REPORT ON UNCTAD'S ASSISTANCE TO THE PALESTINIAN PEOPLE

Prepared by the UNCTAD secretariat

Executive summary

By 2003, three years of continuous economic decline and widespread devastation had transformed the occupied Palestinian territory into a "war-torn economy". The economic legacies of war identified in comparative research on conflict economies are relevant in recognizing the true nature of the Palestinian economic predicament: structural deterioration and sustained negative growth; declining export capacity and emergence of an unsustainable trade gap; fiscal pressures as expenditures outpace revenues and the budget deficit widens; a shift towards non-traded activities and de-formalization of the economy; and deterioration of real incomes, per capita consumption and savings, greater external dependence and extended poverty. The income losses and sharp deterioration of physical and human capital between 2000 and 2003 and the performance of all sectors of the economy are consistent with this war-torn economy typology to an extent that renders such recognition essential to elaboration of policies and strategies for recovery and development.

The State of Palestine as envisioned in United Nations Security Council resolution 1397 (2002) should seek to benefit from all relevant development experiences and "international best practices" in the post-conflict phase. Economic development and trade policy must be grounded in a clear understanding of the implications of performing as a small, landlocked and war-torn economy, albeit one with a set of ambitious national objectives to achieve within the next few years. While still needed, relief assistance should no longer be addressed in isolation from development assistance. In this respect, the role of the Palestinian enterprise sector decimated by war and uncertainty acquires special significance. Enhancing its contribution to developmental relief should also be placed within the context of a cohesive development strategy, which takes into account the structural changes that have occurred in the economy. UNCTAD's technical cooperation activities for the Palestinian people continue to deliver concrete assistance to enable them to better address such challenges.
CONTENTS

Chapter                                    Page

I. THE WAR-TORN PALESTINIAN ECONOMY, 2000–2003 .............................................. 3
   A. Protracted conflict and war-torn economies ........................................... 3
   B. Macroeconomic performance and aggregate developments .......................... 5
   C. Private sector response to the crisis: Households and firms .................. 9
   D. Bridging relief and development: The role of the Palestinian private sector .... 12

II. UNCTAD'S ASSISTANCE TO THE PALESTINIAN PEOPLE ................................ 14
   A. Framework, objectives and completed activities ......................................... 14
   B. Operational activities underway .............................................................. 15
   C. UNCTAD response to the Palestinian economic crisis: Proposed new activities .... 16
   D. Resource mobilization, coordination and harmonization ............................ 17

Table 1  Palestinian economy (West Bank and Gaza Strip):
         Key indicators – selected years
Chapter I

THE WAR-TORN PALESTINIAN ECONOMY, 2000–2003

1. Even more than in 2002, when the secretariat presented its last report on UNCTAD's assistance to the Palestinian people, three factors impose a development challenge that is quantitatively different from the one faced so far. The first is the beginning of implementation of the international community's "Performance-based Road Map to a Permanent Two-State Solution to the Israeli-Palestinian Conflict", endorsed by both Israel and Palestine as the frame of reference for the coming period.1 To the extent that the parties succeed in taking the first steps, the road map process will immediately entail elaborating an "economic road map" which will have to be seriously addressed if the political process is to have a chance of succeeding. Second, the impact of the three-year conflict on the Palestinian economy has to be addressed. In the transition from a war-torn economy to a successful developing economy, the State of Palestine as envisioned in United Nations Security Council resolution 1397 (2002) should be able to benefit from worldwide experiences in appropriate (and inappropriate) policy packages to move the economy onto a sustained growth/development path. A third new challenge in the transition from the current confrontation mode to a post-conflict situation is to establish a more coherent, elaborate and prudent national development policy and strategy. In all these respects, UNCTAD's research and operational activities are relevant to its Palestinian counterparts, as demonstrated by the increasing call by the Palestinian Authority (PA) on UNCTAD for assistance, as reviewed in chapter 2.

A. Protracted conflict and war-torn economies

2. By mid-2003, the Palestinian people had endured decades of volatile and adverse conditions affecting their economic and social development: under Israeli military occupation and since 1994, limited Palestinian interim self-government, interspersed with periods of prolonged popular uprisings and violent confrontations, the most recent of which has spanned three years. To a degree not previously discernible, these conditions have effectively transformed the occupied Palestinian territory into a "war-torn economy" with most of the salient features of many war/conflict economies.2 Defining the predicament faced by the Palestinian economy in these terms is relevant because of several factors which continue to affect its performance:

- Accumulation of structural distortions and imbalances arising from skewed integration with the Israeli economy under prolonged occupation (1967–1993);
- Incomplete and fragile economic gains of the interim period (1994–2000); and
- Physical destruction and income losses throughout the economy experienced since the outbreak of sustained armed conflict in 2000.

