, of the Protocol states that the PMA should operate a discount window to advance loans to commercial banks, and act as a lender of last resort. Article IV, Item 4, states that the PMA will act as the sole financial agent (locally and internationally) to the Palestinian Authority, as well as being its financial advisor. It also holds and manages the foreign currency reserves of all public sector entities.

Obviously, the ability of the PMA to perform some of these functions, like that of lender of last resort, depends in great part on its ability to

control the monetary base (high powered money, which is the sum of currency held by the public and reserves of commercial banks usually held at a Central Bank). In other words, it needs to be able to satisfy the public demands for currency, and the bank's demands for reserves. However, as is shown in Appendix (III-1), this power is severely restricted by the absence of national currency, and the stipulation that the liquidity requirement on Shekel accounts be linked to that used in Israel (Article IV, Item 11 (6)).

As is also explained in the Appendix, the PMA could attain some control over the monetary base by using certain instruments. These include the management of government deposits, open market operations in foreign currency, and the discount window. Nevertheless, these instruments are useful in the short run, and only for very moderate operations. A major excess demand for reserves cannot be met by any of these tools, unless the PMA is willing to borrow heavily either from Jordan or from Israel (depending on which currency is demanded) and in doing so place a burden on the fiscal system.

The inability of the PMA to exercise the traditional control of a central bank over base money implies also that its ability to manage public debt on behalf of the Government is circumscribed. More importantly, its role in using monetary instruments to counterbalance short-run fluctuations, and to effect long-run readjustments, is severely undermined.

Moreover, there is another problem associated with the use of a double currency standard, that of currency mismatching (again, see the Appendix). It stems from the fact that commercial banks might find themselves with liabilities denominated mainly in the appreciated currency while assets are mainly constituted in the depreciated currency. The risks of this will inhibit commercial banks from performing the function of maturity transformation (accepting short-term deposits and extending loans over longer terms).⁵⁴

3. Future monetary arrangements

It was demonstrated in the last two subsections, and in Appendix (III-1), that, although the monetary arrangement during the transition period constitutes an improvement over the monetary situation that prevailed until 1994, it is by no means optimal. In fact, it embodies some of the worse aspects of the two polar exchange rate regimes. The absence of a national currency renders monetary policy less effective, which is a characteristic of the fixed exchange rate regime. On the other hand, the existence of a dual currency standard has the potential of increasing the costs associated with instability in purchasing power, which can occur under a flexible exchange rate regime. It should be apparent, therefore, that improving the monetary arrangement after the passage of the transition period requires, first and foremost, the movement toward a single currency standard, and then choosing a particular exchange rate regime. Naturally, the question arises as to which currency standard should be adopted.

In principle, the following alternative currency arrangements can be envisioned:

- adopting an independent Palestinian currency;

- adopting the JD;
- adopting a Palestinian currency in a currency union with the JD;
- adopting a Palestinian currency in a currency union with the Israeli Shekel; or,
- adopting a Palestinian currency in a currency union with the JD and the Israeli Shekel.

The following paragraphs depict the argument that only the second and third options constitute reasonable choices. In other words, the Palestinian economy is best served either by retaining the JD as the only legal tender, as it was in the West Bank before 1967, or by adopting a national currency that is tied to the JD. This argument is underpinned on two considerations. First, a currency union with the Israeli Shekel is not in the interest of the Palestinian economy. Second, the Palestinian interest is not served by a completely independent currency in the foreseeable future.

A single currency area (currency union or block), is a domain within which member countries use either a single currency, or different currencies linked through permanently fixed exchange rates. It has the advantage of reducing the cost of monetary transactions among member countries. By removing the uncertainty which arises from fluctuations in exchange rates, it helps stimulate specialization in production and the flow of investment and trade. A successful currency union induces economic agents to view the entire area as a single market and allows them to benefit from greater economies of scale in production. On the other hand, the currency union has the disadvantage of denying each member country the separate use of the exchange rate as an instrument of macroeconomic policy. A member country is thereby inhibited in carrying out a short-run stabilization and a long-run growth policy. In particular, a country suffering from a chronic unemployment problem, would be at a great disadvantage within a currency union if the other members of the union pursue policies of curbing inflationary pressures. It would be forced to use non-monetary measures to tackle its own problem.

Both the theoretical and the empirical literature on optimal currency areas has demonstrated that the cost of abandoning the exchange rate as a policy instrument will be small providing certain conditions prevail.⁵⁵ These include a high degree of factor mobility of labour and capital among the various member countries, a great similarity of economic structures, a high degree of product diversification, and an environment where shocks are common rather than country specific. These conditions would render the use of exchange rate changes in response to external shocks either unnecessary or ineffective.

The need to use the exchange rate to absorb shocks is substantially reduced by the ability of labour and capital to move from a country with excess supply (where wages and returns to capital are falling) to a country with excess demand (where wages and returns to capital are rising). Similarly, the need for exchange rate variations to effect changes in relative prices is greatly reduced if the economy is highly diversified. Such an economy, with a wide range of industries and exportable goods, does not need frequent changes in its exchange rate to absorb shocks since their impact will tend to be

localized in certain industries. Thus, an unemployed resource in one industry will move to other industries. On the other hand, the effectiveness of the exchange rate as an instrument to effect changes in the terms of trade is greatly reduced if the countries have similar structures and, thus, face similar terms of trade shocks.

It is apparent that capital and labour would be much more mobile between Palestine and Jordan, and much less so between Palestine and Israel. This is because both labour and capital markets in Jordan are relatively free and integrated with Palestinian markets, while in Israel they are to a great extent controlled by the Government, and have strong ties with European and North American markets. An Israeli Commission of Inquiry investigating the collapse of banking shares in October 1983 has described the Israeli capital market as follows: "The central feature characterizing Israel's capital market for as long as Israel has existed is the government's domination of the capital market. The government's involvement transcends anything that is known in politically free countries. The main expression of this involvement is the fact that most of the finances that accumulate in the various savings schemes are channelled to the state's budget or allocated by it. The government sets, for every financial instrument, its term, rate of interest, and tax regulations. Since the government is the chief mobilizer of savings, it is also the main allocator of credit. The lion's share of long, and medium-term credit to households (mortgage loans) and the business sector (finance of investment in industry, agriculture, tourism, etc.) is allocated by the government through its budget or by other means." ⁵⁶

The Israeli Government's domination of the capital market explains why, over a period of 27 years of occupation, there was no appreciable flow of Israeli private capital to the Palestinian territories, despite the relatively low cost of labour and sub-contracting practices. Investment in the West Bank and Gaza Strip was not included in the Government's system of subsidies and tax concession. ⁵⁷

Considering the capital needs of the Israeli economy in the near future, in view of requirements for settling new immigrants, it is unlikely that there will be major changes in the Government's role in the capital market, or a substantial flow of Israeli capital into the Palestinian territory. On the other hand, a capital flow in the other direction will not be encouraged, even under the privatization and liberalization efforts, mainly because of political and strategic factors. ⁵⁸

By contrast, the Jordanian capital market is relatively free, and is organically tied with Palestinian capital. As was mentioned above, efforts to revitalize the financial sector in the West Bank and Gaza Strip are partly the result of initiatives taken by Jordanian financiers, and Palestinian financiers residing in Jordan. ⁵⁹

Similarly, the labour market in Israel cannot be considered a free market, where the employment levels and wage rates respond quickly to changes in supply and demand. ⁶⁰ Thus, notwithstanding its importance to Palestinian income and employment, work in Israel does not constitute a mechanism by which an external shock adversely affecting the Palestinian economy, and causing unemployment, can be absorbed by increasing employment in Israel. Employment of Palestinians in Israel is determined mainly by the economic conditions in Israel. Thus, the

hiring of Palestinian commuters to work by the day in Israel does not reduce the need for an exchange rate policy.⁶¹ On the contrary, it is by itself a source of fluctuation and instability, because it ties the activity of the labour market to security uncertainties and an explosive political situation on a daily basis.⁶² A further element of instability for Palestinian workers in Israel arises because most of the work is carried out in the construction sector, which is the most volatile in the economy.⁶³ This stems from its sensitivity to fluctuations in immigration, in addition to the usual variations in demand for housing arising from changes in income and the interest rates.

Given the events that have taken place since the establishment of the Palestinian Authority, it is fairly certain that the number of Palestinians working in Israel will not regain the levels of the mid-1980s, when more than a quarter of the labour force migrated for work in Israel.⁶⁴ On the other hand, the mobility of labour between Palestinian territory and Jordan is likely to increase with the opening of the border between them. In particular, many of the Palestinian returnees are expected to come from Jordan, as the success of the reconstruction effort depends on some skilled and professional Palestinians presently residing in Jordan.

More important than the low factor mobility between Israel and the Palestinian territory is the great dissimilarity between the structure of their economies. The size of the Israeli economy is around 14 times that of the Palestinian economy; its product diversification is much greater; and the manufacturing sector's share in GDP is more than three times larger.⁶⁵ These large differences in size and structure would make the Palestinian economy's capacity to absorb external shocks much weaker than that of Israel when the two are members of a currency union.

Finally, since the traditional orientation of the Israeli economy is toward North America and Western Europe, while the Palestinian economy historically has been closely linked to the Arab hinterland, the two will thus face different external imperatives, which will make the prospects for monetary union uncertain. This is readily apparent if one considers a shock caused by a substantial drop in the world price of oil (similar to the one that occurred in the mid-1980s). Such a shock would have a very different impact on the Israeli and Palestinian economies. It could lead to expansion of economic activities in Israel due to a positive supply shock to its highly industrial economy, and an increase in exports to the similarly affected economies of North America and Europe. In contrast, the shock would cause a contraction in the Palestinian economy triggered by the drop in both the remittances from and exports to, the Gulf States. Thus, if the Palestinian currency is tied with the Israeli Shekel in a currency union, the exchange rate would not be allowed to absorb the contraction, and the adjustment would have to be carried out through increases in unemployment. Furthermore, given the relative size and sophistication of the two economies, Israel would be able to conduct sterilization operations to contain any inflationary pressure caused by the expansion, and prevent the Palestinian economy from using expansionary monetary policy to moderate the impact of the recession.

In conclusion, the economic prerequisites representing compatible structures and stages of economic development, necessary for a successful single currency area do not exist between Israel and Palestine for the time being. The situation is very different in the case of Jordan. Notwithstanding the important differences between the two economies, reflecting almost three

decades of separate development and barriers to movement of people and goods, the ties between Jordan and the Palestinian territory are still strong, and can be expected to grow stronger with the dismantling of the prevailing restrictions. The agreement signed in Amman on 26 January 1995, between the Palestinian National Authority and the Jordanian Government, reveals the extent to which the two economies are linked together. ⁶⁶ The agreement on transportation and telecommunications also confirms that Jordan is the passage to the Arab world, and essential to reorienting Palestine trade in that direction. Other aspects of the agreement concerning various fields underscores the important role of the relatively developed Jordanian institutions in supplying expertise and training to develop the new Palestinian institutions in areas of mutual interest.

In addition, there is the question of the Palestinian returnees. The majority of the immediate returnees to the West Bank will be Palestinians residing now in Jordan. ⁶⁷ Some are Jordanians of Palestinian descent, who have property and/or family ties in the West Bank, and others have temporary residence status in Jordan. In the longer run, the question of returnees is embedded in the larger question of Palestinian refugees and their future, as will be determined by the final status negotiations. The important point to note here, though, is that accommodating labour migration from Jordan to the West Bank and Gaza Strip, with minimal disruption to the labour markets of the two countries, requires coordination and planning by the two governments, especially since both suffer a problem of unemployment, particularly for skilled and professional labour.

The above factors strongly support the hypothesis that the Palestinian territory and Jordan constitute an optimal currency area, and that they could therefore form a currency union. Accordingly, the PMA could embark on initiating effort in two directions. First, establishing a Palestinian currency, as the only legal tender, to be used after the passage of the transition period. Second, negotiating with the Central Bank of Jordan all the aspects of monetary union. At a later stage, and within the context of possible future confederation, it may be more practical to merge the Central Bank of Jordan and the Palestinian Monetary Authority into one Supranational Central Bank, carrying out all the functions of the central bank for both Jordan and the Palestinian entity. The new institution might consist of a central headquarters, responsible for broad policy decisions and two separate agencies one for each entity. This arrangement would have the following advantages:

- (i) It promises organizational economies of scale and provides the Palestinian side with the experience of a well-established institution;
- (ii) It would increase the independence of the central bank and the ability to limit irresponsible and unsound fiscal actions of either Government; this would enhance the power of the central bank, and, provided it was under appropriate management, this could improve the quality of economic policy generally.

In addition, a declaration by the PMA favouring such an arrangement after the passage of the transition period, would result in reducing the

uncertainty surrounding the present system, enable the banks to overcome the problem of currency mismatching and so become more forthright in performing their functions of financial intermediation and maturity transformation (see Appendix III-1).

D. The trade sector

Parallel to designing and reforming the public finance and monetary sectors, and of equal urgency, is the need to revitalize, reorient, and strengthen the trade sector. Success in redressing the trade imbalance, and gearing the economy towards a viable external payments position, is a crucial task of the reconstruction effort. Sustainable economic development cannot be obtained unless the economy undergoes a transformation in which goods are substituted gradually for labour services as the main export and source of foreign exchange. The trade sector, therefore, has to play the pivotal role of freeing the economy from unreliable sources of income. The opportunities for such a transformation cannot be adequately ascertained without first analysing the present trade situation. Accordingly, the highlights of the present trade situation are presented in the following section. This is followed by a discussion of the tasks of restructuring trade flows in the interim period while the last section explores the question of the long-run trade strategy appropriate to the Palestinian economy.

1. The current situation of Palestinian external trade

The Palestinian external trade sector currently depicts a weak and deteriorating situation. The pattern of trade has been greatly skewed toward one market, and merchandise trade suffers from a large and increasing deficit, which results from the long-term trends of declining exports and unconstrained imports. The ratio of merchandise exports to GDP has declined from a high of 40 per cent in 1980 to around 21 per cent in 1993.⁶⁸ The decline was accompanied by a change of composition, reflecting a gradual reduction in agricultural exports from 40 per cent of total exports in 1980 to 30 per cent in 1990.⁶⁹

Simultaneously, there has been a mounting import bill, which peaked at around 75 per cent of GDP in 1987. It declined thereafter, as a result of the austerity and import substitution measures during the first three years of the intifadah. However, it resumed its upward trend again after 1990, and was estimated at 62 per cent of GDP in 1993.⁷⁰

Naturally, these two trends in exports and imports have resulted in a substantial and increasing trade deficit, which reached about 40 per cent of GDP in 1993. The bulk of the deficit has been with Israel, reflecting its growing relative significance as an export market and predominant role as a source of imports. The share of Palestinian merchandise exports to Israel increased from 65 per cent of total exports in 1980 to 85 per cent in 1992. Meanwhile, Palestinian exports to Jordan and the rest of the Arab world have fallen from 31 per cent of total exports in 1980 to 13 per cent in 1992. Concurrently, Israel remains the principal source of Palestinian imports – around 90 per cent of the total – which are mainly consumer goods, raw materials, intermediate inputs and capital goods. Trends in trade cannot

be separated from those in production, because there is always an inherent link between them in small economies; changes in trade patterns affect production,

and vice versa.

To illustrate this, it is useful to examine recent trends in production and trade of Palestinian agricultural output and how these reinforce each other. In recent years, the share of Palestinian agriculture in GDP and exports has declined continuously. Furthermore, at present, both exports and total trade is unusually low by international standards.⁷¹ This contraction in both production and trade is the result of three different kinds of restrictions, each reinforcing the others.

The first set of restrictions affect the use of natural resources, which raise the cost of production, and lead to the loss of competitiveness in foreign markets. One example of this kind of restriction pertains to the use of Palestinian water. The shortage of water has forced Palestinian farmers to stop the irrigation and planting of fruit trees, bringing a decline in both quantity and quality and resulting in the loss of competitiveness vis-à-vis agricultural exports from Turkey, Greece, and Spain in traditional Arab export markets, especially in the Gulf States.⁷²

The second type of restrictions work in the opposite direction; loss of accessibility to foreign markets reduces the demand for Palestinian goods, and reduces both production and efficiency. Barriers to trade are the most important factor in this category. They include such practices as setting protectionist quotas on the import of Palestinian agriculture products in neighbouring markets, lifting them only when there are severe shortages that can be met by allowing imports beyond specified quotas.⁷³ These have reduced Palestinian agricultural exports to Israel and Jordan, while Palestinian trade with the rest of the world is also substantially inhibited by the agreement that it should pass through Israeli channels.⁷⁴ Barriers like these have resulted in the loss of profitability for Palestinian farmers, and brought a decline in their investment and production.

The third kind of restriction results from the custom union that governs the Palestinian economy, and the substantial trade diversion that it has created. High tariffs are imposed on a range of imports to protect domestic products. Palestinian farmers have been obliged to buy their machinery, fertilizer, packing materials, and other inputs from the Israeli market at prices substantially higher than those available in neighbouring countries. To a great extent, these high prices of inputs have been responsible for annulling the cost advantage of relatively cheap agricultural labour.⁷⁵

In addition to these direct restrictions, Palestinian agriculture also has been caught between the traditionally supported agriculture of Israel, and the emerging support for agriculture in Jordan. Israel has one of the most comprehensive and sophisticated support systems for agriculture. It includes a structure of generous subsidises, marketing boards, a comprehensive insurance scheme and marketing research facilities.⁷⁶ These function to increase the profitability of Israeli farmers, smooth the fluctuations in production, prices and incomes, spread risks, help to develop new products and furnish accessibility to new markets. Jordan also has recently adopted a policy of

government support for the agricultural sector.⁷⁷ It is aimed at achieving a large degree of self-sufficiency in food production through the use of subsidies on inputs and guarantees on prices of outputs.

Similar restrictions are responsible for the continuing decline of trade in manufacturing and services. Accordingly, the revival and reorientation of Palestinian external trade in general is contingent on a substantial improvement in three factors: capacity, competition, and accessibility. Enhancing the productive capacity requires the removal of restrictions on the use of natural resources, and improvement in the economic infrastructure and general public support system. Regaining competitiveness, in order to sell traditional Palestinian agricultural products as well as new products, requires the removal of tariffs on many inputs and capital goods, so that Palestinian producers can acquire them at lower cost. It is also necessary to amend many tax and other relevant regulations which have reduced the profitability of production in the past. Finally, increased accessibility to foreign markets requires changes in protection and practices by other countries, as well as negotiating new trade agreements.

Positive changes in these three factors can help to free the Palestinian economy from the vicious circle in which constraints on production limit trade, and the loss of markets decreases investment, production, employment and income. However substantial changes will take time. Therefore, it may be misleading to talk about an optimal trade regime for the Palestinian economy (free trade, custom union, etc.) independently of the time factor. Indeed, a trade arrangement that could be envisioned as optimal in the long run might be detrimental if it were imposed immediately, because it would lock-in the consequences of the occupation era. In other words, reforming external trade patterns has to follow a sequence of stages, reflecting the degree to which the economy has successfully overcome the harmful effects of policies operating in the past 27 years, and regained its ability to avoid the vicious interplay between declining trade and inefficient production. The following section considers trade issues in the immediate and medium terms. The subsequent section is devoted to trade options and trade strategy in the long run.

2. The tasks of trade policy and prospects in the transition period

The task of revitalizing the trade sector involves policies to increase the capacity for production, remove distortions in the cost-price structure and re-establish entry into neighbouring markets and access to new ones. These formidable tasks cannot be completed during the interim period which is insufficient to affect such a profound and comprehensive transformation of production and trade structures. Furthermore, the economic policy environment of the interim period limits the possibilities for bringing about complimentary changes which are a prerequisite for successful transformation. The protocol on Economic Relations between Israel and Palestine does not give the Palestinian Authority full control over natural resources. Restricted use of land and water, with their attendant distortions in prices, will continue to hamper the regaining of full capacity utilization. Therefore, in the interim period, the Palestinian Authority cannot begin the tasks of re-zoning and expanding the land for urbanization, agricultural use and improved transport networks. Negotiating trade agreements with neighbouring countries is also not free of obstacles. The trade arrangement with Israel during the interim

period, which retains many features of a custom union coupled with some elements of free trade, presents obstacles to negotiating suitable trade arrangements between the Palestinian economy and its other neighbours. Finally, a number of the non-tariff barriers (NTB) that constrained exports of

Palestinian products in the past still exist.

Nevertheless, the Protocol does have some positive elements that allow Palestinian trade to become more vibrant, and gradually assume the role of a growth generating factor. The Protocol allows the Palestinian Authority to choose its own tariff on a list of "development goods", and thus enables the importation of capital and intermediate goods at a lower cost, which in turn reduces the cost of the reconstruction effort. Rebuilding the physical infrastructure of the economy is the key factor in creating the supportive system, without which trade activities are destined to be limited in scope and pattern. Of high priority is the transportation and communication systems, and general marketing facilities.

At present, the existing transport system is in a very poor condition, deteriorating owing to neglect over the last 27 years.⁷⁸ In fact, the conditions of roads present a formidable obstacle to both internal and external trade activities. The whole network needs a comprehensive rehabilitation and expansion programme. Also, building a direct outlet to the world, so that Palestinians can easily and efficiently trade with other countries, is essential to enlarged export activities, and to independent trade. Accordingly, the establishment of shipping services and the development of a commercial sea port in Gaza, constitute a priority area of action. Serious consideration also needs to be given to enlarging and modernizing the airport of Qalandia, north of Jerusalem. A similar project for the operation and development of the airport in the Gaza Strip needs to be accorded priority. Development in the transport system cannot be fully effective and sustainable, however, unless parallel steps are taken to establish the legal and institutional framework for the system. This will enable the private sector to expand and modernize the road transport network and industry.

At present, marketing institutions and services are either non-existent, or of a primitive nature. Specialized export institutions for agricultural and industrial products are urgently needed, to provide information, technical expertise, and general guidance to producers, especially small businesses. In this regard, technical assistance available through international agencies could be used extensively.⁷⁹ A host of technical problems related to quality control, grading, storage, packing, etc, need to be addressed so as to ensure the upgrading of Palestinian products to international standards.

The other major task during the interim period is to establish trade with the markets of neighbouring countries. The Protocol allows for a limited opening to the markets of Jordan and Egypt, by granting Palestinians the right to set their own tariffs on a list of goods imported from these two countries. This should also enable the acquisition of preferential treatment for some Palestinian exports to Jordan and Egypt.⁸⁰ The Protocol also removed all direct barriers to the Israeli market, with the exception of certain agricultural products, until 1998.⁸¹ This opening of neighbouring markets ought to be aggressively pursued, as the first step towards the reintegration of the Palestinian economy into the region. This should be

coupled with efforts to exploit new markets that have accorded Palestine a preferential treatment, especially the markets of the European Union and countries signatories to the GSTP among developing countries - both having accorded unilateral concessions to Palestinian goods.

The relaxation of restrictions imposed on trade flows are expected to improve the situation, and some studies have predicted a promising outlook in the interim period.⁸² Here, the findings of one study are reported, since these are predicated on the assumptions of the Alternative Scenarios, which were used in the last chapter.⁸³ The study's aggregate results are summarized in table III-6. They show that the deficit in merchandise trade tends to decline in relative terms if there is a complete removal of the quotas imposed by Israel and Jordan on Palestinian agricultural products.

The study indicates that both import-substitution and export-promotion activities could be used successfully if properly balanced and sequenced. In the next few years import-substitution activities could have very positive effects on agriculture in the Gaza Strip. It is estimated that by the year 2000, agriculture in the Gaza Strip would regain its position as a net exporting sector, as in the period 1984-1987. Agriculture in the West Bank is not expected to be able to make the same improvement. Instead, imports from the Gaza Strip will increase, and its general trade deficit will decline. The West Bank, however, is expected to have more success in the export of manufactures.

3. Elements of a trade strategy

As noted in the last section, there are two major tasks of trade sector reform in the interim period: building of the infrastructure needed to underpin the expansion of the productive capacity, and reorienting and expanding trade flows. Pursuing these two goals is best achieved in terms of guidelines articulating the Palestinian perspective on future relations with the Israeli and the Arab economies.

The nature of the future economic order will depend to a large extent on the political conditions prevailing in the area, which in turn depend on the outcome of the peace negotiations between Israel and Syria and Lebanon, and the final settlement between Israel and Palestine.⁸⁴ Given the complex political realities, and the track record of the peace process so far, it is hard to envision a comprehensive peace, and a resolution of the overall Palestinian-Israeli conflict being achieved quickly. Accordingly, it is not realistic to expect a new economic order in the area to emerge in the immediate future. Paradoxically, however, this political uncertainty makes more urgent the articulation of a Palestinian perspective on the future. The thesis that successful economic cooperation and coordination can precede political negotiations and settlements has so far been shown to be flawed.⁸⁵ Accordingly, the Palestinians need to articulate a perspective of their long-run interest, and pursue its path without being overly influenced by short-run considerations.