3. Recent literature on the impact of war and conflict on developing economies stresses the profound changes they endure, which will not be reversed once hostilities cease.3 UNCTAD has analysed this war-torn economy typology through reference to 25 comparative indicators and actual Palestinian performance over the 1990–2003 phases of conflict affecting it. Although the 1990–1999 period saw some contrary trends, the Palestinian economy since
2000 has come to share many of the features of a variety of developing economies throughout the world, which have faced and surmounted conflict at considerable economic and social cost.

4. While a forthcoming secretariat study will take this comparative analysis further, the findings of an exhaustive study of 20 developing countries identify the main economic legacies of war, which are found to be mainly typical of the Palestinian economy since 2000. These are in addition to death and injury and heavy human costs which are incurred as a result of falling public entitlements affecting infant mortality rates, nutrition and health:

   - **(a) Structural factors:** dependence on a few export sectors; vulnerability to external shocks; deepening and widening poverty; intersectoral impact of war; prolonged uncertainty; physical destruction and degradation; and balance of payments disequilibria. *Economic growth is negatively affected across the board and human costs are incurred in shifts in infant mortality rates and nutrition levels;*

   - **(b) External constraints:** reduced export income growth; reduced absolute levels of exports; external resource flows (humanitarian aid, budget support) not determined by economic criteria; a build-up of debt levels with new borrowing to cover arrears; and emergence of parallel financial markets and dual price structures. *Export capacity tends to decline while import capacity is sustained and an unsustainable trade gap emerges;*

   - **(c) Fiscal constraints:** upward pressure on public expenditures; mismatch between nominal and real public resource allocations; and reduced public revenue base. *While government revenue's share of gross domestic product (GDP) can hold up in war, expenditure outpaces revenue and leads to growing budget deficits;*

   - **(d) Private sector (firms) response:** activities shift from traded to non-traded goods; heterogeneous response as corporations, public enterprises and small and medium-sized enterprises (SMEs) cut investment; capital flight with a portfolio shift from fixed to non-fixed and domestic to foreign currency assets; quasi-rent generation as composition of investment shifts away from productive uses. *Over a sustained period these factors combined can encourage a shift towards de-formalization of the economy;*

   - **(e) Private sector (household) response:** household consumption demand faces supply bottlenecks and leads to depressed inflation in the official market and open inflation in parallel markets; distribution of real household income deteriorates; the poor, with less access to quasi-rents and official welfare, pay for war; established employment patterns disintegrate; a "portfolio reallocation" of household labour resources and radical changes in labour participation. *As a result, falls in per capita consumption, accompanied by falls in domestic savings, lead to greater external (aid) dependence.*

5. Understanding the structure and the performance of the Palestinian economy within such a context helps to frame and analyse well-established problems and patterns from a new angle, suggesting useful lessons and implications. Simply put, the next "post-conflict" policy/aid package will have to be qualitatively different than those that accompanied previous recoveries from shocks and upheaval. The post-1993 euphoria and widely shared belief that a new era of Israeli–Palestinian-regional economic cooperation had begun called for a flexible and outward-oriented economic policy regime and an international assistance package that was in tune with the political prerogatives of the peace process. Even the 1996/1997 shocks to Israeli–Palestinian economic relations and the growing internal pressure
for improved PA performance were inadequate to press home the argument for major policy reform and re-orientation. The mixed economic and institutional development outcomes of the interim period, whereby the PA was not able by 2000 to achieve all that was expected or hoped, were further degraded by the rapid deterioration in the situation beginning in October 2000. And while PA and international attention since has been fully preoccupied with the humanitarian emergency, the deeper development costs incurred have yet to be taken into account.

6. Accordingly, the coming phase of economic rehabilitation and "peace-building" in the region cannot simply take as its goal a return to the pre-2000 situation, whose shortcomings paved the way for events witnessed since. While still needed, humanitarian and relief assistance should no longer be addressed in isolation from development assistance. Similarly, instead of simply aiming to reform a Palestinian authority that was only intended to serve for a limited, interim period, efforts should be geared to the formation of the vision, policies and institutions for an independent, democratic and viable State of Palestine, as called for in United Nations Security Council 1397 (2002) and the above-mentioned Road Map. In this respect, the new State of Palestine should seek to benefit from all relevant development experiences as well as "international best practices".

7. Alongside the political/security steps of the Road Map, a series of "economic facilitation measures" have been proposed by the PA for action by Israel to rapidly alleviate constraints, which have intensified since 2000. Meanwhile, economic development and trade policy should be grounded in a clear understanding of the implications for the new State (during Phase III of the Road Map, within its provisional borders) of performing as a small, landlocked, war-torn and not fully sovereign economy, albeit one with a set of ambitious national economic and political objectives to achieve within the next few years. In the same vein, international development cooperation for the Palestinian people requires more than ever that it be demand-driven - by an empowered and technically capable Palestinian Government and a vibrant, rebuilt market economy - towards a vision of desirable development, determined by the Palestinian people themselves.

B. Macroeconomic performance and aggregate developments

8. Restrictions on the movement of goods and people caused by the closure policy and the economic contraction have had profound socio-economic ramifications through sharp falls in private and public consumption, investment, exports and labour income from Israel. These changes have further reinforced structural weaknesses arising from prolonged occupation and increased vulnerability. Palestinian economic performance has exhibited a downward trend since the outbreak of confrontations in September 2000, with the slowdown intensifying since March 2002 as Israeli security measures and the internal and external closure policy imposed on the Palestinian territory have intensified. Palestinian gross domestic product (GDP) declined by more than 22 per cent in 2002, adding to the 24 per cent loss in 2001 (see table 1). Projected growth for 2003 is also negative. In real terms, in the last three years the Palestinian economy has foregone all the growth it had achieved in the preceding 15 years, with real GDP today below its 1986 level. Furthermore, the loss of national income since September 2000 has reached $5.4 billion, more than the gross national income (GNI) generated in the whole of 1999. Consequently, GNI per capita has fallen to 46 per cent of its 1999 level, reaching $755 in 2002. As a result over two million Palestinians in the occupied territory are now living below the poverty line of $2 per day, while the average annual
unemployment rate has reached an unprecedented level over 40 per cent, with rates in the Gaza Strip exceeding 50 per cent.7

9. In addition to direct income losses, the physical damage suffered by the Palestinian economy from September 2002 until April 2003 is estimated at $370 million, with a cumulative total of $1.1 billion since October 2000.8 This is constituted by damage to the private and public infrastructure, establishments, equipment and utilities, and represents a sharp reduction in the existing capital stock and, therefore, a contraction in the economy's domestic supply capacity. This imposed erosion of productive capacity, coupled with the closure regime and the sustained decline in income, is effectively creating a subsistence economy heavily dependent on agriculture and the informal sector in the form of petty services, and commercial and rent-seeking activities. The remnants of the Palestinian manufacturing sector lack access to the credit required for capital replacement and are faced with prohibitively high production and transaction costs to the extent that they are increasingly unable to compete domestically with imports from Israel.

10. The impact of war is also reflected in the shift experienced in the structure of the economy. With more than 27,000 jobs lost in the manufacturing sector, the latter's contribution to the economy declined from 16 per cent in 1999 to an estimated 14 per cent in 2002. Construction lost half of its share in GDP, down to 6 per cent by 2002. Agriculture, on the other hand, managed to increase its contribution to the smaller economy of 2002; its share in GDP grew from 11 per cent in 1999 to 15 per cent in 2002. Similarly, the share of public administration and other services increased from 42 per cent to 45 per cent. Commerce and tourism contracted at a rate in line with that of the economy and therefore maintained a share around 14 per cent of GDP. This suggests that while the economic and employment impact of the ongoing crisis was most severe in the manufacturing and construction sectors, agriculture and public administration were able to withstand the pressures of sustained decline and maintained minimum levels of employment and aggregate demand, thus shielding the economy from complete collapse.

11. Undoubtedly, an economic crisis of such a magnitude has undermined the livelihood and welfare of all segments of Palestinian society. However, and against all the odds, the Palestinian economy continues to function, though on a much lower scale. There appear to be three main reasons for this: (a) the resilience that Palestinian society has shown and the informal safety nets and innovative responses it has developed to deal with the crisis - probably the most remarkable factor of all; (b) the ability of the PA to operate and to employ almost one-third of those who are currently working; and (c) the increase in disbursements of donor support for budgetary solvency, relief and development efforts.
### Table 1
Palestinian economy (West Bank and Gaza Strip): Key indicators – selected years