The Palestinian trade interest is conditioned generally by two primary concerns: the need for openness, and the need for diversification. Open relations without trade restrictions is necessitated by the size of the Palestinian economy, its geographical location, and its need to attain

sustained growth. The small market of the West Bank and Gaza Strip renders any strategy based primarily on import-substitution and inward development highly inefficient. The proximity of Palestinian areas to Israel, Jordan, and Egypt, and the fact that they have no natural borders with Israel, makes a protectionist regime very costly as it generates rent seeking, smuggling and monitoring of border flows. Moreover, the reconstruction effort and the ensuing growth require the importation of capital goods, intermediate goods, and raw materials, which in turn require a matching value of exports to pay for them. In light of these considerations, the Palestinian economy needs to adopt an outward export-oriented strategy.

Liberalizing Palestinian trade and diversifying its composition and direction reflect two important considerations. The first is related to the requirements of Palestinian self-reliance. Given the present and expected future realities of the Israeli-Palestinian relationship, any overwhelming Palestinian economic dependency on one trading partner can easily become an instrument of pressure which will again compromise Palestinian self-reliance. The second reason concerns Palestinian economic growth in the long run. Emphasizing bilateral trade with one partner, at the expense of multilateral trade involving also other partners, is inappropriate owing to the great economic disparity between the two trading partners.⁸⁶ For example, the present composition of trade between the two partners is mostly inter-industry trade, where Israel exports skill-intensive goods to the Palestinian territory, and imports from it low-skilled goods. Expansion along these lines means that the price of skill-intensive goods will fall relative to the price of low-skilled goods, encouraging Palestinian production to rise in low-skilled industries, and fall in skill-intensive ones, thus "locking in" the present pattern. The demand for skilled workers will fall, and their wages will decline, relative to those of the low-skilled.⁸⁷ Palestinians will be discouraged from investing in human capital and this will retard growth and development in the Palestinian economy.⁸⁸

It follows from the need for openness, and for diversification, that the Palestinian trade strategy should aim at gradually moving away from inter-industry trade toward intra-industry trade. Usually, this kind of trade flourishes among economies of similar size and factor proportions,⁸⁹ implying that in addition to Israel, countries like Jordan, Syria, and Lebanon as well as those of the Gulf constitute the appropriate markets. Removal of tariffs and all other obstacles to trade between these markets and the Palestinian market will realise conditions for economies of scale, encourage specialization and facilitate trade in differentiated products.

E. Macroeconomic policies

As outlined above, the reconstruction of the Palestinian economy facilitating the achievement of rapid and sustainable growth requires the successful completion of two major tasks. The first is removal of constraints on business activities. The second is the building of infrastructures and provision of public services, creating a support system conducive to investments, production and trade activities in the private sector. Essential to the success of carrying out these two tasks is the effective use of the external aid available from the international community. The aid will play two important roles in the construction effort. It will supply the funds required to finance the investments needed in the absence of adequate national

savings, which have declined in the last few years. Private saving has declined as a result of contraction in economic activities following the Gulf war and the Israeli closure of borders in 1993, 1994 and 1995/96. Public saving, on the other hand, cannot be significantly increased until the Palestinian Authority develops an effective tax and expenditure system. The second role of external aid is to fill the trade gap, which was discussed in Section D, by supplying enough foreign exchange to pay for imported capital and intermediate goods, needed in the reconstruction phase.

By its very nature, external aid is a temporary remedy, and its success is measured by the extent to which the economy is stimulated to create substitutes in the form of increased productive capacity, national savings, and exports.⁹⁰ This requires not only economic growth, but rates of growth in investment and exports which outpace the rates of growth of consumption and imports. Indeed, the positive results shown in the two scenarios discussed in the first section of this chapter, explicitly assumed that appropriate macroeconomic policies were implemented to ensure the satisfaction of these relations among growth rates. The question therefore arises as to what these policies are, and this section attempts to provide an answer bearing in mind the constraints posed by the public finance, the monetary and the trade sectors, as discussed above.

Intensifying investment and raising exports requires substantial expansion of the productive capacity of the economy and restraint on increases in consumption and imports. Thus, there is a need for macro policies to affect the supply side, and others to affect the demand side. The former deals with policies generating savings and their allocation among competing investment projects. The latter deals with policies controlling the level and composition of aggregate demand, so as to prevent inflation or a harmful trend in relative prices. The following section is devoted to the analysis of policies related to supply issues, and the subsequent section explores policies related to demand management.

1. Supply issues

The Palestinian economy is largely "supply determined", implying that productive capacity, rather than aggregate demand, poses the major constraint on economic activities. This is due to shortage of capital, outdated technology, and low skills, as discussed in the last chapter. Investment in both capital equipment and human capital are therefore needed to reduce the constraints on capacity. This requires an increase in the share of investment in GNP, and two sets of policies to bring it about. The first raises savings needed to finance investments, and the second ensures that the savings will be allocated optimally among investment projects.

Monetary policy cannot be relied upon to encourage saving. As was discussed in Section C, and Appendix (III-1), money supply in the transition period is an endogenous variable related to the balance of payments, and tight money with a high interest rate is not an effective tool for stimulating saving in less developed countries.⁹¹ Fiscal tools, involving taxes and expenditures, therefore, are the main instruments available to achieve the objective of high saving. Since national saving is equal to GNP minus consumption (private and public), it can be increased by any measure that reduces consumption without causing a fall in production (GNP). Taxes could be used to discourage private consumption, which would increase private saving provided they do not produce a disincentive to work and/or invest. In this regard, the tax reform, discussed

in Section B, emphasizing the importance of reducing rates of income tax, and increased reliance on consumption taxation, is a major step toward creating appropriate incentives.⁹² The use of neutral lump-sum taxes in agriculture and small business could serve the same purpose of discouraging consumption without reducing production.⁹³ At a later stage, schemes could be introduced to target certain types of savers. Examples of such schemes which have been used very successfully in many countries are registered retirement saving plans, and home ownership saving plans.⁹⁴

Public saving could also be increased by reducing some items of public consumption. In the Middle East, national defence and State security are two major items in every government budget. The Palestinian Authority does not have to allocate resources for defence, and it should seek to minimise the resources devoted to security. The same is true for some other public expenditures which serve political, rather than economic, interests. In particular, the bureaucratic apparatus of the Palestinian Authority and the future Palestinian entity should grow with the needs of the economy, and their growth should not become autonomous.

In addition to policies geared toward generating savings, policies are also needed to influence the pattern of investments. During the next few years, the majority of investment projects will be public, but this could induce private capital (domestic and foreign) to invest in unessential industries (luxuries). This would be harmful for two reasons. First, it would raise the price of necessities, and cause a redistribution of income in favour of the rich. Second, it threatens to create production bottlenecks and sectoral imbalances. To avoid these harmful effects, fiscal incentives should be directed toward investment in projects catering to basic needs and to increasing and diversifying exports. Private capital interested in building small houses for people of limited income should also be given more fiscal inducement than private capital interested in building luxury houses and/or hotels.

Traditionally, development banks are used as an instrument to affect the pattern of investment. Small farmers, and firms who lack access to commercial banks, are provided with a source of cheap subsidized loans to help them invest. The problem of such banks, as demonstrated by the experience of many developing countries which have used them, is that they often end up serving the wrong clients; large land-owner farmers, and well-endowed business establishments.⁹⁵ If the Palestinian Authority is to establish some development banks, with the aim of affecting the patterns and volume of investment, it has to provide an institutional framework containing safeguards against abuse.

2. Demand issues

Demand issues will assume growing importance in the Palestinian economy during the reconstruction period, with increased infrastructure outlays financed mainly by external resource transfers. Ensuing changes in either the general level of aggregate demand or its composition without corresponding increases in output, might trigger inflation or changes in the relative prices,

which could retard growth. The danger of a rise in the general level of prices is a very real one, since the building of infrastructures generates an increase in income while it does not immediately generate an increase in consumption goods. The situation would be exacerbated if political changes and the positive prospects of peace trigger a large speculative capital flow from Palestinian expatriates and others. Indeed, the increase in land prices in 1994 can be attributed in great part to such speculation, and this will not facilitate productive investment and growth.⁹⁶ While monetary policy cannot be used at the macrolevel to reduce aggregate demand for reasons already outlined, it can be used to restrain speculation. The PMA, as a controller and supervisor of all financial institutions, could discourage financial activities involved in facilitating speculative pursuits. Fiscal measures could, perhaps, be even more effective. Taxation of speculative activities, while sparing real investments, would be appropriate.

The other major danger during a period of sizeable flow of external aid is an appreciation of the real exchange rate, leading to a decline in external competitiveness. This phenomenon, can accompany the transfer of external resources. The use of external resources in the domestic economy increases the demand for both tradable and non-tradable goods, but since increases in demand for the latter has to be satisfied by domestic resources, while increases in demand for the former can be met by imports, there can be an increase in the price of non-tradables, a shift of resources from tradable sectors (agriculture and industry) to non-tradable sectors (construction), and an appreciation in the real exchange rate, leading to a decline of the country's competitive position in the foreign markets.⁹⁷ This will squeeze agriculture and industry and retard growth in the productive sectors.

Admittedly, the chance of this phenomenon occurring is relatively small, at least in the next few years, since the Palestinian economy has huge under-utilized resources which provide capacity to increase production of non-tradables without shifting resources from the tradable sectors, and without putting much pressure on the real wage. At a more advanced stage of the reconstruction phase, however, pressure on resources could occur, and bring about appreciation of the real exchange rate. Nevertheless, other forces are likely to dominate and bring a depreciation of the real exchange rate. A sizable decline in the remittances of Palestinians working in the Gulf States, or a major depreciation of the Jordanian or the Israeli currency, are some of the negative shocks that could affect the Palestinian economy.

The conventional macro policy package at times advocated combines expenditure reduction with expenditure switching, with the aim of "getting prices right", so restoring equilibrium between aggregate supply and aggregate demand. It is assumed that a devaluation of the nominal exchange rate will raise the domestic price of both exports and imports, and thus switch expenditure away from foreign goods toward domestically produced goods, which in turn reduce the trade deficit. Expenditure reduction (tight money and contractionary fiscal policy) is used to prevent the domestic price level from rising, and negates the nominal depreciation of the exchange rate.

The effectiveness of this stabilization package is disputed. Some critics claim that the policy does more harm than good, by causing a contraction in economic activities, a loss of income and greater hardship to the poor.⁹⁸ Moreover, in the Palestinian context the complete package cannot

be used, since there is no national currency to devalue. Consequently, any devaluation of the real exchange rate has to be achieved via expenditure reduction, accompanied by a mixture of tariffs on imports and subsidies to exports. However, this will encourage rent-seeking activities, and, more importantly, it contradicts the trade strategy discussed in the preceding section, which hinged on gradually removing all barriers of trade with neighbouring countries. A more appropriate set of policies might be to use a subsidy and tax mix, whereby exports would be selectively subsidized, and consumption goods would be taxed, with imports used as inputs in domestic production exempted from taxation. ⁹⁹

Chapter IV

SECTORAL ISSUES OF STRUCTURAL TRANSFORMATION

The analysis in the last chapter focused on issues related to the growth of total national production and on the macro policies needed to ensure that growth. The related aspect changes in the sectoral composition of national output was not referred to. In this chapter it is explicitly recognized that different sectors grow at different rates, together with the possibility that this might create disequilibria in both production and consumption. These can occur because the growth of one sector implies an increase in its demand for inputs from, and its supply of output to, other sectors; a failure of the other sectors to grow at appropriate rates will create bottlenecks in production and/or deficiencies in demand that constrain the growing sector. To the extent that markets are relatively efficient, and the economy is open to international trade without prohibitive tariffs, and there are no inappropriate government policies seeking to expand certain sectors inefficiently, these constraints will be short lived and the price mechanism will shift resources to accommodate the new patterns of production and consumption. On the other hand, market failures, protectionism and ill-considered policies favouring particular sectors, could prevent the required adjustment, and thus slow down growth, or even abort it completely. Accordingly, the smooth development of the Palestinian economy requires removing existing distortions imposed during the occupation, adopting the correct trade regime, and formulating a development programme which takes into account the main linkages among the various sectors.

The purpose of this chapter is to analyse these issues for the main sectors of the economy: agriculture, industry, construction and services. Before considering these issues, however, it is useful to provide a general picture of the sectoral composition of the economy, and examine the need for structural transformation in order to set the economy on a path of sustainable growth devoid of major disequilibria. This is presented in the first section of this chapter. The following four sections deal with issues related to agriculture, industry, construction, and services, respectively. The final section is devoted to the public utilities sector, whose development is essential to the development of the other four sectors.

A. The sectoral composition of the Palestinian economy and the need for structural transformation

Table IV-1 presents four sets of figures on the sectoral composition of GDP. The first pertains to the West Bank in 1966 (one year before the occupation), the second is for the Palestinian economy (the West Bank and Gaza Strip) in the late 1980s and early 1990s, the third are the averages of 16 countries having comparable per capita income to that of the Palestinian economy in the late 1980s, and the fourth are averages of all developing countries in 1990.

Comparing these four sets of GDP figures reveals the distorted nature of the Palestinian economic structure. While development is usually characterized by a decline in the agricultural share, and an increase in the industrial share, Palestinian agriculture has declined coupled with a stagnating industrial sector. This distorted development has resulted in less than one third of Palestinian GDP being produced by agriculture and industry, compared to more than one half in economies with comparable per capita income. This reflects declining profitability in non-service sectors, and results from distortions in the factor markets, land prices, wages, and the cost of capital were all inflated during the 1970s and 1980s.¹⁰⁰

Creating an environment conducive to increasing the activity of the productive sectors therefore requires the removal of these distortions in the factor markets. The situation in the land market is more serious than in the labour and capital markets. The opening of Palestinian and Arab banks in the West Bank and Gaza Strip, under the supervision of the PMA, and the substantial decline in the number of Palestinians working in Israel, have reduced the distortion in the capital and labour markets.¹⁰¹ The pressure on the wage rate has eased, and the cost of capital is expected to fall and its availability to increase. Accordingly, policies are primarily needed to remove the distortion in land prices, and to ensure that the advent of intensive construction activities does not place inordinate pressure on the wage rate and the cost of capital.

The macro aspect of these policies was discussed in the last chapter, while their sectoral implications are analysed below. However, putting the sectoral dimension in the proper perspective requires a clear understanding of the inter-sectoral relationship operative at different stages of the reconstruction effort. This question is addressed in the remainder of this section.

The reconstruction effort will start with the construction of physical infrastructures, building new public institutions, issuing new laws and abolishing some old ones, with the general purpose of creating a supportive system for activities in the private sector. The success of this will be judged by the extent to which the private sector is induced to expand activities in the direction of correcting the present sectoral imbalance, and thereby placing the economy on the road of achieving sectoral articulation. At this early stage, when the construction of infrastructure and the building of public institutions are under way, policies are needed to promote the expansion of agriculture.

This is essential for two reasons. First, the sector has to increase the supply of food in order to counterbalance the increase in demand generated by an increase in both income and population. The former arises from new spending on infrastructure and institutions, and the latter occurs from natural increase in population and the expected flow of Palestinian returnees. An inadequate supply of food will lead to an increase in prices, and subsequently to an increase in the real wage rate for manufacturers, which could constrain the expansion of the private sector.¹⁰² Second, the agricultural sector at this early stage of reconstruction has to absorb some of the unemployed workers, especially those who used to work in Israeli agriculture and lack other skills. Agriculture is the proper place for them in the first few years of reconstruction because they were trained to

undertake agricultural work, and expanding agricultural production at this stage requires relatively less capital expenditure than expanding other sectors. A failure to expand agriculture, coupled with an increase in construction activities, will result in a general increase in food prices, and a continuation of the problem of unemployment. In addition to hampering economic development and creating a disturbing socio-political situation, and will further redistribute income away from the poor.

With a successful completion of the first stage of the reconstruction programme, a different emphasis and alternative policies become relevant. Unlike the first stage where growth arose primarily from construction activities and was complemented by extensive agricultural expansion, the second stage would concentrate on industry and require intensive agricultural development based on an increase in productivity. The main objective of the second stage is to start the structural transformation which will lead to sectoral articulation, and bring about at least a doubling of the share of industry in GDP. ¹⁰³ This increase in industrial production will put great pressure on agriculture.

On the supply side, expansion of industry requires an increase in employment with a relatively stable real wage rate. Both cannot be achieved simultaneously unless the productivity of agriculture increases concurrently, in order to release labour to the industrial sector, and expand production so as to keep the price of food (and hence the real wage) stable. On the demand side, industrial expansion requires expanded markets, which will not occur unless the increase in agricultural productivity generates enough income in the rural sector, and, in turn, increases demand for industrial goods. This rural demand is essential in supporting the initial expansion of industry, before foreign demand takes over, and becomes the primary support for Palestinian industrial expansion. The time-span in which rural demand will be the main market for industrial goods depends on the pace of development at the regional level, and on the emergence of a new regional market conducive to intra-industry trade based on specialization and economies of scale. ¹⁰⁴

This argument can be viewed from a different angle that has the advantage of highlighting policy considerations. At the initial stage of industrial expansion, the terms of trade between agricultural and industrial products (the price of agricultural goods in terms of industrial goods) is very important. A high terms of trade increases agricultural income, and is thus good for industrial demand. On the other hand, a low terms of trade reduces the price of food and the real wage, which is good for industrial supply. Accordingly, there is an equilibrium terms of trade where the supply and demand for industrial products grow in harmony, and where industrial expansion is neither demand nor supply constrained by agriculture. ¹⁰⁵ The experience of many other developing countries has demonstrated, time and again, that government policies geared to tip the terms of trade in favour of industry, with the aim of speeding its expansion, have ended up instead with low purchasing power in the rural economy that has held back industrial expansion. ¹⁰⁶

Agriculture is therefore crucial in both stages of the reconstruction, albeit for different reasons. This position does not imply that the agricultural sector will play the role of the engine of growth for the Palestinian economy. It does mean, however, that improvements in agriculture are a prerequisite for the proper functioning of that engine, which is the

combination of manufacturing and services sectors. This emphasis might seem unwarranted in view of the fact that at present the domestic production of some crops exceeds consumption, and faces problems of restricted entry into other markets. However, it is important to note that this is the case for only some crops, whereas the value of the total consumption of agricultural goods is more than total production, so signifying the fact that the Palestinian territory is a net importer of agricultural products. Furthermore, the surplus in some crops is a direct result of the distorted development in agriculture and trade, which is expected to be alleviated in the reconstruction programme.

B. The agriculture sector

At present, the agriculture sector produces around one quarter of total output, employs a little more than one quarter of the labour force, and provides almost a fifth of total exports. These shares will change in the course of development, and, as indicated above, two stages can be distinguished in the process. In the first stage, the source of growth in the economy stems mainly from the construction activity necessary to build the basic infrastructure, and the expansion of agriculture will be primarily to relieve the pressure in the labour and goods markets, by reducing unemployment and inhibiting increases in the price of food.

Since an increase in the productivity of agriculture will take some time, this initial expansion has to be induced by a combination of an increase in the employment of labour, and some capital investment.¹⁰⁷ The impact of this expansion on other sectors will take time before it becomes instrumental in generating their growth. Thus, it is possible that such an expansion will increase the relative size of the agriculture sector in GDP. In the second stage, however, the emergence of a supportive system will stimulate investment in manufacturing, services, and private construction, and the expansion of these sectors will impact on agriculture in two ways. It will activate the forward and backward linkages, leading to a feed-back mechanism of growth. And it will also exert upward pressure on agricultural wages, leading to mechanization and a continuous increase in agricultural productivity. This productivity growth is expected to reduce employment in agriculture, both absolutely and relatively. More importantly, it will increase the volume of production and exports but with a declining relative share of GDP and share of total exports.¹⁰⁸

No doubt, there will be some overlapping in these two stages, and policies and measures taken in the first stage will affect the direction and the speed of the second. Nevertheless, it is important to separate the two stages conceptually, and to identify the requirements of each. First the role of agriculture in development is outlined. This is followed by a discussion of the requirements for successful agricultural development in the two stages. The end of this section is devoted to general policy recommendations to encourage agricultural development.

1. The role of agriculture in development

As already indicated, agriculture will play a key role in reconstructing the Palestinian economy, both in the immediate future and in the long run. This section examines this role in some detail under three separate headings: agricultures' contribution to production, to factor supplies, and to foreign exchange.

(a) Agriculture's contribution to production

Obviously, the most important contribution of agriculture is that it supplies food. This role is especially important in the Palestinian context because the reconstruction effort will bring about sizeable increase in the demand for food. In addition to a high rate of population growth, the increase in income generated by reducing unemployment, together with the flow of Palestinian returnees, will increase demand substantially, given the relatively high proportion of expenditure devoted to food by the average Palestinian family, and the relatively high income elasticity of demand.¹⁰⁹ For certain food items, where there is at present an unmarketable surplus, supply could increase without much cost. These items include vegetables, fruits, dairy products, red meat, poultry, and olive oil. However, supply will be inadequate in other items, where there is a little or no local production and where severe shortages are already evident, such as wheat, seed oil, and sugar.

The second major contribution of agriculture to production is its supply of raw materials to other sectors, especially manufacturing. This role assumes greater importance in the Palestinian context, since industrialization in the initial stage is expected to involve many industries based on the processing of agriculture outputs.¹¹⁰ At present, agro-industries account for less than 20 per cent of the total number of industrial operations in the Palestinian territory.¹¹¹ Expanding agro-industry will utilize the surplus of some produce like grapes, olives, and citrus, as well as expanding the production of others.

(b) Agriculture's contribution to factors market

Here, it is necessary to distinguish between the two stages of agricultural development noted above. In the first stage, involving an expansion of employment in agriculture, the sector will absorb labour, and will require a flow of capital (on a small scale). In the second stage, that of expansion via productivity increase, the sector will be able to release labour to other sectors, as well as capital derived from its marketable surplus.

(c) Agriculture's contribution to foreign exchange

As already shown, one of the most striking developments, in the last decade and a half, has been the declining volume of agricultural exports. Reversing this trend, and increasing the volume of exports, is essential in order to finance the import of capital goods needed for investment, especially when external aid is reduced. At the same time, agriculture's contribution should be directed toward reducing the import of food. Expanding food imports to meet the increase in demand (discussed under (a)

above) has a high opportunity cost, since it uses foreign exchange and reduces the import of capital goods needed for investment and growth. On the other hand, expanding domestic production at this early stage will mainly use unemployed labour, and a relatively small amount of capital, so it involves a small opportunity cost.

2. Prerequisites for ensuring the success of agriculture's role in development

This section examines the basic requirement of the agriculture sector to ensure that it plays its role, given the existing constraints.

(a) Land

The small land area encompassed by the West Bank and Gaza Strip will probably constitute the most important single constraint on agricultural development. It will become increasingly binding with the progress of the reconstruction programme, which places increasing demands on land for non-agricultural uses, including the building of roads, schools, hospitals, play grounds, etc, as well as houses for an expanding population including refugees and returnees. This increasing demand will exert pressure on land prices (in addition to the speculation discussed before), which will, in turn, reduce investment in agriculture. Accordingly, the expansion of the area of land under irrigation, and of rain-fed farming, becomes essential to the expansion of agricultural production. While these are technically possible, ¹¹² such an expansion has not yet received approval. For example, a low ceiling has been placed on irrigated farming in the Jordan Valley. Similarly, expansion in rain-fed farming on hill slopes is equally restricted. The future of Palestinian agriculture, therefore, depends to a great extent on the form of the final status settlement, in which Palestinians expect to achieve greater control over their natural resources.

(b) Water

The limited supply of water imposes rigid constraints on the expansion of the agricultural sector. The problem is further complicated by the anticipated rise in demand for household domestic and industrial uses. It is not only those sectors, especially the former, that have priority over agriculture, but also that household users and industrialists will be willing to pay higher prices than those which are economic for most farmers. A recent study has projected the demand for irrigation water in the year 2005 at 244 million cubic meters, which is 200 per cent higher than that used at present. ¹¹³

This increase in demand will require an increase in supply, and more efficient use of water in agriculture. The increase in supply cannot be achieved until the Palestinians regain the control of water resources, and obtain a more equitable distribution of water resources in the region.