<table>
<thead>
<tr>
<th></th>
<th>1995</th>
<th>1999</th>
<th>2000</th>
<th>2001&lt;sup&gt;Est.&lt;/sup&gt;</th>
<th>2002&lt;sup&gt;Est.&lt;/sup&gt;</th>
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<td></td>
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<tr>
<td>GDP – million US$</td>
<td>3 225</td>
<td>4 201</td>
<td>4 108</td>
<td>3 138</td>
<td>2 308</td>
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<tr>
<td>GNI – million US$</td>
<td>3 699</td>
<td>4 932</td>
<td>4 793</td>
<td>3 528</td>
<td>2 594</td>
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<tr>
<td>GDP per capita US$</td>
<td>1 299</td>
<td>1 391</td>
<td>1 304</td>
<td>951</td>
<td>671</td>
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<tr>
<td>GNI per capita US$</td>
<td>1 490</td>
<td>1 633</td>
<td>1 522</td>
<td>1 069</td>
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<tr>
<td>Real GDP growth (%)</td>
<td>6.1</td>
<td>8.6</td>
<td>-5.6</td>
<td>-24.4</td>
<td>-22.1</td>
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<tr>
<td>Real GNI per capita growth (%)</td>
<td>7.9</td>
<td>4.1</td>
<td>-10.7</td>
<td>-26.8</td>
<td>-22.7</td>
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<tr>
<td>Domestic absorption (% of GDP)</td>
<td>147.0</td>
<td>160.0</td>
<td>152.4</td>
<td>153.0</td>
<td>155.0</td>
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<td>Inflation (CPI – annual %)</td>
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<td>5.5</td>
<td>2.8</td>
<td>1.2</td>
<td>5.7</td>
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<td><strong>Population and labour</strong></td>
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<td></td>
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<tr>
<td>Population (millions)</td>
<td>2.48</td>
<td>3.02</td>
<td>3.15</td>
<td>3.30</td>
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<tr>
<td>Unemployment (% of labour force)</td>
<td>18.2</td>
<td>11.8</td>
<td>14.1</td>
<td>25.5</td>
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<td>Total employment (thousands)</td>
<td>417</td>
<td>588</td>
<td>597</td>
<td>508</td>
<td>486</td>
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<td>In public sector</td>
<td>51</td>
<td>103</td>
<td>115</td>
<td>122</td>
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<td>In Israel and settlements</td>
<td>68</td>
<td>135</td>
<td>116</td>
<td>70</td>
<td>50</td>
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<td><strong>Fiscal balance</strong></td>
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<td></td>
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<tr>
<td>Government revenue</td>
<td>13.2</td>
<td>23.7</td>
<td>23.1</td>
<td>8.6</td>
<td>13.0</td>
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<tr>
<td>Current expenditure</td>
<td>15.3</td>
<td>22.5</td>
<td>29.1</td>
<td>34.9</td>
<td>43.4</td>
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<tr>
<td>Total expenditures</td>
<td>25.5</td>
<td>29.9</td>
<td>34.3</td>
<td>41.9</td>
<td>52.2</td>
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<tr>
<td>Recurrent balance</td>
<td>-2.1</td>
<td>1.2</td>
<td>-5.9</td>
<td>-26.3</td>
<td>-30.4</td>
</tr>
<tr>
<td>Overall balance</td>
<td>-12.3</td>
<td>-6.2</td>
<td>-11.1</td>
<td>-33.3</td>
<td>-39.2</td>
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<tr>
<td><strong>Balance of payments</strong></td>
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<tr>
<td>Exports of goods and services</td>
<td>499</td>
<td>684</td>
<td>657</td>
<td>329</td>
<td>197</td>
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<td>Imports of goods and services</td>
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<td>2926</td>
<td>2103</td>
<td>1671</td>
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<tr>
<td>Trade balance (% of GDP)</td>
<td>-52.0</td>
<td>-63.6</td>
<td>-55.2</td>
<td>-56.5</td>
<td>-63.9</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td>-19.7</td>
<td>-31.7</td>
<td>-21.0</td>
<td>-21.2</td>
<td>-24.0</td>
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<tr>
<td>Trade balance with Israel (million US$)</td>
<td>-1388</td>
<td>-1644</td>
<td>-1583</td>
<td>-1268</td>
<td>-1047</td>
</tr>
<tr>
<td>Trade balance with Israel (% of GDP)</td>
<td>-43.0</td>
<td>-39.1</td>
<td>-38.5</td>
<td>-40.4</td>
<td>-45.4</td>
</tr>
<tr>
<td>Current account balance with Israel (% of GNI)</td>
<td>-21.1</td>
<td>-14.3</td>
<td>-15.8</td>
<td>-22.7</td>
<td>-27.1</td>
</tr>
<tr>
<td>Imports from Israel /PA private consumption (%)</td>
<td>56.5</td>
<td>52.4</td>
<td>52.5</td>
<td>50.4</td>
<td>54.5</td>
</tr>
<tr>
<td>Total PA trade with Israel/total Israeli trade (%)</td>
<td>3.9</td>
<td>3.9</td>
<td>3.0</td>
<td>2.3</td>
<td>1.8</td>
</tr>
<tr>
<td>PA trade with Israel/total PA trade (%)</td>
<td>79.6</td>
<td>68.5</td>
<td>73.4</td>
<td>73.9</td>
<td>74.0</td>
</tr>
</tbody>
</table>