(c) Institutional and legal framework

The 27 years, during which there was no indigenous authority over agriculture, means that the Palestinian Ministry of Agriculture faces a crucial task of creating an environment conducive to expansion and growth. A pressing need is to review the regulatory framework of the agricultural sector, especially the military orders and other measures enacted during the occupation. Detailed recommendations regarding the abrogation of some laws, the adjustment of others, and the introduction of new ones, should be submitted to the Palestinian Legislative Council as soon as possible. The future prospects of agriculture depends to a great extent on removing the restrictive measures and regulations which exist at present, and on creating a clear legal framework for the ownership of land, tenancy, and inheritance.

Another need which requires immediate attention is Ministerial coordination with the Palestinian Monetary Authority (PMA) so as to create financial facilities thus extending credit to farmers. Given the shortage of funds, priorities should be established based upon the type and location of projects, and their overall impact on employment and production.

(d) Infrastructure needs

Growth in agriculture will require vigorous efforts aimed at reversing the deterioration in related infrastructure which occurred during the past 28 years. Of high priority is a major improvement in artesian wells and springs. New wells may have to be drilled in those areas where topography permits intensive cultivation. Cisterns can be repaired or upgraded where they play a useful role in remote hilly areas. Transport networks need to be modernized in order to minimize losses. Rainwater harvesting projects should be encouraged, especially on the eastern slopes of West Bank mountains. Water conserved could be used to alleviate the growing salination of artesian wells in the Jordan Valley.

Agricultural roads need to be substantially expanded and improved so as to remove another obstacle that constrains production and trade. Making electric power available at reasonable cost also will help modernize many aspects of farming operations. In particular, this will help modernize artesian wells, most of which still use old engines with low efficiency. Finally, the modernization of marketing facilities is urgent. Prominent examples include the construction of packing and grading operations, cold storage facilities, and a deep sea port in the Gaza Strip with adequate warehousing and handling capacities.

(e) Technical skills

Expanding the production of the agriculture sector, and increasing both its productivity and competitiveness, requires a general rise in the level of technical expertise. Among the most pressing needs are the following:

- Reducing production costs, and raising the productivity of olive orchards is one of the highest priorities. This involves identifying efficient ways of weeding and pest control, introducing cheaper ploughing techniques, applying fertilizer at

the correct rates, and acquiring proper pruning skills. Likewise, several improvements are needed with regard to oil processing and marketing techniques.

- Introduction of forage crops and the management of pastures is another fundamental prerequisite for a flourishing livestock sector. This would help to raise value added, which is particularly low in some livestock branches.
- Water conservation and irrigation techniques are far from optimal. There is still much room for improvement in the level of skills in these areas.
- Much research is needed on methods of fertilizer application and chemical use in agriculture. Inadequate application of fertilizers and other chemicals has resulted in lower productivity, high toxicity hazards, and an undue rise in production costs. ¹¹⁴
- Adaptive research is needed for introducing new crops and livestock strains. This would help achieve one of the fundamental prerequisites for a more vigorous agricultural sector, namely, the introduction of high value-added production patterns.

(f) Human resources

To be able to respond positively to institutional developments and market opportunities, and to absorb new technical advances, labour skills - especially entrepreneurial and managerial have to be developed. Entrepreneurship in the Palestinian territory has been severely obstructed by numerous impediments and constraints, as discussed in the last two chapters. Removing these constraints, promoting favourable policies, availing businessmen of the skills in the areas of project appraisal and implementation can be expected to reactivate entrepreneurship.

Manpower deficiencies in the area of management are probably more serious than those relating to entrepreneurship and technical expertise. Managerial deficiencies are evident even in branches where cost consciousness and competitiveness are present, as in greenhouses and poultry. Low managerial capacity has many causes, including the relatively high age of farm owners, the low level of educational aptitude and inadequate management training opportunities. Accelerating agricultural development will require vigorous action aimed at rectifying these deficiencies.

Similarly, workers' skills need continuous upgrading in all aspects of the production and marketing processes. Again, the Palestinian Authority will have to address problems related to the rundown of governmental training facilities. The new authority will have to improve ways to mobilize the efforts of NGOs and those of local training institutions, established during the past two decades. Some of the most pressing requirements include the following:

- application of pesticides, so that the job is accomplished at both low cost and minimal hazards;

- installation and operation of modern irrigation techniques;
- teaching farmers proper pruning technologies;
- training in skills relating to marketing, especially in quality control, gardening, and the operation of cooling and storage facilities; and,
- new technology of food processing and agro-industries, especially those using local inputs.

(g) Agricultural trade

One of the most disturbing features of changes in agriculture during the past decades has been the increasingly adverse impact on the territory's balance of trade. As discussed earlier, reversing this trend is contingent on substantial improvements in capacity, competition, and accessibility. All measures discussed so far, and those that are discussed later, are aimed at increasing the capacity of agricultural production and its competitiveness especially in the following foreign markets:

(i) Israel

Even though tariffs and quotas will be removed completely by 1998, non-tariff barriers, and in particular the complex subsidy network, still exist. These present a formidable obstacle to full accessibility of Palestinian agricultural output to this market. Future accessibility depends on the extent to which Israel reduces its subsidies to agriculture. A recent study estimates the gain to Palestinian agricultural exports to Israel once NTB, are lifted at around \$20 million a year. This amounts to around 38 per cent of the value of present total Palestinian agricultural exports to Israel. ¹¹⁵

(ii) Jordan

As was indicated in chapter II, the Jordan-Palestine agreement of 26 January 1995, stipulated that a special committee from both countries will meet bi-annually to negotiate the gradual movement towards free trade in agricultural products. It is expected that some time will be needed by both sides to bring about the adjustment necessary before free trade is re-established between them.

(iii) Other Arab countries

The Palestinian Authority needs to try to reach bilateral agreements with the rest of the Arab world, similar to the one signed with Jordan. With a clear commitment toward free trade, these should achieve two important objectives. First, they will start the adjustment process in each economy, and set the stage for future trade based on specialization and economies of scale. Second, they will prevent a sudden decline in employment and income triggered by immediate free trade.

(iv) Western Europe

Exporting to Western Europe depends to a large extent on improvements in the supportive services, like transportation, cooling and refrigeration, communications, promotion, and market information. Also, it is desirable for Palestinian producers to consider cultivating new crops which are of higher value and subject to less competition from other low-cost exporters to Europe. Such crops might include asparagus, celery, carnations, and strawberries. Given the Palestinian climate, farmers could export early fruits and vegetables to Europe. The volume of Palestinian exports to EU countries, however, may increase substantially if Palestinian and Israeli authorities agree on coordinating their agricultural trade in those markets. Palestinians could focus more on the productive side, where they have a clear cost advantage, while Israelis could provide most of the services required for delivery to European consumers.

(v) Eastern Europe

The emerging market economies of Eastern Europe could become important export markets for Palestinian agriculture. However, the problem here will be basically the same as with Western Europe, namely, the lack of a sophisticated supportive system to ensure the transportation and marketing of the agriculture goods according to international standards and at competitive cost.

3. Policies and measures to develop Palestinian agriculture

The previous section identified the general requirements for creating a more hospitable environment conducive to the growth of the agriculture sector in both the immediate future and in the longer term. This section translates these general requirements into some specific policies and measures, in the areas of natural resource base, production patterns, agro-industry, marketing, and agricultural education. While many other proposals are also relevant in these areas, attention is confined to policies, measures and projects that need to be initiated on a priority basis. ¹¹⁶

(a) Planning and policy formulation

There is an urgent need for the creation of a national Agriculture Planning Board (APB), to be responsible for the planning of agricultural development. This body could be a department in the Ministry of Agriculture, though including representatives of other ministries and departments, such as Finance, Water, Land, Trade, Cooperatives and Industry. The APB should set both national and regional priorities, to which local and foreign NGOs adhere.

(b) Land management policies

Expanding the area of irrigated and rain-fed land is a prerequisite for expanding the capacity of the sector. It is recommended that the expansion be carried out through the following policies and measures:

(i) Land reclamation units

The reclamation process could be most efficiently undertaken by well-equipped machinery units. Such units could be of a cooperative nature,

or private firms. A fairly large capital outlay is needed for these reclamation projects. ¹¹⁷

(ii) Agriculture roads

Reclaimed land in remote areas need roads in order to connect them with urban centres, and make them suitable for commercial cultivation. Construction of a comprehensive agricultural feeder road system is an ambitious and costly project which should be accomplished gradually over many years.

(iii) Anti-fragmentation policies

A special committee in the Ministry of Agriculture needs to be created with the objective of recommending to the Palestinian Authority a set of rules to regulate land holdings, so precluding parcelling of land into non-economic plots. In areas where holdings have already become unduly fragmented a land reform project may be desirable, according to which land will be consolidated, developed, parcelled, and redistributed to owners according to an accepted efficiency criterion. Such a project is required on the plains of Deir Sharaf, Howara, and Sawyeh.

(iv) Zoning and tenancy regulations

Present zoning schemes and tenancy arrangements are anachronistic, and need a major study concentrating on formulating clear land zoning schemes, and more appropriate laws of tenancy.

(c) Irrigation and water policies

The following is a partial list of projects and policies aimed at the expansion and efficient use of water resources in agriculture.

(i) Artesian wells and springs

As the most important source of irrigation water, artesian wells need to be the focus of intensive efforts aimed at increasing their efficiency and minimizing the cost of water production. It is therefore strongly recommended that the Water Authority conducts a comprehensive technical survey of all wells. There is overwhelming evidence suggesting this would recommend the closure of many wells which are unsalvageable. Others with more potential should be renovated so as to attain higher productivity. In principle, the cost could be borne by the owners of the wells. However, extending loans at more favourable terms than the market is justified by their public good characteristic. In addition, it is estimated tentatively that 20 new wells need to be drilled for irrigation purposes. It is recommended that such wells be owned by groups of farmers, organized in cooperatives or companies, and be provided with loans covering 50-75 per cent of total drilling costs.

Despite being the source of good quality water, West Bank springs are in poor condition and are improperly utilized. It is recommended that all springs be developed and maintained under the direct supervision of the Water Authority. Ultimately, water could be sold to farmers and other users at cost price, but in the initial stage of expansion a lower price might be more

appropriate.

(ii) Reservoirs and cisterns

Many reservoirs were constructed during the early years of the occupation, but the process slowed down over the past decade due to severe restrictions on licensing. It is recommended that a project of expanding the construction of reservoirs in all areas of intensive irrigated farming be seriously considered. It is estimated that around 200 reservoirs are needed in the West Bank and 150 in the Gaza Strip. It is also recommended to help farmers renovate some of their deserted cisterns and dig new ones when necessary. Loans at concessional rates could be very effective in implementing the project.

(d) Production patterns

Production patterns have gone through profound changes during the occupation because of restrictions on production and trade. The following paragraphs present a very brief description of these changes and provide appropriate recommendations for individual crops.

(i) Citrus

Citrus production, after a notable expansion in the 1970s, has witnessed a steady decline in the 1980s and early 1990s. The future of citrus depends on three factors. First, improving productivity, which requires eliminating citrus orchards of inferior quality, and active supervision of the extension services orientated to improving the level of husbandry through fertilization, pest control, pruning and irrigation practices. Second, securing access to new markets, possibly those of Eastern Europe. Third, the use of citrus fruits in processed forms.

(ii) Olives

Olives continue to be essential to West Bank agriculture. Olive orchards occupy 75 per cent of the total land area with trees. The average annual production of olives has increased in the last two decades, but part of this was due to non-economic factors. In some places farmers planted olives in order to demonstrate that land is under cultivation, and hence had less chance of being taken over by the authorities.¹¹⁸ This, and the lack of modernization, has contributed to the drop in productivity. At the same time, costs of production have increased, in particular the cost of labour. Understandably, then, improving the economic viability of the olive branch has to concentrate on increasing productivity. This requires an active role of the public sector in two ways. First, supply extension services are required to help farmers reduce the costs of fertilizer application, protection against disease and insects and the pruning of the trees. Second, credits will have to be extended to revive the olive oil presses and pickling capacities.

(iii) Vegetables

The last two decades have witnessed a major shift in Palestinian agriculture toward cultivation of vegetables. This was more profound in the Gaza Strip, where the value of vegetable production now accounts for 50 per cent of the total value of agricultural output, compared to 11 per cent

in the late seventies.¹¹⁹ The expansion in the West Bank was obstructed by limits introduced by the authorities on vegetable cultivation in the Jordan Valley.¹²⁰ At the same time vegetable cultivation was hampered by restrictions introduced by Jordan in 1987 regarding Palestinian agricultural exports.¹²¹ The future of these crops depends to a great extent on accessibility to new external markets. This entails an active role of the public sector in initiating a research programme to help farmers introduce new kinds of produce with high values and great export potential. It also requires the availability of credit for seasonal and medium-term needs.

(iv) Livestock and fishery

At present, these two branches account for almost half of agricultural production in the West Bank, and around a third of that in Gaza. Domestic production had benefited considerably from measures implemented during the intifadah with regard to the boycotting of imports of Israeli meat. With the exception of red meat, local demand is currently satisfied by local production. The future development of the livestock branch depends to a great extent on modernizing the production of its inputs, and on improving marketing facilities. In this regard it is recommended to:

- initiate research with regard to forage crops and pasture management, with the aim of identifying the right strains of crops and appropriate technology to be used under local conditions. Acquiring expertise in the field could be greatly expedited by drawing on the experience of specialized research institutions, such as ICARDA;
- extend credit for the purpose of establishing three poultry hatcheries (two in the West Bank and one in the Gaza Strip). This will remove one of the most important constraints confronting the poultry branch;
- establish three modern veterinary laboratories (two in the West Bank and one in the Gaza Strip) for upgrading the level of diagnostic and treatment services. Each need to be equipped with a mobile clinic; and
- initiate extension services to help modernize the dairy industry, raise both its quality and hygiene standards, and expand the range of its products.

Fisheries are important to the economy of the Gaza Strip. Their future depends on the removal of restrictions imposed on the area of fishing and on negotiating an agreement with the Egyptian Government allowing Palestinian fishermen access to Egyptian territorial waters off north Sinai.

(e) Agro-industry

At present, the agro-industry in Palestinian territory is very small. The number of agro-industry firms is less than 20 per cent of the total number of industrial firms. They include olive presses, citrus packing, food processing, olive pickling, cigarettes, and dairy plants. Many of these firms, especially those related to dairy products, food processing and tobacco, use imported inputs, thus cutting the linkage between the industry and domestic agriculture. This is because the local inputs are produced by many small farmers who have no cooperative arrangements and lack the capacity to supply firms with needed inputs promptly. In this regard, activating linkages between agro-industry firms and domestic agriculture is a top priority as it enhances the growth in both sectors. The public sector should play a leading role in this regard, by extending assistance facilitating the development of an institutional framework through which small farmers can pool their resources and meet the supply requirements of agro-industry firms. Areas of potential expansion are fresh grape juice, wine production, hide tanning, and freezing vegetables.

(f) Marketing

Modernizing Palestinian agriculture and increasing its competitiveness requires an improvement in marketing facilities. An Agricultural Marketing Board needs to be established, comprised of representatives from both the public and the private sector, which takes responsibility for initiating and coordinating all marketing facilities. These would include the following:

- opening promotion and handling offices in export markets;
- organizing trade promotion missions to foreign markets;
- collecting and disseminating market information; and
- conducting, or commissioning, action-oriented studies on specific problems.

At present, the following projects need feasibility studies:

- the planned seaport in the Gaza Strip, needs to provide Palestinian exports with cheaper and more reliable services than those available at present from nearby ports;
- central wholesale markets, which are needed to replace the small ineffective markets that exist presently in a number of towns; and
- quality control institute, specializing in all aspects of quality control of fresh and processed food products.

(g) Agricultural education

The long-term future of Palestinian agriculture will depend heavily on agricultural education in colleges, and activities in centres of agricultural research. These will have to become intimately involved in all aspects of agriculture, so as to increase productivity, solve marketing problems, and

help farmers adapt to changing economic situations. In this regard, it is recommended that an assessment of college and pre-college agricultural education be carried out. The assessment should identify ways and means of maximizing the efficiency of the existing educational institutions, and increasing their relevance to local needs. It is recommended that the investigation could fruitfully be conducted under the auspices of FAO.

In the field of organizational research, it is recommended that a department of applied agricultural research be established in the Ministry of Agriculture. A primary task of this department would be the supervision of experimental stations in all major farming areas, especially the following:

- Wadi Fara'a Research station in the middle of the Jordan Valley, specializing in research related to irrigated farming patterns in subtropical regions;
- Arroub Station, close to Hebron, specializing in vineyards, apples, peaches and plums;
- Askar Station in Nablus, specializing in olives, almonds, and other trees suited to hilly land in the northern West Bank; and
- Beit Hanoun Agricultural Station (Gaza Strip) specializing in vegetable crops and citrus.

C. The manufacturing and mining sector

During the past two and a half decades, the manufacturing sector's role in the economy stagnated at low levels with its contribution to GDP never exceeding 10 per cent. This stands in striking contrast with economies of comparable per capita income, whose industrial share varies between 20 and 38 per cent. ¹²² A major task of the reconstruction programme is, therefore, to remove the causes of stagnation and stimulate activities, in order to increase the sector's share in GDP. This task requires an active role for the public sector in creating a support system which can stimulate both private sector investment in industry, and facilitate linkages between manufacturing and other sectors, especially agriculture and construction. The policies essential to this role are discussed below.

The next section gives a brief summary of past performance of manufacturing and the main causes for stagnation. The following section will analyse the role of the public sector in removing those causes. Section 3 will analyze the role of the sector in the reconstruction programme. The final section is devoted to industrial strategy.

1. Past performance and causes of stagnation

The industrial sector of the West Bank and Gaza Strip is fragmented and dominated by small-scale workshops. Textiles, food processing, repair, and handicrafts predominate, and there has been much subcontracting for Israeli firms. In 1991, 62 per cent of industrial establishment of the West Bank and 64 per cent of those in the Gaza Strip employed less than four workers. Those employing more than 20 workers accounted for just 4 per cent and one per cent in the two areas, respectively. The total number of establishments never

exceeded 4,000. In the same year, manufacturing employed just 9.2 per cent of total labour force in the West Bank and 11 per cent of the Gaza Strip.¹²³ As noted earlier, industry accounts for under 9 per cent of Palestinian GDP. The sector is heavily dependent on Israel, importing 90 per cent of its inputs and exporting 70 per cent of its exports.

The stagnating situation in the manufacturing sector is largely attributed to the restricted environment prevailing for more than a quarter of a century. Investment in industrial projects was generally discouraged by complicated and time consuming licensing procedures which had virtually prevented the establishment of large industrial enterprises. The disincentives embodied in the tax structure and trade regime further acted as barriers to investment in this sector. Both had transformed the Palestinian territory into a market for its dominant trading partner. It is estimated that in the mid-1980s out of the 10.6 per cent of total Israeli exports marketed in the Palestinian territory, 48 per cent constituted manufactured goods.¹²⁴ Another major obstacle to investment in industry has been the lack of effective financial intermediation and risk sharing institutions. This has led to a situation where the majority of industrial establishments are self-financed, with a low level of working capital.¹²⁵ Equally important has been the absence of a public sector role in supplying complementary and supportive infrastructures and services. The impact of these factors has been further compounded by the lack of both natural resources and an adequate supply of skilled labour force.

2. The role of the public sector

It can be expected that the removal of the above restrictions, and the revival of the financial sector, supplying both financial intermediation and the management of risk, will stimulate activities in manufacturing. There are, however, some industrial enterprises that can play a leading role in both domestic and foreign markets, once these restrictions are partially lifted. These include some very successful firms in clothing and textiles, leather and shoes, soap, soft drinks and cigarettes. In addition, there are also successful firms that produce more sophisticated products, such as agricultural machines, which have been able to supply sizable amounts to the Israeli market.¹²⁶ However, a major transformation, in which the contribution of industry to GDP, trade and employment is substantially increased, will require an active role for the public sector. This role should include emphasis on the following:¹²⁷

(a) Infrastructure

Development of infrastructure serving the manufacturing sector primarily concerns energy sources, transportation and communications and industrial zones. At present, almost all electricity in the Palestinian territory is purchased from Israel.¹²⁸ Since electricity is the major source of energy to the manufacturing sector, it should be independently produced in order to ensure that supplies cannot be disrupted. Thus, there is a need for installation of generators, transformers, capacitors, and extensions of the network to reach rural and industrial areas.

Transportation networks at present are designed mainly to connect the Israeli settlements with major cities in Israel and in line with Israeli security concerns. Communications and postal services are provided only by Israeli companies. New road networks, therefore, need to be constructed, with emphasis placed on connecting potential manufacturing units with market outlets and sources of material. Expansion of industrial activities require the construction of industrial zones, which could lease industrial buildings at reasonable prices, and provide the necessary services of electricity, water, transportation, etc. to producers. In locating these zones, regional parity should be a consideration. In this regard, there is a need to strengthen the industrial base of the border cities of Tulkarem, Jenin, Qalqilya and Bethlehem. More than half of the labour force in these cities previously worked in Israel, and are in need of domestic employment.

(b) Human resources

The manufacturing sector's share of employment has traditionally exceeded its contribution to GDP. For example, in 1981 it accounted for 16.5 per cent of total domestic employment, but only 8.8 per cent of GDP. This makes industrial output per worker just half of average GDP per worker, and table IV-2 shows that in the 1970s and 1980s industry was the least productive sector of the economy. Two factors are responsible for this. First, the primitive technology that is used, which reflects many years of low investment and a low capital/labour ratio. Second, the lack of skilled workers, due to the absence of training institutions, and the very costly in-house training resulting from the small size of most industrial establishments. While increased investment in the sector will increase the use of capital and modern technology, productivity will not be maximized unless resources are also allocated to investment in human capital. This should include measures to create a link between science faculties at the universities and industrial firms, and establishing technical institutions suitable for training industrial workers capable of working with specialized engineers. The most needed skills are in the areas of electronics, electric tools and communications.

(c) Support system

Expansion of manufacturing requires the creation of a support system which offers services that are essential to the functioning of industrial activities. The system should include:

- a new business law covering all aspects of business transactions, ownership, liabilities, and the protection of workers' and consumers' rights;
- a plan to strengthen the local Chambers of Commerce and Industry, and equip them with facilities for supplying information on factors of production, domestic demand, and potential export opportunities;
- a centre for quality control and standardization, which is needed both to improve quality and facilitate the acceptance of Palestinian products in both domestic and foreign markets. The

initial steps taken by An-Najah University, in collaboration with the Federation of Palestinian Chambers of Commerce and Industry, to create such a centre should be encouraged and supported;

- developing the legal and institutional framework within which foreign investment is encouraged, and induced to transfer technology, train local labour, and increase industrial exports;
- negotiating with Egypt and Jordan agreements to establish "free trade areas". This will enhance the process of marketing Palestinian industrial products in Arab countries; and,
- establishing an Industrial Development Bank, with the dual functions of supplying finance for the expansion of industrial activities and offering technical advice, which would include floating stocks, financing exports, and managing joint ventures and branches of multinational corporations.

3. The role of the manufacturing sector in the reconstruction programme

The characteristics of growth behaviour under the two stages of the reconstruction programme are distinct. As noted, the first stage is generated mainly by the construction of infrastructure, where emphasis is placed on expanding the agricultural sector in order to create employment and stabilize the price of food. The success of both these activities requires an expansion of the manufacturing sector. Construction of infrastructure will also increase the demand for building materials substantially, especially cement, concrete, asphalt, crushed stones, aluminium, and iron and steel rods, and this increased demand has to be met by an increase in domestic production, so that a shortage of foreign exchange is avoided. At the same time, the expansion of agriculture requires a parallel expansion in agro-industries as an outlet for agriculture surplus and as a supplier of processed food, which could reduce the pressure on both foreign exchange reserves and the price of food. In this regard the manufacturing sector during the first stage plays a prime role among the different sectors. Accordingly, the sector is expected to grow at a rate similar to the overall growth rate of the economy. Expansion is expected primarily to be in textiles, leather, pharmaceuticals, in addition to agro-industries and building material industries.

In the second stage of the reconstruction programme, the manufacturing sector has to play a leading role. Here, growth will be generated by the expansion of the industrial and services sectors. Expansion in industry has to achieve two important tasks. The first is to correct the sectoral disarticulation of the economy by increasing the share of manufacturing in GDP. Assuming that the first stage requires 5-7 years, and manufacturing grows at the same rate as the economy, the second stage will begin with industry's share in GDP at no more than 10 per cent. Sectoral articulation requires, at a minimum, the doubling of this percentage. Assuming that the second stage will take up to 10 years, this implies that the sector has to grow in this period at an annual rate which is 7 per cent higher than the rate of growth of the economy. This in turn implies that between the year 2000 and 2010 investment in industry should not be less than \$190 million per annum (in 1990 prices).¹²⁹ The second task of the manufacturing sector during the second stage is to establish new industries

capable of providing agriculture with some of the tools and instruments necessary for its mechanization and the increase in its productivity. At the same time expansion in services, especially financial services, and the modernization of construction, requires the existence of industries employing highly skilled labour and using advanced technology, like engineering designs, electronics and computer software.