**Sources:** All data exclude east Jerusalem; historical data are obtained from the Palestinian Central Bureau of Statistics; Israeli trade data are obtained from the Israeli Central Bureau of Statistics, Monthly Bulletin of Statistics; data for 2001 and 2002 are estimated by the UNCTAD secretariat on the basis of historical data and IMF estimates, February 2003. Total Palestinian and Israeli trade data refer to goods, and non-factor and factor services.
12. With domestic absorption at more than 150 per cent of GDP, Palestinian trade statistics indicate a persistent deficit with a high degree of dependence on, and excessive leakage of economic resources to, one partner. Although both imports and exports have declined as result of the crisis, the decline in exports was faster than in imports. The Palestinian trade deficit is estimated at $1.475 million in 2002, some one-third less than in 2000, and its ratio to GDP has reached 64 per cent, 9 points above the average for the period 1995–2000. The current account balance, which includes labour income from abroad and current transfers, shows a lower estimated deficit of 24 per cent of GDP in 2002, which is not far from its historical average for the period 1995–2000. These data confirm a high degree of resource leakage to the outside world, which needs to be reversed in order to enhance the effectiveness of donor funding in the development process. Indeed, during the period 1995–2000 about 30 per cent of Palestinian exports were re-exports, a fact which suggests, along with other features of export composition, an overall low-value-added component in Palestinian exports.

13. The total value of Palestinian trade (including labour services) in 2002 represented less than 2 per cent of the total value of Israeli external trade (compared with over 5 per cent 10 years ago). However, Palestinian trade with Israel represented 74 per cent of the total value of Palestinian trade (compared with 90 per cent 10 years ago). These figures highlight the growing insignificance of trade with the Palestinian economy to the more advanced Israeli economy, which occupies a totally different position in the global economy. This implies a need to re-examine the imperatives for integration, which were so decisive in designing the interim period (semi-customs union) Israeli–Palestinian trade regime. These data also reflect the degree of vulnerability of the Palestinian economy to external shocks, such as the impact of Israeli trade liberalization in the 1990s or Israel’s shift towards employing non-Palestinian foreign workers, demand for whom has reached hundreds of thousands. This vulnerability is increased and PA policy space for avoiding such shocks is reduced by the absence of a national currency and the impossibility of resort to monetary and exchange rate policy.

14. Palestinian dependence on the Israeli economy is also clear from the share of Palestinian imports from Israel in domestic private consumption, which is estimated at 55 per cent in 2002. Meanwhile the Palestinian trade deficit with Israel accounts for 71 per cent of the overall trade deficit. From the trade and fiscal deficit financing point of view, these figures suggest that some 70 per cent of foreign borrowing (mainly donor support funds in this case) required to finance lopsided merchandise bilateral trade pays for Israeli imports. The most revealing statistic in this regard is the ratio of the Palestinian trade deficit with Israel to Palestinian GDP. For 2002 this figure is estimated at 45 per cent, which means that for every dollar produced domestically, 45 cents are channelled to the Israeli economy. The implication for Palestinian development and employment generation programmes is significant, as it cannot be expected under the present circumstances that donor funds injected into the Palestinian economy would have a noticeable positive income multiplier effect in the Palestinian territory. On the contrary, a positive multiplier effect of these funds would be felt in the Israeli economy.

15. The fiscal conditions created by the crisis are also typical of the characteristics of a war-torn economy with reduced revenue, increased pressure on spending and heavy reliance on deficit financing. The PA deficit mushroomed from 6 per cent of GDP in 1999 to 39 per cent in 2002. While expenditure rose from 30 per cent in 1999 to 52 per cent in 2002, revenues collapsed from 24 per cent of GDP to 13 per cent of GDP. On the expenditure side, the
spending needs of the PA have increased since 2000 as a result of spreading poverty, the large number of casualties and the physical destruction caused by Israeli incursions. On the revenue side, the decline was driven by two factors: (a) contraction of the domestic tax base and deterioration in tax collection administration; and (b) withholding of customs, excise and value added tax (VAT) revenue collected by Israel on behalf of the PA.

16. The fiscal deficit in 2002 was financed by $464 million of donor budgetary support, mostly from the League of Arab States (LAS), as well as from the European Union and the World Bank. Despite this budgetary assistance, the PA accumulated payment arrears to private sector suppliers totalling $415 million, and debt of $65 million to domestic banks. By the end of 2002, Israel still withheld PA revenue estimated at $700 million, and its release is one of the few explicit economic measures contained in the Road Map. Meanwhile, Israel has resumed monthly flows of clearance of current PA revenue. Since the PA has cut non-wage expenditure to line ministries in its 2003 budget by about 50 per cent, it is expected that the PA fiscal balance will improve in 2003. However, the viability of its budget will critically depend on the accelerated release of withheld tax revenues and sustained donor financing.

17. In addition to short-term domestic debt, the PA had accumulated by the end of 2002 external debt amounting to $855 million, which is the disbursed outstanding debt out of total loan commitments of $1,236 million. The largest part of this debt was accumulated in the last three years, with more than 47 per cent lent by LAS for budgetary support in 2002. Although almost 75 per cent of external debt is to multilateral creditors, debt service will become an additional budget burden. Even with most loans still within the grace period, interest/service payments grew from $1.4 million in 1998 to $3.8 million in 2002, with accumulated arrears of $2.4 million. At present levels, debt-service projections show a steep increase in future obligations to foreign creditors. Principal and interest payments will amount to $28 million in 2004 and increase to $55 million by 2007. For this reason, and because many of the projects financed by debt were either made necessary by the crisis or damaged during it, it may be expected that the PA will request creditors to consider forgiving outstanding debt. Such a move would be in line with approaches advocated for other war-torn economies, and could help the PA in addressing relief needs while re-establishing a focus on development priorities in the post-conflict reconstruction stage.

C. Private sector response to the crisis: Households and firms

18. The continuous decline in incomes since 2000 has effectively exhausted Palestinian households’ coping strategies, rendering poverty and destitution common. By the end of March 2003, households’ median monthly income had reached its lowest level since October 2000, registering a 44 per cent decrease. Around 47 per cent of households have lost more than 50 per cent of their income and those living below the poverty line ($390 per household of six per month) accounted for 63 per cent of Palestinian society in March 2003.

19. The reduction of expenditure on basic needs has become the main strategy for nearly 70 per cent of households. Indeed, households cut consumption of food by 86 per cent over the period March 2002–March 2003, and delayed payments for utility services by 60 per cent. At the same time, households are becoming heavily indebted, with 63 per cent reliant on borrowing from family and friends to maintain their subsistence. The crisis has also forced 20 per cent of families to resort to such "erosive coping strategies" as selling productive assets and jewellery, thereby depleting their subsistence base in an irreversible manner. Moreover,
child labour is emerging as another mechanism against vulnerability, reducing future productivity and increasing the likelihood that poverty will be transmitted across generations. According to one source, resort to child employment doubled from 10 per cent of households in December 2001 to 20 per cent in December 2002, as more children were taken out of school to contribute to family income.\textsuperscript{16} Under such circumstances, 42 per cent of families were destitute by the end of March 2003, having become reliant on humanitarian assistance to maintain their subsistence.\textsuperscript{17} Only 16 per cent were found to be capable of withstanding the adverse situation for another year, while 79 per cent were in dire need of assistance.

20. At the firm level, the impact of falling incomes is compounded by the unprecedented restrictive measures, with a debilitating impact on the economy's development prospects. In particular, these measures have increased transport costs, particularly in the West Bank, rendering trade activities prohibitively expensive. The consumer price index (CPI) for transport and communications in these areas registered a 22 per cent annual increase by the end of 2002.\textsuperscript{18} Traders accrue significant costs in the form of damaged goods, being forced to use alternative long, winding and unsafe routes to circumvent internal closures. Meanwhile, Palestinian enterprises are facing the threat of losing their market share, especially to Israeli companies that have easier access to domestic markets.\textsuperscript{19} Enterprises participating in international trade accrue additional costs in view of the tightened transport procedures at crossing points with Jordan, Egypt and Israel, which limit the types of vehicles and routes that Palestinian enterprises can use.\textsuperscript{20} Furthermore, Palestinian enterprises lack financial leverage in view of the banking sector's strict lending policies.\textsuperscript{21}

21. Palestinian enterprises have a limited capacity to withstand the consequences of such an adverse economic environment. The economy is dominated by micro-scale, family-owned enterprises employing fewer than five persons. These constituted around 90 per cent of total registered operating enterprises in 1999, and they employed around 56 per cent of the labour force in the private sector. Small-scale enterprises employing 5–9 persons represented around 9 per cent of all enterprises and absorbed 28 per cent of the domestic labour force in the same year, while medium-sized enterprises employing 20–50 persons were less than 1 per cent of all enterprises.\textsuperscript{22} Around 90 per cent of enterprises are involved in traditional manufacturing labour-intensive activities, including food and beverages, furniture, footwear, textiles, apparel and fabricated construction materials. These had a low capital/labour ratio of $6,320 in 1999, a limited asset base of $433 million and a low net investment ratio of less than 1 per cent after depreciation.\textsuperscript{23} Moreover, most of these enterprises are heavily reliant on Israel for obtaining raw materials and equipment: the textile sector, for example, obtains up to 86 per cent of its raw materials from Israel.\textsuperscript{24}

22. Enterprises involved in high-value-added activities constitute a minority, and are concentrated in the pharmaceuticals, textiles, food processing and information technology (IT) sub-sectors. These are technology-rich industries and have a high capitalization base, estimated at $1.9 billion in 2002.\textsuperscript{25} In the same year only 232 enterprises participated in international trade. These are dominated by medium-sized enterprises, mainly involved in manufacturing activities, information technology and services.\textsuperscript{26} The protracted conflict has aggravated the structural weaknesses of these enterprises, thereby undermining the supply capacity of the industrial sector as a whole.