It is worth noting, however, here that the success of the manufacturing sector in achieving these two tasks implies the achievement of another important goal of the reconstruction effort - the elimination of economic dependency on one trading partner. The development of new relations based on equitable reciprocal advantages to both sides cannot be achieved until Palestinian industry develops. Only a mature Palestinian industry, in which highly educated workers are employed producing skill-intensive products, can hope to prosper from trade with Israel along the lines of economies of scale and specialization, and through joint ventures.

4. Elements of industrial strategy

The poor natural resource base, and the small size of the Palestinian economy, make export-oriented activities the appropriate medium for the long-term development of the industrial sector. In the short-run, however, there is an important role for import substitution. These activities should be encouraged in precisely those areas where domestic production could replace imports without protection, and become competitive largely as a result of removing the harmful restrictions of the occupation and the emergence of a public support system. Agro-industry products are most suitable, and their expansion will have a stimulative impact on growth and employment in the whole economy owing to their strong linkage with agriculture and their labour-intensive technology. In addition, agro-industries promote a rural-urban balance by providing rural workers with income, thus reducing their incentive to migrate to urban areas.

In the first stage of industrial expansion, emphasis should be on agro-based projects that have forward linkages with agriculture. Projects like grape juice, leather shoes, dairy products, animal-based textiles, and corn and grain mills, could be established with relatively small capital. In the second stage, projects with backward linkages with agriculture should be considered. Chemical fertilizers, and agricultural machines and instruments, need more capital and sophisticated technology. In this regard an agreement with Jordan and Israel concerning the establishment of production facilities around the Dead Sea is essential for creating a chemical fertilizer industry.

These import-substitution activities could play a very important role in expanding and revitalizing the manufacturing sector, as they have the potential, according to some estimates, of replacing at least half of the goods currently imported from Israel.¹³⁰ Nevertheless, these activities by themselves, will not be able to secure a leading role for manufacturing. This depends on the success of orienting the sector toward export activities. To a large extent, and most especially in the early years, Arab countries, in particular the Gulf States, will provide the natural markets for Palestinian industrial products. Accordingly, the Palestinian economy has to offer an attractive option for Arab

and foreign capital to invest in industries supplying the Arab markets. Whereas the relatively low cost of labour will play a role, it is not enough by itself.

Other elements have to be developed. These include:

- the development of a transport system connecting the Palestinian territory with the rest of the world (by sea and air) and the Arab markets (by land), so as to ensure a low cost of transporting both inputs and outputs; ¹³¹
- the adoption of a trade regime and tax policies which work to gradually integrate the Palestinian economy into the neighbouring Arab economies. This cannot be achieved by Palestinian efforts alone; it needs the coordination and cooperation of the other Arab countries within the frame of a regional development project; and,
- the development of a human resource base capable of supplying the managerial, marketing, and financial skills required by the export industries. In the short-term, the return of highly-skilled exiled Palestinians is essential to augment the human resources of the West Bank and Gaza Strip. In the longer term, the Palestinian education system will have to play the crucial role in building human capital.

Achieving these tasks will enable Palestinian manufacturing to develop new industries, starting from small tool and light engineering industries, and gradually moving toward more sophisticated electrical, electronics, plastics, and other highly skilled industries. Modern technology no longer dictates huge industrial establishments. The crucial factor is market size, and the Arab markets are sufficiently large, provided that regional arrangements create a new economic order based on specialization and economies of scale.

D. The construction and housing sector

The construction sector witnessed considerable growth particularly during the last two decades. Whereas its contribution to GDP never exceeded 6 per cent before 1967, it rose to around 17 per cent by the end of the 1970s. It remained over 15 per cent during the 1980s until the intifada in 1987, when it declined to around 12-14 per cent. Meanwhile, the sector's share of employment also increased from about 14 per cent in 1970 to 22 per cent in 1993. ¹³² This expansion, however, reflected the lack of investment opportunities in other sectors, and an increase in the relative price of houses. In fact, housing in the West Bank and Gaza Strip is highly priced and characterized by high density occupation for people with modest income. According to some studies, it is estimated that more than one third of households live with three or more persons per room. ¹³³ This implies that despite the high per cent of investment (around 20 per cent of GDP in the 1970s and 1980s) in construction of mainly owner occupied houses, housing needs remain a pressing area of preoccupation for the Palestinian Authority.

This situation in the housing market arises from restricted supply, coupled with a continuous increase in demand. On the other hand, the prices of building materials, which are mainly imported from Israel, are relatively high as compared to other neighbouring countries (e.g. Jordan and Egypt) where similar construction and residential patterns prevail. The rental market has

been weak due to outdated rent control laws which provide no inducement to residential investment for rental purposes. On the demand side, rapid population

growth and household formation continues to exert pressures. It is estimated that the annual rate of household formation in the late 1980s and early 1990s was 5.4 per cent.¹³⁴ Demand is also expected to increase substantially in the eventuality of an inflow of Palestinian returnees, as well as the resettlement of refugees. Thus, the sector has to play a crucial role in the reconstruction programme, meeting this expansion in demand through increases in supply rather than prices. In addition, the construction sector has to build the needed infrastructure. In performing these two tasks the sector will have a prominent role in the growth of the whole economy as it creates employment and stimulates linkages to other sectors, in particular the industrial sector.

The rest of the section is organized as follows: subsection (1) presents some estimates of the present and future demand for residential construction. Subsection (2) is devoted to building for public community services and subsection (3) outlines some elements of a housing strategy.

1. Estimates of the demand for housing

Future demand for housing will come from three sources: new household formation and Palestinian returnees, replacement and upgrading of existing units, and the demand for the resettlement and home improvement for the refugee camp population. While financing for the first two demands is expected to be mainly provided by the private sector, the public sector will be called upon to meet the demand of the third source. Resettlement of refugees should be a high priority given the poor conditions of the camps. The following paragraphs present rough estimates of the future demand for housing in each of the three areas.

(a) New household formation and Palestinian returnees

There is no precise estimate of the population in the occupied territory. However, Palestinian and other researchers agree that official Israeli statistics underestimate the size of Palestinian population, and that the rates of population growth and household formation are high by international standards.¹³⁵ Furthermore, the future trend of the Palestinian population in the West Bank and Gaza Strip depends on the number of Palestinian returnees. This will be determined by many factors, but two stand out as the most important. First, the future agreement between Israel and the Palestinian Authority regarding who will be given the right to return. Second, the future economic opportunities in the new Palestinian entity. Thus, it is not easy to estimate the number of returnees either in the short or the long term. The UNCTAD secretariat has made two forecasts of the future population of the West Bank and Gaza Strip up to the year 2010. The lower estimate assumed that around 1 million Palestinians would have returned in that period. Based on this, table IV-3 presents an estimate of the expected demand for housing arising from new household formation and returnees, replacement and upgrading of existing units.¹³⁶

(b) The resettlement of refugees ¹³⁷

According to UNRWA statistics, in 1993 there were around 456,000 refugees living in camps in the West Bank and Gaza Strip; 330,000 living in 8 camps in Gaza Strip, and 125,000 living in 20 camps in the West Bank. ¹³⁸ Although some of the camp residents have managed to build shelters of acceptable quality and adequate services, the majority of camp residents still suffer from excessive overcrowding, inadequate shelter and generally hazardous environmental conditions. In this regard, the reconstruction programme should aim at relocating at least 50 per cent of the refugee population outside the present camps boundaries, and radically improving the housing and infrastructure services of the remaining 50 per cent. Of those who will relocate outside the camps, it is anticipated that about 70-80 per cent may settle in existing urban centres, particularly in the vicinity of the camps, while the other 20-30 per cent may be expected to relocate to rural areas of the Jordan Valley.

The rate at which the resettlement and home improvement process proceeds will depend on a number of factors, including the availability of developed land in the relocation areas, housing construction capacity, and the availability of housing finance. It is assumed, however, that the resettlement programme is implemented over the next 15 years on the basis of constructing 3,015 houses annually. The estimated cost, in 1995 prices, will range from \$120 to 180 million annually, totalling between \$1.8 to 2.7 billion for the whole period. ¹³⁹

(c) Replacement and upgrading of existing units

A natural demand for housing arises from the need to replace housing units due to deterioration beyond repair or lack of suitability. In addition, there is a need to upgrade existing units mainly by adding kitchen and bath facilities, and the construction of additional rooms in order to relieve overcrowding.

It is difficult to estimate the number of housing units required to replace deteriorated units or upgrade existing ones without conducting a territory-wide survey to assess the actual conditions of the housing stock and households' characteristics and needs. A rough estimation suggests that in the next 15 years the total number of units requiring replacement or upgrading is about 7,133 annually. ¹⁴⁰

(d) Total demand for housing

Table IV-3 shows that the average yearly demand for houses to satisfy household formation and returnees is 15,524 units. Adding to this, the average for replacement and upgrading and the average for resettlement of refugees, the yearly average reaches 52,670 units. This number represents an increase of 7.5 times the present annual average, and would overwhelm the existing institutional and financial capacities. Hence, new institutions are required, especially an upgrading of the administrative, managerial and technical capabilities of the local authorities, in order to increase their capacity to plan, implement and administer housing projects. The private sector is expected to play a major role in the delivery of the required units, but, even so, this requires the

provision of financial facilities in the form of loans to developers, and a system of incentives to direct their activities to rural communities as well as a network of infrastructures supporting the vast housing programme.

2. Building for public and community services

As indicated earlier, public services are in a poor condition due to their neglect during the past decades. The existing buildings for public schools, health centres, hospitals, cultural and recreation facilities, post offices and police stations are all inadequate. It is estimated that current services fall 30 per cent below actual needs. Accordingly, table IV-4 presents the estimated requirements for public and community service facilities by category of service and district. Total investment is estimated at approximately \$2.2 billion, and is based on an average cost of about \$350 per square metre of constructed area. About 86.5 per cent of the total investment will be for schools and cultural facilities, 11 per cent for health facilities, and 2.5 per cent for public services.

3. Policy measures for the development of the sector

In order to meet the expected surge in demand for housing through increases in supply, there is an urgent need to formulate a housing strategy with the aim of creating an adequate delivery system providing a more equitable distribution of resources and benefits. The formulation and execution of this strategy will be a formidable task owing to the fact that housing in the territory has not involved any public sector role during the last 27 years. The strategy should be articulated and implemented by the Ministry of Housing in coordination with municipal and village councils, housing cooperatives, the recently established Housing Council and private-sector development enterprises. It should include the following elements:

(a) Removing distortions from the housing market

The immediate task that has to be carried out under the Palestinian national housing strategy is to remove the distortions within the housing market resulting from the political, legal, financial and institutional constraints imposed during the last 27 years. This task entails a review of all existing regulations relating to urban boundaries, subdivision of plots, granting of construction permits, assessment of property taxes, and rent control. It also calls for a reform of the regulatory environment aimed at expanding the land area available for construction of houses and removing those elements that tend to increase the cost of construction, especially to those of modest income.

(b) Infrastructure needs

An expansion of urban boundaries will not by itself stimulate the construction of houses unless it is accompanied by the expansion of basic infrastructures. This needs to be carried out according to a comprehensive plan based on reasonable estimates of the future population density in different regions, and taking into consideration the settlement of returnees and resettlement of refugees. An incentive system is called for so as to encourage settlement in relatively low density areas, like the Hebron district and the

Jordan Valley. Failure to expand the infrastructure in these areas will result in settlements in large urban centres, thus overloading their service-delivery capacities.

(c) Finance

The development of a mortgage-lending market is essential to the development of the housing sector. This could be located primarily in the private market, limiting the public sector role to regulating the market by establishing clear rules of property rights, titling and foreclosure. In addition, the public sector will also need to establish institutions extending mortgaging services to the poor at low rates of interest, and facilitating the resettlement of refugees.

E. The services sector

The development of the service sector during the last two decades was uneven. Branches which cater to consumption and imports have grown substantially (retail and wholesale trade), and those that cater to production have stagnated (transport, engineering designs, financial services and others). Most notable is that the contribution of public services to GDP has steadily declined, see table IV-5, as has its share of employment (see table IV-6). In the face of an increasing population, this situation has made most public services inadequate, and well-below the standard of neighbouring countries.

In the analysis of public finance, trade, monetary, agriculture, manufacturing, and construction sectors, many aspects of producer and distributive services were discussed, so only priorities are highlighted in the next subsection. The following two subsections are devoted to personal and social services, respectively.

As noted, the contribution of the primary and secondary sectors to the Palestinian economy and to its process of development had been minimal, as was their contribution to growth of services. The development of the former sectors had been stifled by the restrictive regulatory and policy framework and unequal competition with the more developed Israeli economy. This in turn had constrained the development of certain (especially producer) services, while promoting the growth of others (wholesale and retail-trade services). The Palestinian economy did not witness the inducement to increased demand for services usually generated by an economy's shift from emphasis on the primary to secondary sectors (manufacturing). Indeed, the growth of the construction sector absorbed much of the human and financial resources which were thus reallocated.

The growth that did occur in services was not part of a deliberate comprehensive development process. Instead, what may be termed as "growth poles" emerged in certain services branches which were stimulated by externally generated demand either in the form of international consumers (e.g. tourism) or through the availability of external income and imports, thus increased personal consumption (e.g. distributive services). This did not have a demonstrative or other effect elsewhere in the economy, owing to the weak market, and to institutional and physical inter-sectoral linkages in the Palestinian economy in addition to restrictions. The specific situation of the occupied territory (e.g. its restrictive regulatory and security environment)

was an important factor which discouraged greater investment, and hence growth, in services. Indeed, had the policy and regulatory climate permitted, Palestinian expertise in providing relatively high-quality producer and distributive services elsewhere in the region could have been an important element of overall investment in domestic services activities. The potentially dynamic role of many Palestinian services branches has yet to be thoroughly explored.

Though growth in Palestinian services was largely demand induced, this was mainly via final consumer demand, thus promoting trade and distributive services. Another salient feature of growth in Palestinian services was its concentration at the lower end of the skill and technological spectrum, with associated lower productivity (as compared to the high productivity gains often cited in cases of development of certain services branches elsewhere). Furthermore, the external linkages of much of the demand for services rendered these branches especially vulnerable to the erratic and turbulent trends in output elsewhere in the economy and in consumer demand for services. This was most vividly exhibited in the contraction in tourism activity, the cuts in public services and the significant consumer compression (affecting especially distributive services) over most of the 1988-1991 period.

However, given the "blurring" of frontiers which is often characteristic of the links between services and some other sectors, the real potential of Palestinian services is not always evident. The very nature of most services provided in (and by) the Palestinian economy implies mobility (geographically, sectorally and occupationally), operation in the frame of a large informal and unregistered economy, and relatively rudimentary technological levels. Thus, the true significance of the Palestinian "service economy" may be greater than is statistically apparent, though its growth potential is constrained by prevailing low levels of skills, technological sophistication and capital investment. The ensuing structure (including capital, human and institutional assets) of the Palestinian services sector thus leaves much to be desired in terms of specialization, efficiency and economic growth potential.

Although variations in the relative importance and growth of different services exist within and between the modern "service economies", these have tended to be marginal. For the Palestinian economy, however, strong services growth has involved a contribution to GDP and employment which was concentrated in distributive services branches, growing along with personal income levels until the mid-1980s. The other services branches within the Palestinian economy had experienced either marginal or no growth, reflecting meagre contribution to GDP and employment. Since 1967, the contribution to GDP of the public and community services sector had decreased while its share of employment had increased only marginally. Producer services branches had contracted, primarily owing to restrictions imposed by the authorities and the absence of conditions conducive to industrial growth.¹⁴¹

1. Producer and distributive services

Producer services include financial, insurance, real estate, engineering designs, accounting, legal and other business services. The immediate priority in the financial sector is for the Palestinian Authority to change the existing laws and regulations governing financial operations. These are a patchwork of pre-1967 Jordanian laws (West Bank), and British Mandate laws

(Gaza Strip), subsequently modified by some 265 Israeli military orders.¹⁴² A new unified legal and regulatory framework that applies to both the West Bank and Gaza Strip, and suits the present conditions of the economy is needed. This should be designed so as to increase the role of banks in the economy, by strengthening their financial intermediary function. Regulations aimed at ensuring the stability, solvency, and liquidity of banks are essential to increase the supply of credit. On the other hand, measures modernizing the methods of finance, mortgages, and collateral systems are needed to increase the demand for credits. Establishing development banks designed to stimulate the expansion of industry, agriculture, and housing, by providing credit to small businesses, farmers, and families of moderate income is a priority for the medium term.

The insurance market was until 1993 dominated by Israeli companies, and by one domestic company with virtual monopoly power. New entrants to the market have since been recorded.¹⁴³ But many obstacles remain arising from the complicated licensing process and minimum capital requirements.¹⁴⁴ New insurance regulations are needed with the view to simplifying procedures, and fostering competition so as to reduce prices and expand services. Concurrently, a national campaign to educate the public as to the benefits of insurance is also required in order to increase the level of insurance activities which would encourage investment by reducing risk.

In the field of construction and engineering design, the reconstruction programme, with its emphasis on building the infrastructure and the resettlement of refugees, is expected to stimulate activities. All efforts should be made to induce Palestinian expatriates outside the West Bank and Gaza Strip who have achieved considerable success in these fields to participate in the reconstruction programme. This participation has the potential of making construction an important services export sector.

There is presently no modern standardized system of accounting and auditing, and there is a great shortage in professional accountants and auditors.¹⁴⁵ The policies of the Palestinian Authority which are directed at modernizing the tax and expenditures systems need both types of skills. Similarly, both are needed to facilitate the expansion of business and financial activities. In the long run, universities and professional associations are expected to graduate and certify enough accountants and auditors, but in the immediate and medium terms there is a need for suitably qualified Palestinian expatriates to return and for organizing short crash courses with some assistance from international organizations.

The distributive services include transportation, communications, information, and domestic wholesale and retail operations. The transport system has been neglected during the occupation and most of the development in the sector was orientated to the needs of Israeli settlements. Consequently, it is important for the capacity of the national authority to be strengthened and developed so as to assess, develop and implement programmes aimed at meeting the following needs:

- rehabilitation and improvement of the whole network of roads in the West Bank and Gaza Strip;
- establishment of rural networks of roads to facilitate access to

villages and farm areas;

- designing effective schemes of traffic flow in the main urban centres; and,
- building a commercial seaport in Gaza, and the Qalandia and Gaza Strip airports, as well as improve arrangements and facilities for the Jordan Valley bridges and for movement between the West Bank and Gaza Strip.

In the telecommunications field, the immediate priority is to create an institutional framework oriented to two tasks. First, to train enough skilled personal for managing, operating, and maintaining the telecommunication system. Second, to embark immediately on an expansion of the telephone network. The existing network is very small and does not satisfy basic needs. The number of telephones per capita is the lowest in the region, and out of 400 villages in the West Bank only 80 had telephone services as of the end of 1991.¹⁴⁶ In the fields of domestic wholesale and retail services, there is a need to improve the physical marketing infrastructure through the provision of facilities for grading, packing, cold storage, and processing. Technical assistance to farmers should be provided by new marketing organizations.¹⁴⁷ The information service is still embryonic. This is due partly to a lack of demand resulting from the fragmentation of markets, and partly to the lack of effective telecommunications facilities. This is expected to change gradually once demand starts to increase in response to the general improvement in both business activities and the state of infrastructure. The degree to which the increase in demand will be met by an increase in supply depends to a great extent on the availability of skilled manpower capable of developing computer software. Computerization is most needed in the tax and expenditure systems, the collection of general economic, demographic, and social data, project management, word processing, and translation. In this regard, the programme sponsored by the UNDP and Bir Zeit University to train personnel in the use of computer assisted manufacturing equipment is an important step, and should be expanded to cover other universities.¹⁴⁸

2. Personal services

Among the different personal services branches in the Palestinian economy the tourism industry stands to gain most from peace and independence. The opening of borders with the other Arab countries is expected to bring new tourists, both religious and recreational. The former include Muslims who would be able to complete their pilgrimage to Mecca by visiting holy shrines in Jerusalem and Hebron. The latter include Arabs and Palestinian workers who work in Jordan and the Arab countries of the Gulf and would welcome the chance of spending their summer vacation in the more climatically hospitable Palestine.¹⁴⁹ In addition, the normalization of relations between Israel and Palestine will induce some of the tourists who visit Israel (more than 2 million a year) to also visit Palestinian areas. At the same time, independence will enable the Palestinian Authorities to build new facilities and institutions that will overcome the restrictions imposed on the industry during the past two and a half decades.¹⁵⁰

The industry has the potential for becoming an important growth enhancing sector. The World Bank has estimated, "that given political stability, the

Palestinian tourism industry can expect to receive between 500,000 and 1 million tourists (both religious and recreational) on an annual basis, generating income in the entire tourism sector of \$250-300 million".¹⁵¹ Realizing this potential, however, requires the public sector to take an active role in coordination, promotion, and improvement of human resources. The first step is for the National Tourist Authority to coordinate all services needed from the public sector. The functions of this national authority could also include:

- Coordination of all efforts needed from different governmental departments to induce domestic and foreign investment in hotels, restaurants and places of entertainment;
- Coordination with universities and colleges to create courses for training personnel in all aspects of the industry; and,
- Coordination with neighbouring countries to establish a regional framework needed to facilitate the expected increase in the number of both foreign and regional tourists.

In carrying out these functions, the public sector has to provide the supportive system necessary for the private sector to actively perform its role in others. These include:

(a) Improving tourist sites

Various old touristic sites need restoration and better maintenance. Tourist access to the sites needs much improvement including better roads, parking facilities and related services. Sites of potential interest to leisure and other categories of tourists also require development.

(b) Developing the transport systems

Expanding the tourist industry requires major improvements in the air, sea, and land transport facilities. Developing the Qalandia airport in the West Bank north of Jerusalem is important as it provides the tourist industry with an independent outlet for travel by air. Similarly, developing port facilities in the Gaza Strip is essential for tourism cruising between Mediterranean ports. The need to improve land transportation is also evident. This requires a major improvement in the road network and a substantial increase in the numbers of public transport vehicles. Building new roads and rehabilitating old ones is needed to connect tourist sites in different cities and towns of the West Bank, as well as connecting them with the Gaza Strip through a multimodal transport system, involving road and railway networks. More buses, taxis, and rental car services are needed so as to eliminate the delays that are common at present, particularly during the high season around Christmas and Easter time. In this regard, special efforts should also be directed toward making frontier crossing simple and hospitable to tourists.

(c) Tourism guides

At present, there is a lack of well trained tour guides. This is mainly due to the severe restrictions imposed on licensing of guides. To increase their number and improve the quality of their services, a training centre needs to be established. Bethlehem University is the appropriate place for such a centre in

view of its geographical location, and as it already offers a course in tourist guide training. Coordination between the University, the National Tourism Authority, the Islamic Waqf Department and the Christian churches should concentrate upon developing courses in the history of the religious sites, as well as courses in the principal European languages.

(d) Tourist information

The National Tourist Authority needs to assume a leadership role in promotion and advertising for touristic purposes. This effort would be particularly necessary in the next few years before the private sector is able to generate its own promotion services. This should include a range of activities, such as publishing pamphlets, organizing trade fairs, conferences on various cultural and historical issues, managing festivals and exhibitions. In addition, the public sector has to create an appropriate regulatory environment, which will provide incentives and foster competition.

(e) Travel agencies

Prior to 1993, entrance to this branch was effectively barred.¹⁵² To encourage new entry, the licensing procedures need to be changed with the view to creating incentives for prospective entrants. Equally important is the removal of measures that still isolate Palestinian travel agencies. This should be accomplished through negotiations with authorities in both Israel and Jordan, so as to include Palestinian agencies in their promotion and trade fairs, and allow them access to their airports to facilitate the arrival and departure of their clients.

(f) Hotels and restaurants

The number of existing hotels and restaurants is not sufficient to accommodate the anticipated increase in tourists.¹⁵³ There is an urgent need for new hotels and restaurants, with modern facilities conforming to international standards, in most of the towns, especially in Gaza city. To attract Arab tourists, who favour self-catering accommodation, furnished apartments and holiday villages on beaches and summer resorts are needed. It is expected that capital (foreign and local) will move fairly rapidly to invest in this sector. To promote efficiency, licensing policies and construction permits need to be developed with the view to ensuring transparency and avoiding discriminatory practices. Health standards and environmental concerns need to be accorded parallel attention.¹⁵⁴

3. The social services

The most important of social services are those of education and health. Both are essential to the development of Palestinian human capital and thus crucial to the prospects of sustained growth, the long term growth and development.

The education system in the Palestinian territory is provided by the public sector, UNRWA, and the private sector.¹⁵⁵ Pre-school and post-secondary schooling are operated completely by the private sector, and primary and secondary schools by the public sector, private sector, and UNRWA. The UNRWA schools constitute 14.4 per cent of the West Bank schools, 52.2 per cent of the Gaza Strip schools, and 7 per cent of Jerusalem schools. In 1991, there were

330,267 students in 1,321 schools in the West Bank, 179,554 students in 346 schools in the Gaza Strip, and 44,804 students in East Jerusalem. The higher education system consists of universities and community colleges. There are eight universities (6 in the West Bank and 2 in the Gaza Strip) whose total student enrolment in 1991 was around 20,000, specializing in 30 major areas distributed into seven colleges, including engineering, nursing, arts, education, commerce, science, and Islamic studies. In the same year the number of community colleges (two years post secondary institution) was 23, with total student enrolment of 8,359, specializing in 50 major areas of teaching and vocational disciplines. Of the total funds allocated to education (at all levels) an average of 46 per cent has been provided by the public sector and 54 per cent by UNRWA, the private sector, and Arab and international organizations. Currently, the education system suffers from the following major problems:

- Closures of institutions and related measures not only have been disrupting the normal functioning of the educational system, but also undermining its effectiveness and progress in the dynamic context of Palestinian society;
- Currently there are two systems of secondary education, the Jordanian system in the West Bank and the Egyptian system in the Gaza Strip;
- There is a marked shortage of schools, resulting in: crowded class rooms; a very sizable number of schools running on a two-shift basis; and, the use of rental houses with sub-standard rooms. In addition, there is a severe shortage of text-books, audio-visual equipment, laboratories, furniture and sport facilities;
- There is a lack of qualified teachers; only 28 per cent of all teachers in schools have a university degree, and the rest have either a two year diploma or just secondary schooling; and,
- There are imbalances in the fields of higher education. Of all graduates from universities, only 25 per cent have a professional and technical specialization, with the rest majoring in education and academic disciplines. In the same vein, only 31 per cent of graduates from community colleges are in vocational and professional fields, and the rest are majoring in arts. This imbalance is partly responsible for the spread of unemployment among university and college graduates.

Considering these problems, two priorities can be identified. The first is for the Ministry of Education to create an institutional framework responsible for unifying the two systems of education in the West Bank and Gaza Strip. The new unified system should be designed with the aim of transforming the education system toward the acquisition of useful skills. In

this regard, the present two-track secondary school system (arts-science) should be transformed into a unified one track system, providing the students with literacy, basic science and mathematics, and elements of vocational training. The second task for the Ministry of Education is to formulate a long run plan of the future needs in education. This should include projections of population growth, the future needs of different economic and social sectors, and some vision of regional coordination in the field of higher education and scientific

research.

Health services are provided by three sources: government, UNRWA, and private organizations and physicians. The role of government (Civil Administration) in developing the sector had been minimal. The number of governmental hospitals did not change during the occupation. This has resulted in shortages of hospital beds; beds available in 1990 were 1,370 and 933 in the West Bank and Gaza Strip, respectively. With the exception of UNRWA clinics for children, there is no preventive medicine in the territories. Furthermore, government hospitals did not progress over the years, so any patient in need of specialized treatment is transferred to Israeli hospitals. This stagnation of public health services stands in striking contrast to the increase in the number of physicians. In the last two decades, many Palestinians have studied medicine outside the territory and returned to open their own practices. In 1990, the ratio of population to physicians had reached 890 and 900 in the West Bank and Gaza Strip, respectively.

This imbalance between the public and private role in the health sector has resulted in an inefficient system with high costs. It is estimated that 10 per cent of GDP is spent on health care, which is high by international standards.¹⁵⁶ Increasing the effectiveness of the system should be the long term goal of the Ministry of Health, which should formulate a plan for the health care needed in Palestine, and its provision at low cost. Such a scheme should include a plan for the gradual integration of the government system with that of UNRWA, the allocation of roles to the public and private sectors, and the formulation of a national health insurance scheme. The National Health Plan, prepared by the Red Crescent Society and the Palestinian Health Council provides a good starting point.¹⁵⁷

In the short-term, the Ministry has to help some of the private health institutions, whose finances have been reduced as a result of the Gulf War. It has to institute an emergency programme designed to refurbish all medical equipment that has remained without proper maintenance because of lack of funds. It also has to develop another emergency programme to increase the accessibility of health care in some of the remote rural areas.

F. Public utilities

Development of the aforementioned sectors cannot proceed without a parallel rehabilitation and development of public utilities, in particular water and electricity. Currently, public utilities in general and water and electricity in particular in the West Bank and Gaza Strip are in a substandard condition due to the general neglect coupled with the restrictions imposed. The future of such utilities as water and electricity depends to a great extent

on the details of the final status settlement, as these utilities have an important political and regional dimension. The following paragraphs briefly identify priorities with regard to main utilities:

Assuming full control over water resources, forecasts of future Palestinian demand for water are based on the two scenarios which have guided investigation in other parts of this study. Based on these two scenarios, table IV presents a forecast of the need for water over the period 1995-2010. Comparing the future need with present consumption indicates that a considerable increase in water supply is required.

The increase in supply necessitates adopting appropriate policies for water supply, distribution, quality and conservation. Carrying them out requires the establishment of a Palestinian Water Authority (as has been provided for in the Paris Protocol). In the short term the functions of this body could include:

- the takeover and administration of all Palestinian water utility and related institutions;
- water resource exploitation, distribution and development;
- collection and verification of available information related to the availability of water resources, existing water distribution system, and all other related issues (e.g. water demand and population estimates, and the associated process of socio-economic development);
- supervision of all rehabilitation projects of the water distribution system and/or installation of a new system; and,
- providing local municipalities and village councils with advice concerning the most appropriate ways for the development and operation of maintenance procedures for water installations.

In the medium and longer terms, the Palestinian Water Authority would need to embark on a developmental plan which could include the following projects:

- ground water development projects, including rehabilitation of existing wells through replacement of casing pipes, cleaning wells of sediment, deepening of wells and replacement of old inefficient pumps;
- building main reservoirs, and installing main water pipelines;
- building earth or concrete dams for run off harvesting (e.g. in locations such as Wadi Fara'a, Wadi Auja, Wadi Qilt, and Wadi El-Maleh);
- constructing the West Ghor canal to utilize the Palestinian share in the Jordan river basin;
- constructing a water pipeline to transport water from the West Bank to the Gaza Strip in order to overcome the water shortage problem there;

- enhancing cooperation with neighbouring countries in the region in water resource management, conservation, research and development, including the adoption of appropriate technology for water resource exploitation and management; and,
- developing a specialized centre for public education and information related to all aspects of water use and conservation.

Electricity services in the West Bank and Gaza Strip are in urgent need of expansion, modernization and proper maintenance. There are many communities without access to electricity, and others without full services between 6 and 12 hours a day. Much of the power is supplied from stations in Israel. Table IV-8 presents a forecast of future electricity consumption. In the first scenario, the annual rate of increase in per capita electricity consumption is 8 per cent for the period up to the year 2000, and 7 per cent during the period 2001-2010.

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In the second scenario, the increase is 8 per cent over the whole period. Meeting this increase in demand requires the adoption of policies and strategies related to the generation, transmission, and distribution of electricity. Of most importance is the elaboration of a strategy according to which the West Bank and Gaza Strip reduce their dependency on Israel and achieve a measure of self-sufficiency. Such a strategy needs to consider generating electricity by utilizing steam engines, and also connecting the Palestinian electricity network with that of Jordan. The latter could be accomplished fairly quickly, as high voltage lines exist in the Jordan Valley, across the river Jordan.

A mixed supply system which is composed of an improved connection with Israel, a connection with Jordan and self generating capacity could be implemented in two phases. In the first, which can be expected to last over five years, improvements in the interconnections with the Israeli grid are achieved. At the same time, planning and implementing the interconnection with the Jordanian grid would be well under way. During this phase, the purchase of 3-5 emergency peak looping gas turbines of about 30 megawatt each is recommended. In the second phase, two modern steam power plants, one in the West Bank and one in the Gaza Strip could be built.

For adequate and efficient distribution of electricity, the existing network lines need to be replaced by a new distribution system. The new system would have to be designed to cater for future needs, especially those of industrial and housing expansion. The ownership of the transmission and distribution systems may be opened to the private sector, providing there are proper public regulations.

Meanwhile, there is an urgent need to develop the National Environmental Authority, enabling it to assume responsibility for all the planning, design and management of waste water collection and treatment services. The immediate and short term tasks of this authority could be focused on:

- reviewing all the existing projects of rehabilitation, expansion, and construction of new sewage systems. Some of these are at an advanced stage, and others require preparation of detailed designs and estimates.
- setting and implementing sanitation standards and specifications.

The medium and longer term tasks should include:

- upgrading sanitation systems in all main municipalities.
- studying and implementing the construction of a new sanitation system in rural areas based on grouping together clusters of villages for purposes of common sanitary systems.

The new National Environmental Authority also needs to organize refuse collection in urban areas and initiate collection services in rural areas. It needs to construct disposal plants on a regional basis, and promote solid waste classification and material re-use and re-cycling programmes.

Chapter V

AN AGENDA FOR ACTION

A. The essentials of the reconstruction programme

Two major themes have emerged from the analysis of this study. The first concerns the fundamentals of the Palestinian reconstruction programme, and three elements have been emphasized: the need to institute an efficient and mutually supportive relationship between the public and the private sector; the need to correct sectoral disarticulation by stressing the central role of agriculture and industry; and the need to end the economic dependency on one trading partner and achieve closer and more diverse relations with all neighbours. The second theme deals with the potential contradictions between short-run and long-run objectives. It emphasizes the need to address the causes of problems rather than their symptoms, and to remedy pressing concerns by actions whose ramifications expand long-term opportunities rather than constrain them.

The three elements included in the first theme can be elaborated as follows:

1. The role of the public and private sectors

The reconstruction programme should be aimed at creating a legal and institutional framework in which each sector specializes in what it does best. The private sector produces and distributes private goods and services. The public sector produces public goods, including a support system for the private sector, and adopts policies reducing inequality in the distribution of income, between individuals, social groupings and regions (the West Bank vs. Gaza Strip, urban vs. rural, and towns and villages vs. refugee camps). It is important that private wealth be built up independently of political power or position, and vice versa, otherwise rent-seeking will supplant productive activities.

While the nascent Palestinian Authority has assumed control of an economy whose public sector does not include productive or other State-owned enterprises, the temptation to initiate such activities under its domain during the reconstruction phase, out of considerations of apparent "expediency" or "economic security", should continue to be strongly resisted at all levels of government. Indeed, the imperatives of legislating, regulating, supervising and enforcing are so great in the current circumstances that the Palestinian Authority would be hard put to also contemplate engaging in direct business activities or management. Such temptations may present themselves in the public utilities sector (electricity, energy, and telecommunications, etc.), and other strategic areas (e.g. commodity procurement). The Palestinian private sector has adequately diverse professional and technical capacities to assume the leading role. In very few areas where a more active government role is desirable (especially regarding certain physical infrastructure), to the extent possible its involvement should be in partnership and coordination with private-sector actors.

2. The centrality of agriculture and industry

Expanding the capacity and the efficiency of these two sectors is considered the central task of independent development, needed to free the

Palestinian economy from the structural distortion caused by occupation, and to eventually achieve sustainable growth. Agriculture should aim to regain the ground lost during the past decades in export markets and establish new footholds, while expanding the production of foods to accommodate the reconstruction programme and expected increase in both income and population. The manufacturing sector has to expand and achieve a higher share in GDP so as to provide necessary inputs to agriculture, construction and services. This should aim at meeting a higher level of local and external demand for manufactures, without which the development of those sectors will be constrained by bottlenecks and shortages of foreign exchange. The growth of industry, however, will require a corresponding growth in services, in particular producer services, like finance, insurance, real estate, engineering designs, accounting and other business services. This growth is essential in both the short and the long run. In the former, the growth is needed to facilitate the increase in investment needed in industry. In the latter, growth is needed to facilitate the export of manufacturing goods. At the same time, the potentials for development of extractive industries, in particular stone, marble and construction-related materials, should be fully exploited for immediate use in the reconstruction programme as well as for continued (and expanded) export to regional markets.

3. The importance of expanding and liberalizing Palestinian export and import markets

At present, an important part of Palestinian GNP is generated from income of the Palestinian labour force engaged in Israel. Most of Palestinian trade involves importing from and exporting to or through one trading partner. In addition to its negative political dimension, continuing dependency on one trading partner is likely to have an adverse impact on the long-term prospects of Palestinian economic growth. It encourages the Palestinian economy to produce low-skilled goods, and de-emphasize the accumulation of human capital, which is crucial to growth. Furthermore, it limits the opening of the Palestinian economy with the rest of the world to the degree and orientation of Israeli relations with these markets. Palestinian trade, financial and sectoral development policies must therefore be rooted in a clear understanding of the potential gains and losses with all trading partners, including Israeli, Arab, European and other OECD countries, and the global economy in general.

Obviously, these are long-term objectives and as such it is inevitable that policy-makers will often find themselves preoccupied with the present short-term goals and immediate gains. Identifying the adverse long-term effects of short-lived advantages is the subject of the second theme that emerged from the analysis in this study. Major conflicts between short-term gains and long-term losses include the following:

(a) In the short-term, it may be attractive to emphasize services, instead of agriculture and industry. Envisioning the future Palestinian territory as a regional centre for finance, trade and tourism is a concept with wide appeal. The examples of Singapore or Hong Kong are often mentioned by

observers as a model for Palestinian development. Such a vision is, however, simplistic and largely irrelevant. The Palestinian territory does not constitute a city state; it is basically an agricultural economy whose development continues to depend to a large extent on the agricultural sector fulfilling its traditional role in the development process: offering the embryonic manufacturing sector

both low-priced inputs (labour and materials) and increased rural demand for industrial products. At a later stage, the manufacturing sector operates to modernize agriculture, increasing its productivity and releasing labour for urbanization and industrialization. Experience in many less developed countries shows time and again that de-emphasizing agriculture leads to a poor rural population with low purchasing power, which constrains the growth of producer services and industry. An attempt to promote services-sector growth that bypasses the still weak and inefficient manufacturing sector risks creating new structural imbalances and disarticulation that could lead to new external dependencies, to the detriment of long-term economic development.

(b) Since the 1993 Israeli-Palestinian accords, considerable interest has been generated in joint ventures and subcontracting agreements with the industrial sectors of neighbouring countries. The promise of such activities is that they bring a transfer of finance and technology and employ Palestinian labour, thus alleviating unemployment. The problem with such activities in practice is that, while they are likely to employ Palestinians, not much technology is expected to be transferred because such subcontracting and joint venture arrangements may largely concentrate on factories producing labour-intensive goods. This would result in locking the Palestinian economy into the established structure, and relegate Palestinian industry to prolonged dependency. Joint ventures or any other cooperative arrangements should be carefully considered according to the strategic criteria of finance and technology transfers, and not primarily with respect to short-term considerations of unemployment. The latter problem can be better solved by expanding the domestic productive sectors, something which has long-term as well as immediate benefits.

(c) The availability of foreign financial assistance, and the hope of increased foreign investment in the future as a result of stability and peace, has fostered the belief in some circles that domestic savings could cease to be the primary source of capital accumulation. If this results in abandoning policies needed to stimulate domestic savings and constrain consumption and imports, it will have disastrous long-term consequences. Foreign assistance, by its very nature, is a very short-term remedy, and cannot be relied upon for more than a few years. More importantly, despite all the publicity in support of globalization and free capital mobility, foreign investment has not yet become a major factor in capital accumulation in the majority of less developed countries. Most of the international capital is of short-term character, and cannot sensibly be used to finance long-term development investments. The recent Mexican economic crisis was, among other aspects, an example of the unreliability of foreign capital in sustaining a domestic investment programme. It is also no coincidence that the fast-growing Asian countries, which do attract a considerable amount of foreign capital, also have the highest rates of national saving in the world.

These are some of the major areas where a conflict exists between short-term gains and long-term losses, but there are many more. Identifying the conflict in particular policy measures is not easy, and requires analysis by professionals based on sound research. Nevertheless, it is necessary that all policies should be based on competent advice, which includes estimates of both short- and long-term ramifications. Ad hoc decisions, if allowed to become pervasive, could prove to be a very damaging constraint on the reconstruction programme.

To reduce the conflict between short-lived gains and long-term disadvantages, the reconstruction programme needs to tackle immediate problems - such as unemployment - through policies consistent with long-term objectives, and to speed up the effort to reform the distortions in labour, capital and land markets brought about by more than a quarter of a century's neglect. Priority, therefore, should be given to activities that satisfy the double requirement of generating production and employment and expanding the capacity of the private sector. Guided by these two concerns - removing the past distortions, and encouraging activities that have positive impact in both the short and long term - a range of recommendations dealing with each sector has been propounded in previous chapters. These recommendations are outlined below in an integrated manner under four headings: legal and institutional framework, economic policies, infrastructure and human resources.

B. The legal and institutional framework

The existing laws governing the conduct of economic life and business activities in the Palestinian territory are outdated and conflicting. The West Bank has been basically applying Jordanian Laws, which existed prior to 1967, while the Gaza Strip largely relied upon those of Mandate Palestine. The Israeli authorities have also issued numerous military orders regulating economic relations and activities over the last 27 years. Independent development requires the gradual suspension of all these conflicting regulations, in the promulgation of which the Palestinian people had no direct say, and the establishment of a unified system of laws and regulations in both regions of the Palestinian territory, covering the following issues:

- property rights;
- commercial transactions;
- operation of banks, insurance, investment, and trust companies;
- bankruptcy and foreclosure;
- clear land zoning;
- laws of tenancy;
- legal framework of the transportation system.

Equally important is the establishment of many new public institutions needed to allow the public sector to perform its role in the economic sphere. The most prominent of these include:

- National Bureau of the Budget, a department within the Office of the Chief Executive or in the Ministry of Finance responsible for all matters related to the role of the Executive Branch in preparing, implementing and monitoring the central government budget;

- Bureau of Audit, a department independent of any government unit, and responsible directly to the Palestinian Legislative Council. Its function would include auditing all government units, and setting the standards for private auditing practice;
- National Agriculture Planning Board, a department in the Ministry of Agriculture, which includes representatives from Finance, Water, Land, Trade and Cooperatives, which would be responsible for all aspects of directive planning in agriculture;
- Agricultural Marketing Board, comprising representatives of both the private and public sectors, responsible for initiating and coordinating marketing activities;
- Water Authority, responsible for all matters related to water supply, distribution and conservation;
- Energy Authority, responsible for all matters related to securing independent electricity supply and matters related to other sources of energy;
- Environment Authority, responsible, *inter alia*, for planning, designing, and managing waste water collection and treatment services as well as the safeguarding of the environment;
- Housing Authority, responsible for planning and implementing a national housing policy, strategy and programme of action;
- Refugees Settlement Authority, responsible for all aspects of the task of resettling refugees;
- Agricultural Development Bank;
- Industrial Development Bank;
- Mortgage Institute, an institution responsible for lending to moderate income groups for the purpose of building houses.

C. Economic policies

The ultimate goal of the reconstruction programme is to expand the productive capacity of the economy, so that enough production, employment, and trade are generated to correct the labour market imbalance and close the trade deficit. Achieving these goals requires the implementation over a number of years of an economic policy package conducive to intensifying investment and raising exports on the one hand, and restraining increases in consumption and imports on the other. Elements of this policy package were discussed throughout the study. The following paragraphs summarize their main points.

1. Investment and saving

Stimulating private savings requires a tax reform that increases incentives. This would include more reliance on consumption-based taxation, and a reduction in the marginal rate of income tax. Imports of luxuries would need

to be rationalized and subjected to a relatively higher schedule of tariffs. The PMA should also encourage banks to create financial instruments designed for special groups of savers, in particular Palestinians living outside the West Bank and Gaza Strip. Investment can also be increased by establishing Industrial and Agricultural Banks, which would provide loans for investment at subsidized rates, supply technical and financial advice to investors in agriculture and industry, coupled with preferential tax treatment for investment in certain regions, and help create a hospitable climate for foreign investment.

2. Trade strategy

The future of the Palestinian economy would be well-served by having a free trade agreement with all its neighbours. However, movement towards achieving this goal should be gradual, and take place after the Palestinian economy frees itself from the customs union agreed upon in the Protocol, and has had enough time to recover some of the ground it lost in the neighbouring markets owing to the harmful restrictions of the past decades. Free trade agreements with the Arab countries need to be pursued aggressively by entering into bilateral or multilateral agreements that specify a timetable for the removal of tariffs. Non-tariff barriers also need to be treated as part of any free trade agreements with Israel and the Arab countries.

3. Monetary concerns

The two-currency standard (the Israeli Shekel and the Jordanian Dinar) agreed upon in the agreements with Israel and Jordan is not an ideal arrangement. Indeed, it has many disadvantages. It is therefore recommended that, after the transition period, the PMA adopt a national currency, preferably linked initially to the Dinar. In the meantime, the PMA has some very important tasks to perform. Facilitating the establishment of new banks, insurance companies, and other financial institutions, is a matter of major concern. Creating unified rules and regulations to govern the operations of the financial system is another preoccupation. Both of these tasks need to foster an atmosphere conducive to increasing both the supply of, and the demand for, credits. Promoting financial intermediation is essential to carrying the reconstruction programme from the stage of dependence on donor financing to the stage where domestic finance predominates.

4. Macroeconomic policies

An intensive programme of building infrastructures and public institutions financed mainly through external aid without a parallel effort at increasing agricultural and industrial output threatens to heat up the economy and, *inter alia*, change the relative price of tradables and non-tradables. The situation could be exacerbated if positive prospects for peace trigger sizeable inflows of capital from Palestinian expatriates and others for speculative purposes in land and real estate. Preventing these problems from constraining the real growth of the economy requires an effective use of fiscal and monetary policy to achieve both a stable domestic price level and a stable real exchange rate. The PMA in the transition period cannot use monetary policy fully at the macro level since its control over the monetary base is severely restricted by the absence of a national currency. It can, however, use monetary instruments to discourage

harmful activities. Fiscal policy will have to be relied upon to effect both expenditure reduction and expenditure switching, by creative use of fiscal purchases, taxes and subsidies.

5. Sectoral issues

The Palestinian economy suffers from sectoral disarticulation. Less than one third of Palestinian GDP is produced by agriculture and industry, compared to more than one half in economies with comparable per capita income. Programmes aimed at increasing the shares of agriculture and industry have to be carried out in stages. At the early stage, when the construction of infrastructures and the building of public institutions are under way, policies are needed to promote the expansion of agriculture. This is necessary to enable the agriculture sector to supply the economy with cheap necessities and to create rural demand for the products of other sectors. This increased demand will promote the growth of the traditional industries of textiles, leather, pharmaceuticals, agro-industries and building materials. In the second stage, the manufacturing sector would operate to modernize agriculture, increasing its productivity and releasing labour for its own growth. In this stage, the expansion and modernization of services and construction will also depend on the manufacturing sector creating new industries employing highly skilled labour and using advanced technology like engineering design, electronics and computer software.

D. Infrastructure

Physical infrastructures in the West Bank and Gaza Strip are in very poor condition. Public services which rely upon infrastructures are well below those in neighbouring countries with regard to both quantity and quality. This has constrained the capacity of the productive sectors, and caused considerable damage to the environment. The "Programme for Development of the Palestinian National Economy for the Years 1994-2000" (PDP), prepared by Palestine's Department of Economic Affairs and Planning, contains detailed programmes for the construction and renovation of all the required infrastructures. Other parties, including the World Bank, have proposed emergency and short-term programmes to address some of the issues identified by the PDP. The following aspects, emphasized in the course of this study, present a general description of the need in a few areas, the improvement of which is essential to the reconstruction programme. In other words, these are the areas where inadequate infrastructure is partly responsible for the vicious circle created by the interplay of restrictions on production and barriers to trade.