23. According to a survey of SMEs conducted in 2002 by the Palestinian Central Bureau of Statistics (PCBS) and the UNCTAD secretariat, the decline in the number of persons
employed by small enterprises in manufacturing, construction, hotels and restaurants and real estate from June 2001 to June 2002 ranged between 14 and 27 per cent, while the reduction in total compensation ranged between 30 and 43 per cent. Enterprises involved in the textiles sector were particularly badly affected, with a drop of 27 per cent in total employment and 42 per cent in total compensation. The number of persons engaged in small-sized hotels and restaurants as well as in the real estate sector remained unchanged, although the level of compensation of the former declined by 31 per cent. The number of persons employed in medium-sized enterprises recorded a slight decrease, except for the mining and quarrying sector, which registered a 17 per cent decline in employment and a 25 per cent decline in compensation. In contrast, medium-sized manufacturing enterprises involved in food and beverages recorded a 13 per cent increase in total employment and a 36 per cent increase in total compensation, this growth reflecting an increase in the demand for the outputs of these sectors as Palestinians replaced Israeli products with local products where possible. Enterprises involved in capital-intensive activities (e.g. IT and pharmaceuticals) were found to be more resistant to the widespread economic crisis.27

24. However, the ability of larger firms to persevere did not compensate for the significant overall contraction in the average size of Palestinian enterprises and the expansion of the micro-enterprise sector employing fewer than five persons. According to a survey conducted in 2001, the number of micro-enterprises increased by 28 per cent between 2000 and 2001, while the number of small enterprises (employing 5–9 persons) decreased by 29 per cent.28 The number of small enterprises employing 10–25 persons also decreased by - 24 per cent and number of medium enterprises, employing 26–50 persons, decreased by 49 per cent. Large enterprises were also hard hit, with their number declining by 48 per cent.

25. Another pervasive coping strategy is the reduction of working hours. The average number of working hours in enterprises covered by the latter survey dropped from 11 hours before the crisis to 6.23 by the end of 2001. Consequently, more than 60 per cent of enterprises were utilizing only 30 per cent of their production capacity by October 2002, thus creating further upward pressure on already inflated production costs.29 Moreover, more enterprises are using Israeli-registered vehicles to transport their goods to nearby villages and cities to protect their market share.30 Some, particularly wholesalers, resort to building up inventories in order to ensure prompt delivery of goods, while others have built or rented new storage facilities in different locations in the West Bank in order to secure access to major cities and villages.31 Enterprises involved in foreign trade are also using Israeli vehicles to transport goods to and from factories, at a rental cost that is significantly higher than that incurred by using factory-owned trucks.32

26. These responses, coupled with the high degree of uncertainty, have led to significant decreases in investment activities and a fall in the number of registered new companies by around 21 per cent between 2000 and 2002.33 Around 19 per cent of SMEs covered in the PCBS/UNCTAD survey had cancelled their expansion plans by June 2002, while 23 per cent decided to postpone such plans, hoping to implement them once stability is attained. This has resulted in reducing the industrial sector’s asset base, with a consequent limitation of the growth prospects of enterprises. By the end of 2001, the gross fixed capital formation of SMEs had decreased by 25 per cent compared with 1999.34 Seventeen per cent of enterprises surveyed exhausted all coping strategies and were forced to shut down by September 2002.35
D. Bridging relief and development: The role of the Palestinian private sector

27. As emphasized in UNCTAD's 2002 report, the PA supported by the international community should seek to link emergency relief assistance to long-term development objectives in order to strengthen the economy's resilience and set it on the path of sustained recovery. The private sector has an important role to play in this respect, in its capacity as the main source of new investments, jobs and income. Indeed, experiences of other war-torn economies show that unless the private sector rebuilds and strengthens its supply capacity, neither reconstruction nor subsequent growth will be broad-based and poverty will remain widespread and intense. However, private sector development has so far been receiving little attention from the donor community, ranking last in terms of total commitments and disbursements. The share of this sector in total donor disbursements is estimated at only 14 per cent over the period 1999–2001, equivalent to around $152 million.