1. Natural resources

To remove the restrictions on production caused by a declining natural resource base, an increase in the areas of cultivated land and the supply of water is urgently needed. A serious reclamation process is needed to extend the land available for agriculture, industrial expansion, and residential construction. A comprehensive programme aimed at increasing the supply of water entails building new artesian wells, reservoirs, and springs, as well as rehabilitating and renovating old ones. Similarly, the lack of an independent source of electricity places a constraint on production. A unified Palestinian power system operating as part of a regional system is needed.

The system could have some degree of independence, and the capacity to expand the

supply of electricity according to the demand requirement of the Palestinian economic development and growth.

2. Transportation

A major improvement in the transport system is called for to integrate markets and stimulate both internal and external trade.

- The whole road network needs comprehensive rehabilitation and expansion. In particular, a comprehensive agriculture road system is required.
- The Palestinian economy needs a direct outlet to the world economy, so that Palestinians can trade with other countries without going through one trading partner. Such an outlet is essential to enlarged export activities and independent trade. In this regard, the project aimed at building a commercial seaport in Gaza needs to be diligently implemented. Modernizing and enlarging the small airport at Qalandia and building a new airport in the Gaza Strip also calls for urgent action.

3. Public community services

The expansion of economic activities cannot be sustained without a major improvement in the productivity of labour. Such an improvement needs in turn an improvement in health and education, and the general level of public community services. General living conditions are in need of improvement especially in refugee camps, small towns, and villages. The resettlement of the refugees and the ending of the inhuman living conditions in the camps should be a high priority of the reconstruction programme. The Water Authority needs to embark on a programme of rehabilitation and expansion of all water supply and sewage systems. Similarly, the new Environmental Authority should intensify its efforts in organizing solid waste collection in urban areas and initiating collection services in rural areas. The supply of community services is well below current demand. Accordingly, there is an urgent need to build new public schools, health centres, hospitals, culture and recreational facilities, post offices, and police stations. In Chapter IV, section D-2, a set of detailed recommendations was presented, classified according to function and region. It is estimated that around 6,304 dunums of land will be needed for all the recommended buildings. Public schools and cultural facilities occupy 86.5 per cent of the total, whereas public health facilities and public services occupy 11 per cent and 2.5 per cent, respectively.

E. Human resources

The Palestinian territory suffers from three major problems in the area of human resources. The first is the failure of the economy to generate enough employment, leading to one third of the labour force working in Israel and to severe domestic unemployment. The second is a labour participation rate that is considerably below the rate in neighbouring countries. The third problem is low labour productivity, especially in the manufacturing sector.

1. Unemployment

At present, it is estimated that 4,000 new jobs are generated per year in the Palestinian territory, whereas the natural growth of the labour force requires 9,000 jobs. Phasing out employment in Israel over a five-year period requires the creation of 15,000 to 20,000 new jobs per year. Added to this are the new jobs required for the Palestinian returnees. Yet, as was indicated earlier, removing constraints and embarking on an intense investment programme, aided by foreign financial assistance and directed by sensible macroeconomic and sectoral policies, would enable the economy to absorb its labour force and reduce the unemployment rate to 9 per cent by the year 2010. It is recommended that a relief programme designed to aid the families of the unemployed be initiated in order to ease the disruption during the period of adjustment.

2. Participation in the labour force

While unemployment is the most pressing problem at present, the future standard of living in Palestine also depends on raising its rate of labour participation. At present it is 19 per cent, whereas it is 36 per cent in Israel, 27 per cent in Egypt, 25 per cent in the Syrian Arab Republic, and 23 per cent in Jordan. Undoubtedly, the average young age of the population in Palestine and the discouragement generated by high unemployment are contributory factors to the low participation rate. However, other important factors include the role of women in economic life, and the general conditions of labour and employer-employee relations. Regarding the role of women, it is recommended to embark on a general campaign aimed at:

- mobilizing women and enhancing awareness of their rights in various domains within both public and private sectors;
- adopting legislation that would eliminate discrimination against women in employment opportunities, and ensure equal pay and chances of promotion;
- creating an appropriate institutional framework to support women entrepreneurs, and improve women's access to credit, finance and legal assistance;
- extending public financial subsidies to day-care centres that cater for children of poor families; and,
- establishing a database on women's involvement in the economy, which can be used as an instrument for the future planning of the role of women in socio-economic endeavours.

As for labour relations, there is need for new legislation covering all aspects of labour rights in unionization, contractual regulations, hours of work, safety measures, sick leave and vacations, pensions, and insurance against injury, disability and death. Establishment of employment bureaux in major urban centres, in order to supply information concerning the labour market, would also be helpful in minimizing the cost of searching for employment opportunities.

3. Productivity

The productivity of labour depends on three different kinds of capital: private capital used in production; the quantity and quality of public-sector capital which supports the private sector; and the skills and education of the labour force referred to as human capital. In other sections of this study, attention was focused on the need for intensifying investment programmes to augment the stock of capital in both the private and public sectors. The following paragraphs concentrate on recommendations related to the accumulation of human capital and are classified under three headings:

(a) Education

- Create a unified system of education in the West Bank and Gaza Strip. The present two-track secondary school system (arts-science) should be transformed into a one-track system, providing the students with literacy, basic science and mathematics, as well as elements of vocational training.
- Prioritize the building of new schools, and the renovation and expansion of old ones. A time table should be set to eliminate overcrowding in the classroom and the two-shift system. More resources should be allocated to libraries, laboratories, computers and other facilities.
- Formulate a long-term plan of future needs in higher education. This should be based on projections of population growth and the future needs of different socio-economic sectors. The goal should be the gradual elimination of the present imbalance between humanities and arts on the one hand, and vocational and professional fields on the other.
- Assessment of pre-college and college education in the vital sectors of agriculture and industry is recommended. The aim should be to identify ways and means of increasing their relevance to emerging local needs.

(b) Scientific research

- It is recommended that the Council for Higher Education establish a body responsible for the funding and encouragement of scientific research.
- It is recommended that a separate department in the Ministry of Agriculture be established for the purpose of conducting applied agriculture research and supervision of the research activities of all agricultural experimental stations. A similar department should be established in the Ministry of Industry to provide leadership and support to all activities in applied industrial research.
- Research activities should be promoted by giving tax incentives to firms and individuals to encourage the provision of research grants to universities and research institutions.

(c) Labour skills

- Increasing productivity in agriculture requires that the Ministry of Agriculture establish institutions that would train the agriculture labour force in modern techniques. These should include installation and operation of modern irrigation techniques, proper pruning technologies, use of fertilizers and pesticides, training in skills related to marketing, and, especially, the operation of cooling and storage facilities.
- Increasing productivity in industry requires creating a link between scientific facilities at the universities and industrial firms. There is also a need to establish technical institutions suitable for training workers capable of working with specialized engineers. The most needed skills are in the areas of electronics, electric tools and communications.
- In the services sector, there is a lack of formal institutions to train professionals in most of the fields. These include hotel and restaurant management, tourist guides and tour operators, travel agents and insurance, financial and marketing professionals. It is recommended that the public sector should encourage the private sector through subsidies and preferential tax treatment to establish such institutions. In this sphere, the assistance of international organizations could be used to good effect.

Notes

1. Document UNCTAD/ECDC/SEU/6 and Add.1.
2. By the end of 1992, 68 per cent of total land of the West Bank, and 40 per cent of that of the Gaza Strip had been removed from Palestinian use or control as a result of Israeli measures. For more information see UNCTAD "Recent economic developments in the occupied territory" (TD/B/1305), and "Developments in the economy of the occupied Palestinian territory" (TD/B/40(1)8), p. 14.
3. For a detailed account of developments in the financial sector, see "The financial sector under Israeli occupation" (UNCTAD/ST/SEU/3/Rev.1).
4. For recent accounts of developments in the trade sector, see: "Palestinian external trade under Israeli occupation" (UNCTAD/RDP/SEU/1); "Main features of domestic and external merchandise trade of the West Bank and Gaza Strip" (UNCTAD/ECDC/SEU/5); and, UNCTAD "Developments in the economy of the occupied Palestinian territory" (TD/B/41(1)/3).
5. See: Hamed O. and R.A. Shaban (1993), "One sided customs and monetary union: the case of the West Bank and Gaza Strip, under Israeli occupation", in Stanley Fisher, D. Rodrik and E. Tuma (eds.), The economics of Middle East peace, MIT Press, Cambridge, MA. See also: I. Luski and J. Weinblatt (1994) "The West Bank and Gaza Strip: a macroeconomic profile and simulation model", Department of Economics, Ben-Gurion University of the Negev and the Philippe Monaster Centre for Economic Research.

6. The number of Palestinian workers in Israel, as a percentage of the total Palestinian labour force, increased from 11 per cent in 1970 to 34 per cent in 1980, and to 36 per cent by 1992. See: "Review of labour and employment trends in the West Bank and Gaza Strip" (UNCTAD/ECDC/SEU/9), tables 3 and 4. Also see table II-2 in this chapter.

7. The following table presents industrial and housing shares of total investment. It demonstrates that investment in industry has stagnated whereas that in housing increased many fold.

Year	West Bank		Gaza Strip	
	Industry (%)	Housing (%)	Industry (%)	Housing (%)
1970*	60 (1972)	39 (1972)	19	19
1980	27	45	18	74
1987	28	60	20	64

* West Bank data is for 1972.

The percentages are calculated from tables I and II of Appendix II of Luski and Weinblatt, "The West Bank and Gaza Strip ...", op. cit., pp. 114-116.

8. Abu-Shukr et al. estimate that 80 per cent of the industrial establishments that were operating before 1967 had closed down during the occupation, and that subcontracting with Israeli firms was one of the important factors behind the establishment of firms during the occupation. See Abu-Shukr, Saleh and Alawneh, Industrialization in the West Bank, An-Najah National University, Nablus, 1991 (in Arabic).

9. Parallel with the adverse impact of intifada, the economic situation had further deteriorated as a result of the Gulf war. Sara Roy described the severity of the situation as follows: "by June 1991, UNRWA was feeding an unprecedented 120,000 refugee and non-refugee families in Gaza Strip - almost the entire population - and 165,000 families in the West Bank. During 1992, UNRWA distributed an additional 430,000 family food parcels in Gaza and 119,000 in the West Bank to communities with emergent need". Describing the effect of the Israeli closure of March 1993, and the concurrent loss of Palestinian income she states that "one month into closure, UNRWA was planning four emergency food distributions in Gaza Strip, one every two months, for 96,000 refugee families and 30,000 non-refugee families for a total of 480,000 family rations". Requests from refugees and non-refugees alike for food, cash aid, and employment exceed the emergency's capacity to provide them". See: Roy, Sara,

"Separation or integration: closure and the economic future of the Gaza Strip revisited" The Middle East Journal, vol. 48, No. 1, Winter 1994, pp. 12-30. "Unemployment was cited at around 25 per cent (out of a labour force of some 350,000) in early 1994 by some international sources". See: "Developments in the economy ..." (TD/B/41(1)/3), op. cit., p. 14.

10. The total consumption of electricity per capita in the OPT is just one tenth of that of Israel and almost one third of Jordan. In the West Bank, around 50 per cent of villages (with 38.5 per cent of the total rural population) does not have water distribution systems. See: UNCTAD "Public Utilities in the West Bank and Gaza Strip" (UNCTAD/ECD/SEU/2), Chapter III. The World Bank mission to the OPT described the services of basic water supply, transport, and power facilities as below that generally found in countries with comparable incomes. It also observes: "moreover, the poor state of the existing physical facilities for sewerage, water supply and solid waste and drainage, and the inadequacy of services provided in the areas, has already placed a heavy strain on the environment". See: World Bank, Developing the occupied territories: an investment in peace (Washington D.C., World Bank, September 1993) vol. 5, para. 1.3, p. 1.

11. See: "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip, 1990-2010; a quantitative framework" (UNCTAD/ECD/SEU/6). The framework consists of an aggregate quantitative approach to performance of the Palestinian economy, describing the main features of its demography, labour force, and macroeconomic activity. It uses multiple regression analysis on time-series to provide estimates of key parameters during the 1970-1990 period, and to project trends for the period 1991-2010 under different scenarios. These are based on different assumptions concerning the future environment emerging from the peace process.

12. Income generated by Palestinians working outside the West Bank and Gaza Strip accounted for approximately 30 per cent of GNP. In proportional terms, it is probably the highest in the world. See Luski and Weinblatt, "The West Bank and Gaza Strip ...", op. cit., p. 14. For an analysis of the importance of employment for Palestinians in the Arab States, see, ESCWA, "The return of Jordanian/Palestinian nationals from Kuwait: economic and social implications for Jordan", Amman, September 1991.

13. See "Prospects for sustained ..." (UNCTAD/ECD/SEU/6), op. cit.

14. The first agreement constitutes the Declaration of Principles (DoP) signed in Washington D.C. on 13 September 1993. A copy of the agreement is found in Near East Economic Progress Report No. 1, March 1994. The second one is Agreement on the Gaza Strip and Jericho Area, signed in Cairo on 4 May 1994. See United Nations Distr. General A/49/80, S/1994/727, 20 June 1994. This was followed by the Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip signed in Washington D.C. on 28 September 1995.

15. Near East economic progress report, No. 1, 1994.
16. "Protocol on Economic Relations between the Government of the State of Israel and the P.L.O., representing the Palestinian people" (United Nations A/49/80, S/1994/727, 20 June 1994).
17. The exception to this are limitations on the export of six Palestinian agricultural products: poultry, eggs, potatoes, cucumbers, tomatoes and melons. The quotas on these items will be gradually removed on an increasing scale until they are finally eliminated by 1998. (Art. VIII of the Protocol).
18. There are two lists of goods specified in Appendices I and II of the Protocol. The first covers goods produced locally in Jordan, Egypt and other Arab countries. The second covers goods imported from Arab, Islamic and other countries. Goods from both lists can be imported by the Palestinians in quantities agreed upon by the two sides which would reflect the Palestinian needs. The Palestinians' estimated needs will be based on the best available data regarding past consumption, production, investment and external trade of the territory.
19. Nashashibi, K. and Kanan, O., "Which trade arrangements for the West Bank and Gaza", Finance & Development, September 1994, pp. 10-13.
20. Diwan, I., "What Middle East market", Newsletter of the economic research forum of the Arab countries, Iran and Turkey, vol. 1 (4), December 1994, p. 10.
21. Mona Jawhary, "The Palestinian-Israeli trade agreement: searching for fair revenue-sharing", Palestine Economic Policy Research Institute (MAS), December 1995.
22. "Developments in the economy of the occupied Palestinian territory" (TD/B/42(3)/8).
23. The Jerusalem Post, 27 September 1995, p. 3.
24. Mosly, Paul (1986), "Aid-effectiveness, The micro-macro paradox" IDS Bulletin, pp. 22-35, Institute of Development Studies, University of Sussex, 17 April 1986.
25. For important views expressing well-thought-out visions of comprehensive economic development in Palestinian territory, see:
 - Yusef A. Sayigh, "Possible opportunities and factual impediments", a paper presented at a conference on "The reconstruction and development of Palestine", held in Cairo, on 7-9 November 1995, and sponsored by the League of Arab States and the Welfare Association.
 - George T. Abed, "The economic viability of a Palestinian state" Institute for Palestine Studies, Washington D.C., 1990.

- George T. Abed, "The Palestinian economy in the new Arab and international context", a paper presented at a conference on "The reconstruction and development of Palestine", held in Cairo, on 7-9 November 1995, and sponsored by the Welfare Association.
- 26. "Prospects for sustained development ..." (UNCTAD/ECDC/SEU/6), op. cit.
- 27. Since the closure of the territory starting in March 1993, the number of Palestinians working in Israel has dwindled to a fraction of its average during the 1980s. In 1995, the number of Asian workers in Israel was more than the number of Palestinian workers. Israeli policy has moved towards permanent by reducing its dependence on Palestinian workers for security reasons.
- 28. "Prospects ... a quantitative framework" (UNCTAD/ECDC/SEU/6), op. cit., p. 65.
- 29. Ibid. p. 69.
- 30. George T. Abed and Abdelali Tazi, "Laying the foundation: a fiscal system for Palestinian autonomy". Finance & Development, September 1994, pp. 14-17.
- 31. The tax system served as a means to deal with the uprising. The measures comprised the imposition of heavy taxes and levies, and widespread tax-collection campaigns, involving what became known as "tax raids", see UNCTAD, (TD/B/1183), paras. 52-53, (TD/B/1221), paras. 74-75, (TD/B/1266), paras. 42-45.
- 32. I. Luski and J. Weinblatt. "The West Bank and Gaza Strip: a macroeconomic profile and simulation model", The Phillippe Monaster For Economic Research, Ben-Gurion University, Beer Sheva, Israel, 1994.
- 33. In recent years, 80 per cent of health care and 50 per cent of education services were supplied outside the public sector. This over-reliance on the private sector generates inefficiency, due to the fact that both education and health services have externalities, some "public good" characteristics, and are supplied in imperfect competitive conditions. See Stiglitz, J.E., Economics of the public sector, W. W. Norton, 1986.
- 34. The World Bank "Developing ...", op. cit., vol. 2, p. 113.
- 35. The "budget surplus" withdraws resources from the economy, and thus has the opposite impact of stimulating fiscal action on employment, production, and growth.
- 36. One of the methods used by the Palestinian Ministry of Finance, in late 1994, was to change the tax collectors' areas in the hope that new faces would help eradicate from the mind of taxpayers the poor image of tax collection under occupation.

37. These two tables were prepared by Dr. Nidal Sabri in a study commissioned by UNCTAD, 1992 (unpublished).

38. Gillis, Perkins, Roemer, and Snodgrass, Economics of development, Third edition, N.W. Norton & Company, New York, 1992, pp. 313-349.

39. The World Bank "Developing ...", op. cit., vol. 2, p. 113.

40. VAT, sales, and income tax are different from the administration point of view, but are equivalent from the economic point of view. This equivalence stems directly from the equivalence between national income and national output. Thus, a flat tax on income and a flat tax on output must be equivalent. The equivalence between a uniform VAT and a uniform expenditure tax comes from the fact that both taxes are on production, the latter is a tax collected at the end of the production process, while the former is a tax at each stage of production.

41. Some claimed that the income tax rates are high because the identifiable tax base is considerably lower than the real one, owing to under reporting by Palestinians.

42. Abed, G. et al, "Taxation in Israel ..." op. cit.

43. World Bank, (1994) "Emergency assistance to the occupied territories", vol. 1: Investment programme, p. 34.

44. See: Near East economic progress report, No. 1, 1994, and "World Bank, Developing ...", op. cit., vol. 2, Annex 2.

45. See, "Securing peace in the Middle East", op. cit., p. 117.

46. Ibid., p. 117.

47. These allocations are based on considerations related to the present need of the economy, and the requirements of launching the reconstruction programme as specified under the alternative scenario (without population return).

48. See: The Economist Intelligence Unit, "Israel and the occupied territories", 2nd and 3rd quarters, 1995.

49. Near East economic progress report, No. 2, September 1994, p. 4.

50. Ibid.

51. See: Palestinian economic policy research institute (MAS) and Palestine Monetary Authority (PMA), Palestinian banking sector: statistical review, June 1995.

52. Ibid.

53. The relative high ratio for Gaza Strip and Jericho is due to loans extended to government institutions by banks in the Gaza Strip.

54. See Appendix (III-1) for further details.

55. See: Mandell, Robert A., "A theory of optimum currency areas," American economic review, vol. 51 (September 1961), pp. 657-665.

Mackinnon, Ronald I., "Optimum currency areas," American economic review, vol. 53 (September 1963), pp. 717-725.

Kenen, Peter, "The theory of optimum currency areas: an eclectic view," in Robert Mandell and Alexander Swoboda, (eds.), Monetary problems in the international economy, Chicago: University of Chicago Press, 1969.

Masson, Paul R. and Taylor, Mark P., "Optimal currency areas: a fresh look at the traditional criteria," in Pierre L. Siklos, (ed.), Varieties of monetary reforms: lessons and experiences of the road to monetary union, Kluwer Academic Publication 1994.

56. Plassner, Yakir, The political economy of Israel: from ideology to stagnation, (New York: State University of New York Press, 1994), p. 37.

57. Kleiman, Ephraim, "Some basic problems of the economic relationship between Israel, the West Bank, and Gaza", in Stanley Fisher, Dan Rodrik, and Elias Tuma (eds.), The economics of Middle East peace: views from the region, the MIT Press, 1993, pp. 305-333.

58. In Israel, sales of public companies to private investors, under the privatization programme, has to have the approval of the Knesset Finance Committee. It was reported that in order for foreign investors to be acceptable, they have to have "pro-Israeli credentials". For more detail see: Murphy, Emma, "Israel" in Tim Niblock and Emma Murphy (eds.), Economic and political liberalization in the Middle East, London: British Academic Press, 1993, pp. 237-255.

59. Because the majority of Jordanian citizens are of Palestinian origin, many of the Jordanian businessmen establishments have branches in the West Bank, and/or much of the Jordanian capital is owned by Palestinians from the West Bank.

60. See Yakir Plessner, "The political economy ...", op. cit., p. 116, and Feiler, G. "Palestinian employment prospects", in Middle East Journal, vol. 47, No. 4, Autumn 1993, pp. 633-651.

61. Surveys have shown that nearly nine-tenths of all West Bank residents employed in Israel, and three-fourths of those of Gaza Strip commuted to work daily. See Kleiman, "Some basic problems ...", op. cit., p. 312.

62. Since March 1993, there were many weeks where the territories were closed completely, and no workers were allowed. At other times a limited number of workers are allowed, but the uncertainty of work in Israel has increased, especially with the repeated announcement by Israeli officials on the desirability of separation between the two peoples, and the increased importation of Asian agriculture workers to replace the Palestinians.

63. Half of all Palestinians working in Israel in 1987 were employed in the construction sector. See Klieman, "Some basic problems ..." op. cit., p. 312.

64. The number of Palestinians working in Israel was 66,000 in 1975 and reached 109,000 by 1987, accounting for almost one third of the Palestinian labour force.

65. A very broad impression of an economy's domestic product diversification is the share of its manufacturing sector in GDP. In Israel, the share is 21.3 per cent while in the Palestinian economy is around 8 per cent.

66. See Chapter II.

67. Most of the potential returnees will come from Palestinians residing now in Jordan, Syria, and Lebanon. There are around 800,000 Palestinians residing now in Jordan who are the most likely to return. They include those who left during the war of 1967, and those who left between 1967 and 1984.

68. Estimates by UNCTAD secretariat, in "Developments ..." (TD/B/41(1)/3), op. cit.

69. *Idid.*, p. 19.

70. *Ibid.*

71. *Ibid.*

72. See: El-Jafari, Mahmoud, "Non-tariff barriers: the case of the West Bank and Gaza Strip agriculture exports", Journal of world trade, vol. 25. No. 3, June 1991, pp. 15-31.

73. *Ibid.*

74. *Ibid.*

75. *Ibid.*

76. Some of these subsidies have been reduced lately. For detailed account of the Israeli subsidies to agriculture see Y. Plaesser, "The political economy ...", op. cit., pp. 130-31 and p. 178.

77. As the growth of Jordanian economy slowed down towards the end of the 1980s, difficulties were encountered in generating the foreign exchange needed to finance food imports. The Government, reacted by implementing some measures to increase domestic agricultural output. These included an expansion of the area under irrigation, and the creation of a government support system to increase domestic food production.

78. For more details concerning the existing situation of the transport system see: "Developments in the services sector in the West Bank and Gaza Strip, 1967-1990" (UNCTAD/ECDC/SEU/7), pp. 27-30.

79. UNCTAD secretariat has formulated a detailed programme of technical assistance in support of the Palestinian trade, finance and related services (UNCTAD/ECDC/SEU/11).

80. The economic agreement between Palestine and Jordan calls for gradual removal of all barriers to trade between Jordan and the Palestinian territory, (see Chapter II). Free trade between the two countries, however, cannot be achieved during the transition period, while the Palestinian territory is still in a customs union with Israel.

81. These products are poultry, eggs, potatoes, cucumbers, tomatoes, and melons.

82. For more details concerning the prospects of trade, see UNCTAD "Developments ..." (TD/B/41(1)/3).

83. A study commissioned by UNCTAD entitled "Prospects for Palestinian merchandise trade", prepared by Mahmoud El-Jafari, 1992.

84. The importance of Syria to the prospects of genuine comprehensive peace cannot be over-emphasized. The country holds a central role geographically and politically. On the other hand, it is extremely unlikely that a regional economic block will succeed if it is comprised of just Palestine, Jordan, and Israel. The cooperation of Syria, Egypt and Lebanon is essential to the emergence of any new economic order in the region.

85. This theme was tabled by some sources at the Casablanca Conference (October 1994). A number of Arab countries were not at ease with the idea of pursuing economic cooperation ahead of comprehensive political settlement. See the Economist, 18-24 March 1995, p. 46. For an analysis of the Casablanca Declaration, see Said El-Naggar "The Casablanca declaration in the balance", in FORUM vol. I, No. 4, (December 1994), pp. 11-12.

86. For example, the Israeli GDP is over 25 times that of the Palestinian GDP. The average productivity of an Israeli worker is over 3.3 times that of a Palestinian worker, and that of an Israeli industrial worker is over 7.5 times greater than that of the Palestinian industrial worker.

87. The logic of this argument is that of the Stolper-Samuelson theory.

88. The argument pertaining to the adverse impact on human capital accumulation in developing countries as a result of free trade based on comparative advantage is presented in: Stokey, N.L., "Human capital, product quality and growth", Memo, Northwestern University, March 1990.

89. See: Greenaway, D., and Milluer, C.R., The economics of intra-industry trade, Oxford: Basil Blackwell, 1986; Helpman, E., "International trade in the presence of product differentiation, economies of scale, and monopolistic competition: a Chamberlain-Heckscher-Ohio approach," Journal of international economics, August 1981.

90. Foreign investment also could substitute foreign aid, but experience of other countries has shown that foreign investment is not attracted to countries that suffer from chronic disequilibrium in their external and internal balances.

91. See Gersovitz, M., "Saving and development," in Hollis Chenery, (ed.), Handbook of development economics, vol. 1, Chapter 10, North Holland, 1988.

92. A tax reform implies changing the tax base and/or the tax rate while keeping the tax revenue the same, if need be.

93. In both agriculture and small industrial and commercial businesses, it is difficult to apply the income tax schedules. On the other hand, the lump sum tax is neutral to incentives.

94. In the United States, those schemes are called Individual Retirement Account (IRA), and in Canada, Registered Retirement Saving Plan (RRSP). There are some evidences that those schemes tend to increase personal savings. See: Venti, S.F. and Wise, D.A., "Have IRAs increased U.S. saving? evidence from consumer survey," Quarterly journal of economics, August 1990, pp. 661-698.

95. See Todaro, P.M., Economic development, Longman 1994, p. 605.

96. World Bank, "Developing ...", op. cit., vol. 2, p. 61.

97. Note that the real exchange rate could be measured as:

$$\text{RER} = E(P_n/P_t), \text{ where:}$$

RER : real exchange rate
E : nominal exchange rate
 P_n : domestic price of nontradables
 P_t : the price of tradables.

98. For detailed evaluation of the IMF stabilization programme, see Taylor, L., Varieties of stabilization experience: towards sensible macroeconomics in the third world, Clarendon Press, Oxford, 1991.

99. Islam, S, "Devaluation, stabilization policies, and the developing countries," Journal of development economics, 14:37-60, 1984.

100. The distortion of the capital market occurs because of the closing of Arab banks after the occupation. In the labour market there was upward pressure on domestic wage rates because of the reduced supply due to sizeable portion of the labour force working in Israel at much higher wage rates. Finally, land prices were inflated as a result of great demand for residential construction and constructed land supply. This is also due to the lack of other investment opportunities.

101. Whereas the decline in the number of Palestinians working in Israel, reduces the pressure on real wages, it creates a serious problem of mass unemployment.

102. Obviously, food could be imported but this will also put pressure on foreign exchange, and constrain the private sector.

103. At present the manufacturing sector is around 9-10 per cent of GDP. Economies of a comparable per capita income have a share between 22 and 38 per cent. See table IV-1.

104. See Chapter III, Section D.

105. The complementarity between agriculture and industry is formalized in Thirlwall, A.P., "A general model of growth and development on Kaldorian lines", Oxford economic papers, 38 (1986), pp. 199-219.

106. A 1988 study by the World Bank shows that in the 1970s agricultural growth exceeded 3.5 per cent a year in 18 of the 31 countries whose gross domestic product (GDP) grew by more than 5 per cent a year. During the same period, in 15 of the 22 countries with GDP growth below 3 per cent a year, agricultural growth was only 2 per cent or less. Meanwhile, growth in the share of agriculture in GDP differed by less than two percentage points in 15 out of a total of 50 countries, expressing moderate rates. There have been exceptions, of course, but they prove the rule: fast growth in GDP and sluggish agriculture were evident only in countries with oil or mineral-based economies, such as Algeria, Ecuador, Mexico, Morocco, and Nigeria. For more detail see Ibid.

107. Expanding the land available for agriculture might not be possible immediately because the Palestinians do not have yet full control over their land.

108. Ghatak and Ingersent state that "In a developing economy, where per capita incomes are rising, growth in agriculture sector can be expected to lag behind non-agriculture sector for three reasons. First, the demand for food and other agriculture products is generally less income-elastic than the demand for non-agriculture products, due to the Engel effect. Second, due to scientific advances and associated technological innovations in agriculture, farmers become increasingly reliant on inputs purchased from non-farm sector of the economy: this is termed the changing resources structure of agriculture effect. Third, because the demand for off-farm marketing services - distribution, storage and processing - is more elastic than the demand for agriculture products at the farm gate, the farmer's share of food expenditures at retail prices decline with time (the urbanization effect)". For more details see Ghatak, S. and Ingersent, K., Agriculture and economic development, Harvard Press, 1984.

109. See: Sabri, R.N. and Jaber, M.H., "Budget analysis of Palestinian Arab family", Arab studies quarterly. Winter, 1992, pp. 35-44.

110. The importance of agro-industries in the early stage of industrialization of developing countries is documented by World Bank studies. For more details see Ghatak, S. and Ingersent, K., op. cit., p. 37.

111. "The agriculture sector of the West Bank and the Gaza Strip" (UNCTAD/DSD/SEU/Misc.5), p. 76. Also: World Bank, "Developing ...", op. cit., vol. 4, p. 45.

112. The suitable area for irrigated agriculture is just 10 per cent of total West Bank land, i.e. around some 550,000 dunums. This implies, however, that the area under irrigation could be expanded ten times its present level (from an unpublished study prepared for UNCTAD by Hisham Awartani, 1992 on prospects for development of Palestinian agriculture).

113. Awartani, H., "Projection of the demand of water in the West Bank and Gaza Strip: 1992-2005" (unpublished).

114. See: "Environment and development prospects in the West Bank and Gaza Strip" (UNCTAD/ECDC/SEU/8).

115. El-Jafari, Mahmoud, "Sensitivity of Palestinian agricultural trade to monetary and non-trade policies of Jordan and Israel", Newsletter of the economic research forum of the Arab countries, Iran and Turkey, vol. 1, No. 4, December 1994.

116. This section draws in detail on an unpublished report prepared for UNCTAD by Hisham Awartani, 1992, on prospects for development of Palestinian agriculture.

117. Awartani estimates the cost of one reclamation unit to be around \$400,000, and that there is a need for 20 units.

118. World Bank, "Developing ...", op. cit., vol. 4, para. 3.32, p. 20.

119. Ibid, p. 41.

120. The Israeli authorities placed a ceiling on the total area of tomato and eggplants cultivation by Palestinian farmers in the Jordan Valley (Military order No. 1039).

121. See: El-Jafari, M. "Non-tariff barriers...", op. cit., vol. 25, No. 3, pp. 15-31.

122. See: table IV-1 in this chapter.

123. "Securing peace ...", op. cit., tables 2.3 and 2.4.

124. Jordan Ministry of Planning, A program for economic and social development in the occupied territories, 1986-1990, (Amman, November 1986).

125. The World Bank team's survey of industrial establishments in the Palestinian territory reports that "generally, family savings were the sole source of start-up capital, and although this may reflect preference for family ownership and control, the absence of financial sector exacerbates the situation". See World Bank, "Developing...", op. cit., vol. 3, p. 35.

126. Examples of these firms are Bedran Ltd. of Tulkarem, Silvana in Ramallah, Stark Electrodes of Hebron, and Hadded Ltd. in Jenin.

127. These recommendation are based on a report prepared for UNCTAD by Hisham Jahr.

128. Gaza Strip depends totally on electricity bought from Israel while in the West Bank part of the electricity is provided by the Jerusalem Electricity Company, which buys the majority of its electricity from Israel.

129. These figures could be calculated by considering:

$Q_t = \text{GDP.}$
 $I_t = \text{Industry.}$
 q - rate of growth in GDP.
 i - rate of growth in I.

Accordingly, we can write:

$Q_t = Q_0 \cdot \exp(qt).$
 $I_t = I_0 \cdot \exp(it).$

To double industry's share in GDP in t years, the following emerges:

$$(I_t/Q_t) = 2(I_0/Q_0) \quad \text{or}$$

$[I_0 \cdot \exp(it) / Q_0 \cdot \exp(qt)] = 2(I_0/Q_0)$, which can be written as:

$$\begin{aligned} \exp(i-q)t &= 2, \text{ or} \\ (i - q)t &= \log 2, \text{ or} \\ i &= q + (1/t) \log 2 \end{aligned}$$

Assuming t to be 10 years, the following emerges:

$$\begin{aligned} i &= q + .0693. \\ i &= q + .07. \end{aligned}$$

Assuming that the rate of growth of the economy is 5 per cent, then investment in industry has to increase at 12 per cent a year. Assuming that this increase starts at the beginning of the second stage, say the year 2000 when the value added in industry is \$212.13 million in 1990 prices, 12 per cent growth with capital-output ratio of 4 implies an investment averaging \$187.11 million a year over 10 years.

130. UNIDO "Survey of the manufacturing industry in the West Bank and Gaza Strip", Vienna 1984.

131. Development of transport system connecting Palestine with the Arab countries is a necessary but not sufficient condition to increase trade. A gradual lifting of all trade barriers in the Arab countries is essential to create a bigger market with opportunities of trade based on comparative advantage as well as economies of scale (see sect. D-3 of the last chapter).

132. "Construction and housing in the West Bank and Gaza Strip" (UNCTAD/ECDC/SEU/4).

133. Ibid., p. 53; World Bank, "Developing ...", op. cit., vol. 5, p. 33.

134. Ibid., p. 39.

135. The Israeli official population statistics for the occupied Palestinian territory is based on the census which was conducted by the occupation forces in September 1967, and is updated annually by adding the reported births, subtracting the estimated deaths and adding or subtracting the balance of movements of population at the crossing points to Jordan and Egypt. This situation underestimates the population because of the following features:

- (i) The estimates are based on de facto population, including only those who are actually present during a certain year, and therefore, represent an underestimation by at least the number of people who do not return to the Palestinian territory during the year;
- (ii) When the census was taken, a significant proportion of the population was not present because of the war. Except for a very limited number of people who returned

under the "family reunion" arrangement, the majority of the "absent" population has not yet been allowed to return; and,

- (iii) The population of east Jerusalem and the surrounding villages is not accounted for in the Israeli statistics as a result of the annexation of the areas by Israel in 1967.

136. It is assumed that as of 1996, Palestinians from outside the territory will be added to the de facto resident population at a rate declining gradually from 3 per cent per annum of resident population to 1.5 per cent by the year 2010. These rates yield an average annual flow of net emigration of some 40,000 in the case of the West Bank, and 27,000 in the case of the Gaza Strip. Thus, by the year 2010, 600,000 Palestinians would have returned to the West Bank, and another 400,000 would have come back to the Gaza Strip, constituting together a total returnee population of 1 million. It is also assumed that the returning population will have the same age structure, fertility and mortality features as the resident population. It is important to note here that the population estimates of table IV-2 are based on Israel CBS population estimates of 1990, which is believed by most Palestinian sources to have a downward bias of between 300 to 500 thousand. This implies that UNCTAD's estimates of population for the period 1993-2010 (including returnees) is a conservative one. For various estimates of the population see: "Population and demographic development in the West Bank and Gaza Strip until 1990" (UNCTAD/ECDC/SEU/1), table 1.1, p. 57, and "Prospects ..." (UNCTAD/ECDC/SEU/6), op. cit.

137. This section draws on an unpublished report prepared for UNCTAD by Rami Abdul-Hadi, 1992.

138. These figures are taken from "Paper presented by the European Commission to the refugees working group to the Middle East peace process", 1995.

139. These figures are based on the assumption that the average household size is six and the average cost of a residential unit is between \$40,000-60,000 including residential infrastructure. In an unpublished paper entitled "Reparations and rehabilitation of Palestinian refugees", Ruth Klinov estimates the cost of resettlement of all camp dwellers in the West Bank and Gaza Strip to be around \$1.2 billion. Her lower estimate is based, however, on a large average household size (7.5), and very small average cost per residential unit (\$2,000). In a forthcoming publication by FAFO, Elia Zurick reports, based on a survey conducted in the fall of 1995, that average family size is 5.9 and average household size is 6.6. The World Bank mission reports, that in 1993, the least expensive housing unit in the West Bank sold for about \$45,000, in "Developing ...", op. cit., vol. 5, para. 7.12, p. 94.

140. This figure is a rough estimate based on taking certain percentage of the stock. A comprehensive survey of housing is needed in order to arrive at accurate figures.

141. For a detailed investigation of the services sector, reference is made to "Developments in the services sector in the West Bank and Gaza Strip, 1967-1990", (UNCTAD/ECDC/SEU/7).

142. See: "The Palestinian financial sector ...", op. cit., chapter II; World Bank, "Developing ...", op. cit., vol. 3, p. 93.

143. Ibid., p. 85.

144. Ibid.

145. In the West Bank, only 6 out of 58 practising accountants have received formal certificates either from Israel or abroad. The rest are allowed to practise on the basis of minimal one year training. Ibid., p. 49.

146. "Developments in the services ...", (UNCTAD/ECDC/SEU/7), op. cit., p. 31; World Bank, "Emergency assistance ...", op. cit, vol. 1, p. 76.

147. Ibid.

148. Ibid.

149. Many Palestinians who live in Europe and North America would also welcome the chance of spending their vacations in their land.

150. For a detailed account of restrictions and regulations imposed on the tourism industry, see: "The tourism sector and related services in the Palestinian territory under Israeli occupation" (UNCTAD/RDP/SEU/7), chapter II. The following table presents a picture of how important branches of the industry changed during the occupation.

Year	Travel Agents		Tour Guides		Tour Buses	
	Palestinian	Israeli	Palestinian	Israeli	Palestinian	Israeli
1967	47	35	206	N.A.	20	N.A.
1992	36	436	70	4,300	108	1,100

Source: World Bank, "Developing ...", op. cit., vol. 3, para. 1.60, p. 45.

151. Ibid., para. 1.56, p. 44.

152. Ibid.

153. "The tourism sector..." (UNCTAD/RDP/SEU/7), op. cit.
154. See: "Environment ..." (UNCTAD/ECDC/SEU/8), op. cit.
155. This subsection is based on a section of a report prepared for UNCTAD by Khawla Shakhshir Sabri, 1992 (unpublished).
156. World Bank, "Emergency assistance", op. cit., p. 84.
157. The plan identifies 29 programme areas in which health services might be improved. It estimates that by the year 2002 the resultant health care cost would range between 6.3 and 11.2 per cent of GDP, depending on the real rate of economic growth.
158. The projected rates of growth in per capita electricity consumption for the periods 1995-2000 and 2001-2010, are based on the average rate of growth in per capita electricity consumption observed in the West Bank during the last decade, i.e. 5.4 per cent and the expected increase in economic activities as specified in the two alternative scenarios for the two periods. This section draws on unpublished reports prepared for UNCTAD by Sameer Abu Eishah on prospects for development of Palestinian public utilities, 1992.

Table II-1. The resource gap, 1987-1993

	1987	1989	1991	1993
	(Percentage)			
Import surplus <u>a/</u>	54	59	51	43
Investment surplus <u>b/</u>	11	7	12	15
GDP/GNP	72	67	74	81
(1990 U.S. dollars)				
GDP per capita	1 336.0	1 070.4	715.3	1 035.9
GNP per capita	1 856.2	1 549.5	965.1	1 275.5

Source: Calculated from estimates by UNCTAD secretariat in "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip: a quantitative framework" (UNCTAD/ECDC/SEU/6).

a/ Defined as (Imports - Exports)/GNP.

b/ Defined as (Investment - National saving)/GNP.

Table II-2. The labour market imbalance, 1992-1994

	1992	1993	1994
Labour force (thousands)	317	329	370
Unemployment (%) <u>a/</u>	38	30	31
Employment in Israel <u>b/</u> (% of total employed)	36	27	26

Source: Calculated from "Report of the Director General, Appendix". ILO 82nd Session, 1995, and estimates of UNCTAD secretariat.

a/ This rate is calculated assuming no work in Israel.

b/ This assumes maximum employment in Israel.

Table II-3. The sectoral imbalance, 1992-1993

Comparative sectoral shares of GDP (Percentage)				
	Palestinian territory	Jordan	Egypt	Israel
Agriculture	5	6	18	2
Industry	9	27	30	22
Construction	13	7	NA	10
Services	53	59	52	65

Sources: - The figures for the Palestinian territory are calculated as an average of two years to smooth the olive cycle. They are based on estimates of the UNCTAD secretariat for the years 1992-1993.

- The figures for Jordan, Egypt and Israel are in current prices for 1991. They are taken from World Bank, Peace and the Jordanian Economy, 1994, table 1.2, p. 10.

- Data for Jordan are for 1991, taken from UNCTAD Handbook of International Trade and Development Statistics, 1994.

Note: NA - classified with other sectors.

Table II-4. Baseline scenario, 1995-2010

(i) Labour market imbalance

	1995	2000	2005	2010
Labour force (thousands)	369	436	516	600
Unemployment (%)	32	38	44	50
Employment in Israel (% of total employment)	30	28	26	25

(ii) Resource gap

	1995	2000	2005	2010
Import surplus <u>a</u> / (% of GNP)	37	36	35	33
Investment surplus <u>b</u> / (% of GNP)	16	15	15	13
GDP/GNP	78	79	80	80

(iii) Per capita product c/

	1995	2000	2005	2010
GDP per capita	749	753	760	711
GNP per capita	950	949	953	964

Source: (i) Calculated from "Prospects for sustained development of the Palestinian economy in the World Bank and Gaza Strip: a quantitative framework", (UNCTAD/ECDC/SEU/6), table 3/4, p. 38.

(ii) and (iii) Calculated from estimates of UNCTAD secretariat.

a/ Import surplus = Imports - exports.

b/ Investment surplus = Investment - savings.

c/ Per capita values are in US\$ 1990.

Table II-5. Baseline variant scenario, 1995-2010

(i) Labour market imbalance

	1995	2000	2005	2010
Labour force (thousands)	387	482	599	733
Unemployment (%)	20	26	33	39
Employment in Israel (% of total employment)	24	24	19	18

(ii) Resource gap

	1995	2000	2005	2010
Import surplus <u>a</u> / (thousands)	35	35	35	35
Investment surplus <u>b</u> / (% of GNP)	18	20	21	22
GDP/GNP (%)	83	87	86	87

(iii) Per capita product c/

	1995	2000	2005	2010
GDP per capita	1 095	1 223	1 246	1 290
GNP per capita	1 331	1 440	1 446	1 477

Sources: (i) Calculated from "Prospects for sustained development of the Palestinian economy in the World Bank and Gaza Strip: a quantitative framework", (UNCTAD/ECDC/SEU/6), table 3/6, p. 44.

(ii) and (iii) Calculated from estimates of UNCTAD secretariat.

a/ Import surplus = Imports - exports.

b/ Investment surplus = Investment - savings.

c/ Per capita values are in US\$ 1990.

Table III-1. Alternative scenario (without population return), 1995-2010

(i) Labour market imbalance

	1995	2000	2005	2010
Population (thousands)	2 034	2 793	3 677	4 636
Labour force (thousands)	423	606	854	1 127
Unemployment (%)	19	9	10	3
Employment in Israel (% of total employment)	30	17	12	9

(ii) Resource gap

	1995	2000	2005	2010
Import surplus <u>a</u> / (% of GNP)	35	49	40	22
Investment surplus <u>b</u> / (% of GNP)	20	39	29	17
Net transfer/GDP	8	30	19	4

(iii) Per capita product c/

	1995	2000	2005	2010
GDP/GNP	84	90	93	94
GDP per capita	1 203	1 630	1 865	2 273
GNP per capita	1 424	1 810	2 016	2 406

Sources: (i) Calculated from "Prospects for sustained development of the Palestinian economy in the World Bank and Gaza Strip: a quantitative framework", (UNCTAD/ECDC/SEU/6), table 4/5, p. 68.

(ii) and (iii) Calculated from estimates of UNCTAD secretariat.

a/ Defined as (Imports - Exports)/GDP.

b/ Defined as (Investment - Saving)/GNP.

c/ Per capita values are in US\$ 1990.

Table III-2. Alternative scenario (with population return), 1995-2010

(i) Labour market imbalance

	1995	2000	2005	2010
Population (thousands)	2 034	2 407	2 820	3 253
Labour force (thousands)	423	525	653	798
Unemployment (%)	19	9	5	2
Employment in Israel (% of total employment)	30	20	16	12

(ii) Resource gap

	1995	2000	2005	2010
Import surplus <u>a</u> / (% of GNP)	35	44	33	26
Investment surplus <u>b</u> / (% of GNP)	20	32	24	92
Net transfer/GDP	8	22	11	4

(iii) Per capita production c/

	1995	2000	2005	2010
GDP/GNP (%)	84	89	90	92
GDP per capita	1 230	1 603	1 827	2 244
GNP per capita	1 424	1 811	2 020	2 429

Sources: (i) Calculated from "Prospects for sustained development of the Palestinian economy in the World Bank and Gaza Strip: a quantitative framework", (UNCTAD/ECDC/SEU/6), table 5/1, p. 76.

(ii) and (iii) Calculated from estimates of UNCTAD secretariat.

a/ Defined as (Imports - Exports)/GDP.

b/ Defined as (Investment - Savings)/GNP.

c/ Per capita values are in US\$ 1990.

Table III-3. Proposed tax schedule for personal income

Taxable income a/ (U.S. dollars)	Rate (per cent)	Accumulated tax value	Average tax ratio
0 - 2 000	0	0	0
2 000 - 5 000	5	150	3
5 000 - 10 000	10	650	6.5
10 000 - 20 000	20	2 650	13.3
20 000 - 50 000	25	10 150	20.3
50 000 - above	30		

Source: Based on a study prepared for UNCTAD by Dr. Nidal Sabri, 1992.

a/ Taxable income is calculated after the following deductions:
 (i) \$1,000 for non-working wife; (ii) \$500 per child or dependent up to 5;
 (iii) medical expenses in excess of \$1,000 annually; (iv) inflation allowance;
 (v) other paid local income taxes.

Table III-4. **Proposed tax schedule for business income**

Business entities	Taxable income (U.S. dollars)	Rate (percentage)
Partnerships (with limited liability)	0 - 25 000	20
	25 000 - 50 000	25
	50 000 - above	30
Private corporation	0 - 50 000	25
	50 000 - above	30
Public corporation	0 - 100 000	25
	100 000 - above	30
Business owned by non-profit firms	100 000 - above	20
Financial institutions	100 000 - above	40

Source: Based on a study prepared for UNCTAD by Dr. Nidal Sabri, 1992.

Table III-5. A consolidated Palestinian central government budget for 1996
(millions constant 1990 U.S. dollars)

	Total		Per cent of GDP	
Total expenditure	669		23	
Current expenditure	483			
Development expenditure	216			
	(Potential)		(Probable)	
	Total	Per cent of GDP	Total	Per cent of GDP
Total revenue	435	14	227	7
Direct taxes	109		57	
Indirect taxes	175		91	
Non-tax revenue	151		97	
Deficit	264	9	472	16

Source: UNCTAD secretariat estimates.

Table III-6. Prospects for Palestinian trade, 1995-2010
(millions constant 1990 U.S. dollars)

	1995	2000	2005	2010
Agriculture exports	153	210	153	237
Agriculture imports	157	246	156	2
Industrial exports	281	313	282	366
Industrial imports	800	981	782	1 146
Merchandise trade balance	- 374	- 704	- 483	- 792
Trade deficit as percentage of GNP	20	16	17	4

Source: From an unpublished report prepared for UNCTAD in 1992 by Mahmoud el-Jafari on prospects for Palestinian merchandise trade.

Table IV-1. Comparison of sectoral composition of GDP, 1966 and 1987-1993

Γύρος	1966 % κκ	1987-1993 % κκ, % κκ, % κκ	1966 % κκ, % κκ, % κκ	1987-1993 % κκ, % κκ, % κκ
Αgriculture	15	15	15	15
Industry	15	15	15	15
Services	70	70	70	70
Construction	0	0	0	0

- Sources:**
- Antoine Mansour, "The West Bank economy". In The Palestinian economy, G.T. Abed (ed.), 1988, Routledge, London.
 - Calculated from UNCTAD secretariat estimates.
 - M. Syrquin, "Patterns of structural change". In H. Chenery and T.N. Srinivasan (eds.), Handbook of development economics, vol. 1, (North Holland, 1988), p. 247.
 - M. Todaro, Economic development, (Longman, 1994), p. 37.

a/ Services include construction.

Table IV-2. Production, employment and productivity in the Palestinian economy, selected years

	1975		1980		1991	
	(million constant 1990 US\$)	per cent	(million constant 1990 US\$)	per cent	(million constant 1990 US\$)	per cent
GDP	610.4	100.0	785	100.0	1 094.0	100.0
Agriculture	180.9	29.6	301.7	38.4	370.0	33.8
Industry	49.9	8.2	53.4	6.8	96.0	8.8
Construction	94.0	15.4	108.5	13.8	135.0	12.3
Services	285.6	46.8	321.4	40.9	493.0	45.0
	thousands	per cent	thousands	per cent	thousands	per cent
Employment	138.0	100.0	146.7	100.0	179.7	100.0
Agriculture	60.9	44.1	52.0	37.0	49.7	27.7
Industry	27.8	20.1	33.8	24.0	29.6	16.5
Construction	13.5	9.8	18.0	12.8	20.5	11.4
Services	35.8	26.0	36.9	26.2	79.9	44.5
	(constant 1990 US\$)	per cent	(constant 1990 US\$)	per cent	(constant 1990 US\$)	per cent
GDP/ employment	4 423.2	100.0	5 579.2	100.0	6 388.4	100.0
Agriculture	2 970.4	67.2	5 802.0	104.0	7 444.7	116.5
Industry	1 795.0	40.6	1 579.3	28.3	3 243.2	50.8
Construction	6 963.0	157.4	6 027.8	108.0	6 553.4	102.6
Services	7 977.7	180.4	10 075.2	180.6	6 170.2	96.6

Sources: Calculated from the following sources:

- UNCTAD secretariat, unpublished constant price series of Major Economic Aggregates 1987-1992.
- "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip: a quantitative framework", (UNCTAD/ECDC/SEU/6), table 1/1, p. 17.
- World Bank, "Developing the occupied territories", vol. 2, table 31, p. 165, table 33, p. 167, and table 35, p. 169.

Table IV-3. Estimation of population and expected demand for housing arising from new households formation and returnees, 1996-2010

Year	Population (thousands)	Units of new houses
1996	2 166	20 340
1997	2 307	21 662
1998	2 457	23 070
1999	2 616	24 569
2000	2 786	26 164
2001	2 481	11 835
2002	2 560	12 214
2003	2 642	12 605
2004	2 727	13 008
2005	2 814	13 418
2006	2 896	12 533
2007	2 980	12 920
2008	3 066	13 294
2009	3 155	13 680
2010	3 246	14 077

Source: Calculated in an unpublished report prepared for UNCTAD secretariat by Dr. Rami Abdel Hadi on prospects for development of construction and housing in the West Bank and Gaza Strip, 1992.

**Table IV-5. Contribution of the services sector to GDP, (selected years)
(As percentage of GDP at factor cost)**

Year	Public and Community services <u>a/</u>	Transport, trade and other services
1968	19.2	36.3
1975	15.6	30.2
1983	17.5	32.9
1987	12.6	37.6

Source: "Selected national account series of the occupied Palestinian territory, 1968, 1987", (UNCTAD/RDP/SEU/6).

a/ Including water and electricity.

**Table IV-6. Contribution of the services sector to employment,
selected years (percentage of total employed)**

Year	1968	1978	1988
Community and social services	12.2	13.2	11.4
Trade, restaurants and hotels	14.8	12.9	13.7
Transport, storage and communication	5.8	5.2	5.5
Others <u>a/</u>	6.0	4.7	5.6

Sources: UNCTAD "Selected statistical series on the balance of payments, foreign trade, population, labour force and employment of the occupied Palestinian territory (West Bank and Gaza Strip), 1968-1987", (UNCTAD/DSD/SEU/1); and ICBS, Statistical Abstract of Israel, (Jerusalem, 1990).

a/ Includes electricity and water as well as financial, business, and personal services.

Table IV-7. Forecast of water consumption for the West Bank and Gaza Strip, 1995-2010

(millions of cubic meters)

Scenarios	1995	2000	2005	2010
Without population return	73.8	101.1	137.6	183.8
With population return	73.8	117.3	179.4	261.9

Source: An unpublished report prepared for UNCTAD by Sameer A. Abu-Eisheh, 1992, on prospects for development of public utilities in the West Bank and Gaza Strip.

Table IV-8. A forecast of future electricity consumption for the West Bank and Gaza Strip, 1995-2010

(million kilowatt/hour)

Scenarios	1995	2000	2005	2010
Without population return	1 267	2 203	3 619	5 855
With population return	1 267	2 774	5 825	11 548

Source: An unpublished report prepared for UNCTAD by Sameer A. Abu-Eisheh, 1992, on prospects for development of public utilities in the West Bank and Gaza Strip.

Appendix (II-1)

INCOME DISTRIBUTION AND REGIONAL DISPARITY

The following section briefly describes the distribution of family income, while the subsequent section is devoted to the difference between the economic performance of the West Bank and Gaza Strip.

A. Distribution of income

There is no recent study on the distribution of personal incomes in the West Bank and Gaza Strip, but, according to a study reporting the findings of a survey carried out in the summer of 1985, the distribution of income is characterized by marked inequality and the spread of poverty.¹ Tables (A-1) and (A-2) summarize the findings of the study. The inequitable distribution of income is apparent from the fact that almost half of the population receives around 22 per cent of total income, whereas 2 per cent of the population accounts for 48.73 per cent of income. Table (A-2) classifies almost half (48.73 per cent) of the households as poor. This percentage is much higher than the estimates in a World Bank study for the region of the Middle East and North Africa (31 per cent).² The difference, however, should not be taken to imply that the extent of poverty is greater in the Palestinian territory than the region. The difference could be explained by the fact that the poverty line used by the World Bank study is considerably lower than that used by Abu Shukr.³ None the less, it is useful to compare the two, since they contrast local and global standards. In part, a higher poverty line used by local researchers is an indication of high expectations, and it magnifies the inequitable distribution of income.

The principal cause of the inequality is unemployment. More than half of the unemployed are located in the lower income and poverty groups. Another cause is the low rate of labour force participation, which reflects a very young population and a low female participation rate. Other contributory factors include a poor distribution of wealth (in particular land), large family size and the absence of a central authority which pursues redistribution policies and/or social welfare programmes.

Table A-1. Size distribution of income in the West Bank and Gaza Strip (1985)

Percentage of families	Percentage of Income
48.73	21.98
74.91	45.95
93.49	76.89
97.88	89.78
99.98	99.88
100.00	100.00

Source: Abu Shukr "Distribtution of income in the occupied territory, and its social impact". Paper prepared for the workshop on income distribution and its social impact in Jordan, Amman, September, 1988.

Table A-2. Distribution of family income in the West Bank and Gaza (1985)

Income Group	Percentage of Total
Families with monthly income JD601- and above	2.11
Families with monthly income JD401-600	4.39
Families with monthly income JD201-400	18.58
Families with monthly income JD101-201	26.18
Families with monthly income below JD101	48.73

Source: Abu Shukr "Distribution of income in the occupied territory, and its social impact". Paper prepared for the workshop on income distribution and its social impact in Jordan, Amman, September, 1988.

Most observers believe that this situation has worsened with the spread of unemployment resulting from the Israeli closure of borders since 1993. According to a recent study, only half the Palestinians employed in Israel in 1992 were still working in 1993.⁴ Two thirds of those who lost employment in Israel expressed a desire for more work. Less than one fourth of those who lost employment in Israel have found new employment in the domestic market.

B. Disparity in economic performance between the West Bank and Gaza Strip

The disparity between the West Bank and Gaza Strip pervades all economic activities. Column (1) of table (A-2) shows that between 1970 and 1990, GDP per capita in the West Bank was always higher than that of the Gaza Strip.

Table A-3. Comparison of domestic labour productivity in the West Bank and Gaza Strip a/

Year	(1) Ratio of GDP per capita <u>b/</u>	(2) Ratio of GDP per worker <u>c/</u>	(3) (1)/(2)
1970	1.25	1.05	1.19
1975	1.38	1.12	1.23
1980	1.46	1.15	1.27
1987	1.89	1.37	1.38
1990	2.19	1.70	1.29
1991	2.03	1.64	1.24

Sources: Calculated from "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip: a quantitative framework", (UNCTAD/ECDC/SEU/6), table 1/1, p. 17; and Hansmam et al., "Securing peace in the Middle East", Harward University, 1993, table 3.3., p. 75.

a/ In this table Palestinians working in Israel are excluded.

b/ This is GDP per capita of the West Bank over that in the Gaza Strip.

c/ This is GDP per worker of the West Bank over that in the Gaza Strip.

The difference in GDP per capita is generated by two factors: the differences in output per worker (productivity), and the differences in the rate of participation of the labour force. To identify the relative importance of these two factors, GDP per worker in the West Bank is divided by that of the Gaza Strip. This gives column (2) which is a measure of the relative productivity of the two regions. It shows that labour productivity in the West Bank has always been higher than that of the Gaza Strip. To obtain a measure of the relative importance of the participation rate, GDP per capita has to be purged from the influence of differences in productivity. Accordingly, GDP per capita in the West Bank is divided by that of the Gaza Strip while answering that the respective productivities of labour are equal. This is equivalent to dividing column (1) by column (2), which provides a measure of the relative difference in GDP per capita between the two regions due to factors other than differences in the productivity of

labour.⁵ For instance, in 1991 the West Bank's GDP per capita would have been 24 per cent higher than that of Gaza if the productivity in both had been equal. Since the actual GDP per capita in the West Bank in that year was more than twice the size of Gaza, the difference in productivity seems to be very large, and constitutes a more important factor in explaining the regional disparity than the different labour force participation rates.

Table (A-4). Total labour productivity in the West Bank and Gaza Strip

Year	(1) Ratio of GNP per capita <u>a/</u>	(2) Ratio of GNP per worker <u>b/</u>	(3) (1)/(2)
1973	1.26	0.97	1.30
1975	1.26	1.10	1.13
1980	1.23	1.13	1.64
1987	1.40	1.22	1.15
1990	1.80	1.50	1.20
1991	1.75	1.59	1.10

Sources: Calculated from "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip: a quantitative framework", (UNCTAD/ECDC/SEU/6), table 1/1, p. 17; and L. Hansmam, et al., "Securing peace in the Middle East", Harvard University, 1993, table 3.3, p. 75.

a/ This is GNP per capita in the West Bank over that in the Gaza Strip.

b/ This is GNP per worker in the West Bank over that in the Gaza Strip.

These differences do not translate into differences in standard of living between the West Bank and the Gaza Strip. GNP per capita is a more appropriate measure of living standards and table (A-4) replicates the calculations of table (A-3), using GNP instead of GDP, and total employment (domestic employment and employment in Israel) instead of domestic employment. This gives a much better picture of the productivity of labour in the Gaza Strip relative to that of the West Bank, because the productivity measure is an average of labour working in the domestic market and that working in Israel. This raises an important question concerning the large difference in domestic productivity between the West Bank and Gaza Strip. It cannot be explained by differences in investment between the two regions. In fact, the ratio of total investment (private and public) to GDP was higher in Gaza than in the West Bank over the whole period.⁶ The disparity might be explained partly by the fact that the share of industry in GDP is larger in the Gaza Strip than it is in the West Bank, and productivity in the industrial sector is extremely low relative to other sectors (see table (IV-2)). A better infrastructure in the West Bank might be another factor.

Notes to Appendix II-1

1. Abu Shukr, A., "Distribution of income in the occupied territory and its social impact. Paper prepared for the workshop "Income distribution and its social impact in Jordan", Amman, September 1988.

2. World Bank, World Development Report, 1990: Poverty, New York: Oxford University Press, 1990.

3. The World Bank study establishes two global poverty standards. Any person with an income in 1985 purchasing power parity (ppp) dollar below \$275 was categorized as "extremely poor" and those below \$370 were classified as "poor". According to these criteria, 31 per cent of the population of the Middle East and North Africa were classified as poor and 21 per cent as extremely poor. The percentages for South Asia were 61 per cent and 20 per cent, respectively. The two poverty lines are difficult to compare. The World Bank's is expressed in ppp dollars of individual income per year (\$370), while that of Abu Shukr's is in JD of household income per month (JD100). The latter figure is equivalent to an individual income of US\$ 51 per year, assuming that the average household size is 6, and using the average exchange rate for the year 1985, which was US\$ 1 = JD0.39. While this figure is considerably more than \$370, the difference would be even more pronounced if the \$512 is expressed in ppp dollars. This is not possible, however, since no estimates of PPPs exist for the Palestinian territory. Using the conversion of the JD will increase it substantially, while using the conversion of the Israeli Shekel will increase it slightly.

4. Geir Ovensen "Responding to changes: trends in Palestinian household economy", FAFO report 186, Oslo FAFO, 1993.

5. Let:
- G - GDP
 - p - population
 - L - Labour force
 - N - employment
 - 1 - West Bank
 - 2 - Gaza Strip

Then we can write GDP per capita for the West Bank and the Gaza Strip as:

$$(G_1/P_1) = [(G_1/N_1) \cdot (N_1/L_1) \cdot (L_1/P_1)] \quad (1)$$

$$(G_2/P_2) = [(G_2/N_2) \cdot (N_2/L_2) \cdot (L_2/P_2)] \quad (2)$$

Column (1) in the table is calculated by dividing (1) by (2)

to get:

$$(G_1/G_2) \cdot (P_2/P_1) \quad (3)$$

Column (2) is calculated by dividing (G_1/N_1) by (G_2/N_2) to get:

$$(G_1/G_2) \cdot (N_2/N_1) \quad (4)$$

Finally, column (3) is calculated by dividing (3) by (4) to get:

$$(N_1/P_1) \cdot (P_2/N_2) \text{ or}$$

$$(N_1/P_1) \cdot (N_2/P_2),$$

which is the ratio of the rate of employment in the West Bank and Gaza. Note that this ratio is what one gets if one divide GDP per capita in the West Bank (1) by GDP per capita in Gaza (2) provided it is assumed that $(G_1/N_1) = (G_2/N_2)$, that is if it is assumed that productivity in the two regions is equal. Then, column (3) in the table shows the relative differences in GDP per capita due to factors other than productivity (differences in labour force participation rate due to demographic and cultural factors).

6. For the years considered in the tables the ratio of investment to GDP in the two regions was as follows:

Year	West Bank	Gaza Strip
1972	.20	.24
1975	.20	.33
1980	.32	.34
1987	.30	.35
1990	.29	.51
1991	.30	.51

Source: "Prospects for sustained development of the Palestinian economy in the West Bank and Gaza Strip a quantitative framework", (UNCTAD/ECDC/SEU/6), table 1/1, p. 17.

Appendix (III-1)

MONEY SUPPLY AND MONETARY POLICY IN THE TRANSITION PERIOD

This Appendix presents a quantitative frame of the mechanism by which money supply is determined in the transition period, given the constraints of the monetary arrangements agreed upon between the Palestinian Authority and Israel on the one hand and the Palestinian Authority and Jordan on the other. The frame is used to explore some important issues in the monetary sector.

The following section presents the symbols to be employed in the frame, and the Balance Sheet of the PMA, deriving the equations for the monetary base (high powered money), and the money multiplier. The third section explores the effects of changes in the money supply over which the PMA has no control, as well as of changes which can be initiated by the PMA. The last section presents a balance sheet of a typical commercial bank, and outlines the problem of currency mismatching created by the double currency standard (both the Israeli Shekel and the Jordanian Dinar are legal tender during the transition period).

A. Symbols

A	Palestinian Monetary Authority (PMA)
B	Commercial banks operating in the West Bank and Gaza Strip
C	Currency
E	The exchange rate, the amount of Israeli Shekels which are equivalent to one Jordanian Dinar
FR	Foreign reserves held by the PMA
GD	The Palestinian National Authority Deposits held by the PMA
I	Israeli Shekel
IA	Israeli Shekel held by the PMA
IBC	Israeli Shekel held by commercial banks
IBR	Shekels held as required reserves with the PMA by commercial banks
IFR	Shekels held as free reserves by commercial banks
IC	Israeli currency in the Palestinian system
IBL	Loans of commercial banks in Israeli Shekels
IDD	Demand deposits of commercial banks - Shekel accounts
IOD	Other deposits of commercial banks - Shekel accounts
IOL	Other liabilities of commercial banks - Shekel accounts
IP	Israeli Shekel held by the Palestinian public
ir	The required ratio of reserves to demand deposits - Shekel accounts = IBR/IDD
J	Jordanian Dinar
JA	Jordanian Dinars held by the PMA
JBR	Jordanian Dinars held as required reserves with the PMA by commercial banks
JFR	Jordanian Dinars held as free reserves by commercial banks
JC	Jordanian currency in the Palestinian system
JBL	Loans of commercial banks in Jordanian Dinars
JDD	Demand deposits of commercial banks - Dinar accounts
JOD	Other deposits of commercial banks - Dinar accounts
JOL	Other liabilities of commercial banks - Dinar accounts
JP	Jordanian Dinar held by the Palestinian public

- jr The required ratio of reserves to demand deposits - Dinar accounts = JBR/JDD
LA Loans extended by PMA
MH Monetary base (high powered money)
MM The money multiplier
MS Money supply
NW Net worth of a commercial bank
OA Other assets of the PMA
OL Other liabilities of the PMA
ONA Other net assets of the PMA
SAM Securities issued by the Palestinian Finance Ministry and held by the PMA
SAB Securities issued by the Palestinian Finance Ministry and held by commercial banks

θ Proportion of currency held in Dinars

$\phi =$

a Proportion of total Jordanian currency held by the public

$\alpha =$

b Proportion of total Shekels held by the public

$\beta =$

$\gamma =$

B. The monetary base and the money multiplier

By using the above list of symbols, the Balance Sheet of the PMA can be set out as follows:

Balance Sheet of the PMA

<u>Assets</u>	<u>Liabilities</u>
FR	IBR, JBR
IA, JA	GD
LA	OL
SAM	
OA	

The Balance Sheet can be written as the following identity:

(1)

Using the definition of the monetary base as the sum of currency held by the public and reserves of commercial banks held at the PMA, and using the narrow definition of money supply as the sum of currency held by the public and the demand deposits of commercial banks, the following identities emerge:

(2)

(3)

both expressed in terms of Jordanian Dinars. The assumption is made that banks hold no excess (free) reserves. At any moment of time, the total amount of Jordanian Dinars and Israeli Shekels in the Palestinian system is a constant C, expressed in terms of Jordanian Dinar. Thus, it can be written

(4)

It is assumed that there is automatic currency convertibility in the system, and that at any moment of time is held in Dinars and in Shekels. Assuming to be a function of the expected exchange rate, , so it can write , with , which implies that money holders will increase their holding of Dinars when they expect a depreciation in the value of the Shekels.

Assuming, for the moment that is constant, the following can be written

(5)

Assuming that α is the proportion of total Jordanian currency held by the public, so

which implies

(6)

where $\beta = \frac{M_2}{M_1}$.

Similarly, let γ represent the proportion of total Shekels held by the public, so

which together yield

(7)

where $\delta = \frac{M_3}{M_2}$.

Substituting (6) and (7) into (5) results in

which can be written

(8)

where

From the definition of , it can be written

(9)

Substituting (8) and (9) into (2) and (3) the monetary base, , and the money supply, MS, can be written as

(10)

(11)

Dividing each equation by so

(10)'

(11)'

Dividing (11)' by (10)', allows the following to emerge:

(12)

C. Changes in the monetary base

The money supply could vary as a result of changes in the money multiplier or changes in the monetary base. Commencing with changes in the latter, monetary base can be written from equation (1) as

Since the PMA has no direct control over FR, IA and JA, what is left as variables under its control is government deposits, loans and the securities it holds for the Ministry of Finance. In particular, government deposits (GD) could be used as an instrument to effect changes in the monetary base, and consequently the money supply. This could be accommodated if the PNA uses the two deposits policy, according to which the PMA places part of the PNA account with commercial banks, so that charges on these accounts are translated

automatically into changes in its balance sheet and therefore changes of the monetary base. The use of loans and securities is constrained to a great extent by the PMA's limited capacity to create reserves and currency to satisfy the demand of commercial banks and the public. For instance, an increase in loans to commercial banks will increase the monetary base, but, ultimately, the increased loans will give rise to an increased demand for currency. If the PMA cannot meet this increased demand, it has to borrow either from the Central Bank of Israel or Jordan (depending on which currency is demanded). This borrowing will increase external debt.

The monetary base in this system of double currency standard system will also be sensitive to changes in the expected exchange rate. This can be demonstrated by substituting _____ into equation (10).

where _____. By taking the partial derivative of _____ with respect

to _____ the following is obtained.

Thus _____ . Since _____ and _____ and

_____, then _____ implying _____, and the monetary base increases

as a result of a depreciation of the Israeli Shekel if Palestinians hold a higher proportion of their Israeli money in the form of currency than they do with Jordanian money.

D. Changes in the money multiplier

The stock of money could also be altered by changes in the money multiplier. The money multiplier is given by equation (12) as

Taking the partial derivative of MM with respect to (jr) and (ir) the following is obtained,

which represent the traditional results of the impact of the required reserve ratios on the money multiplier.

Of more importance, is the analysis of the reaction of the money multiplier to changes in the expected exchange rate. Taking the partial derivative of M with respect to i yields,

Since $\frac{\partial M}{\partial i} > 0$, we can write,

- (i) if $\frac{\partial M}{\partial i} > 0$.
- (ii) if $\frac{\partial M}{\partial i} < 0$ if $\frac{\partial M}{\partial i} > 0$.
- (iii) if $\frac{\partial M}{\partial i} < 0$ if $\frac{\partial M}{\partial i} < 0$.

Result (i) implies that if the public and the banks treat the two currencies in the same manner, they are in effect one currency, and the exchange rate does not matter. Result (ii) implies that if the public treats the two currencies in the same manner, but the banks treat them differently, then a depreciation could increase (decrease) the monetary multiplier if the banks' reserve ratio on Shekel accounts is more (less) than in Dinar account. Result (iii) implies that if the banks treat the two currencies in the same fashion, and the public treats them differently, then a depreciation of the Shekel could increase (decrease) the money multiplier if the proportion of Jordanian money held in currency is greater (smaller) than the corresponding proportion for Israeli money.

E. Maturity transformation and the problem of currency mismatching

In reality, the impact of changes in the expected exchange rate on the monetary base and on the money multiplier, is stronger than that implied in the quantitative frame elaborated above. This is because banks usually carry higher reserves than that legally required, in the form of excess or free reserves (in the quantitative frame it is assumed that free reserves are zero, i.e. IFR = JFR = 0). The amount of these funds are usually modelled as a function of the interest rate, and risk parameters. In this case, the exchange rate is also important. Suppose that the Israeli Shekel is expected

to be devalued. Then, in order to avoid a loss, banks will not be eager to use Shekels deposits as loans, instead if they keep them at all it will be as free reserves. This reduces the supply of money.

The connection between the expected changes in the exchange rate and the amount of free reserves in the banking system, highlights the more serious and debilitating problem of double currency standard. It undermines the capability of the commercial banks to perform one of their important functions, namely, the transformation of maturity. This is easily demonstrated by considering the typical balance sheet of a commercial bank.

Balance Sheet
of
A Commercial Bank

<u>Assets</u>	<u>Liabilities</u>
IBC, JBC	IDD, JDD
IBR, JBR	IOD, JOD
IFR, JFR	IOL, JOL
IBL, JBL	
SAB	NW

Typically, savers want to save in short-term instruments so as to preserve liquidity. By contrast, borrowers often prefer to acquire long-term loans in order to finance their investment projects. Accordingly, it is most likely that IOD and JOD will be demanded in shorter-term instruments than IBL and JBL. In other words, banks permit savers to save "short" and investors to borrow "long" by carrying their assets in longer-term maturities than their liabilities. In the double currency standard, however, banks find it hard to perform this function of maturity transformation. The reason is that in doing so they run the risk of ending with liabilities denominated in the appreciated currency, and assets denominated in the depreciated currency. This risk is likely to induce banks to shy away from extending long-term loans to investors, and concentrate instead on short-run commercial loans. This behaviour is detrimental to investment and growth.