28. The widespread economic crisis has demonstrated the urgent need to carefully evaluate certain aspects of future development strategies and policies. Notable in this respect are the speed and the sequencing of trade liberalization. The initial disruptive effects of such policies may effectively undermine reconstruction efforts through weakening the ability of the private sector to respond. Of equal importance is the necessity of paying close attention to the quality and composition of growth, and not only to its rate. If anything, the high rates of growth in the years immediately prior to the crisis were mainly generated by unsustainable sources of income arising from donor assistance and the export of labour services to Israel.

29. The policy issues involved are complex and wide-ranging, encompassing macro aspects such as fiscal and trade policies as well as sectoral policies such as the management of the financial sector. For the purpose of this report, it suffices to note a few issues which have become especially prominent in the light of the current crisis. Foremost in this respect is the necessity of designing a sectoral/industrial policy to guide the rehabilitation and development of the decimated Palestinian enterprise sector and to supplement such a policy with the appropriate labour upgrading, investment incentives and institutional infrastructure programmes which target the specific sector/s capable of assuming the role of the "engine of the economy" as well as the strategically important sector/s. Within this context the PA will need to set sectoral priorities and to develop its new trade and labour policies based on an economic vision with quantifiable, time-bound, achievable and sector-focused objectives.

30. Such a strategic framework should also take political conditions into consideration, and while the quantifiable objectives should change according to the prevailing political and security conditions, the sectoral priority and focus should be maintained. This will help to consolidate relief efforts towards achieving quantifiable targets even under politically unstable conditions. So far, the PA has focused mainly on development of its trade policy in isolation from industrial policy. If anything, in the absence of synergies between the two tracks, it would be difficult to recreate markets and employment or attract the required level of investments. Such synergies would allow for targeting specific sectors with support measures, while setting the stage for new activities leading to the diversification of the industrial base towards products with higher value-added in line with sectoral priorities.

31. Enhancing the private sector's contribution to developmental relief should also be placed within the context of a cohesive development strategy, one which takes into account the aforementioned structural changes that have taken place in the economy. Among the major
development challenges resulting from these changes is the inflated unemployment rate, owing to which a sizeable proportion of those who lost their jobs may not be able to rejoin the work force once stability is achieved. This is particularly the case of those previously employed in Israel, whose skills are geared to satisfy Israeli labour market needs, especially in the area of construction. To this should be added the depleted capacity of the industrial base and the damaged commercial networks and trade infrastructures.

32. Critical to the rehabilitation of the private sector are recovery and expansion of the export base to generate the foreign exchange income necessary for providing current imports, reducing economic leakage, undertaking debt service and eventually financing the investment required for growth. Of equal importance is the strengthening of market support institutions, especially those targeting SMEs, in addition to developing schemes for financing these enterprises. Indeed, SMEs played a leading role reconstructing and modernizing the European economies following the Second World War, particularly Germany and Italy. Palestinian SMEs can play a similar role during both the reconstruction and development phases.

33. Another issue is the need to reconsider current labour policies. Indeed, the skills of a significant proportion of the Palestinian labour force may become obsolete with the restructuring of the economy during the next phase of growth. Unless the labour force is provided with retraining and appropriate skills upgrading for the job markets of the future, the economy will continue to generate high unemployment. Labour policy needs to establish a framework for developing human capital in line with the sectoral priorities of the development strategy while creating a safety net for the unemployed and the poor. This could be achieved through establishing a comprehensive unemployment benefits package, including unemployment insurance, subsidized loan programmes for the unemployed and venture businesses, as well as retraining programmes.

34. SME support programmes, in the context of a comprehensive development strategy, require first and foremost clearly identified sectoral priority and objectives, rehabilitation of PA institutions and concerted action by the different actors involved, including the private sector, non-governmental organizations, donors and the international development agencies. In the short run, SMEs provide an important source of employment, given the low level of costs associated with job creation in those enterprises, particularly in labour-intensive activities. In the long run, they constitute a sustainable seedbed for new activities, especially in the area of IT and other knowledge-based services.
Chapter II

UNCTAD'S ASSISTANCE TO THE PALESTINIAN PEOPLE

A. Framework, objectives and completed activities

35. In accordance with the provisions of the United Nations Medium-Term Plan for 2002–2005, paragraph 167 of the Bangkok Plan of Action, and General Assembly resolutions 56/111 and 43/178, UNCTAD has intensified its assistance to the Palestinian people, in close cooperation with Palestine. Since the start of UNCTAD's technical cooperation with the PA in 1995, research and operational activities have expanded to most areas of UNCTAD's competence. The secretariat's programme provides concrete assistance with a view to building capacities for effective economic policy-making and management and strengthening the enabling environment for the private sector. Accordingly, technical cooperation with the PA focuses on four clusters: (a) trade policies and strategies; (b) trade facilitation and logistics; (c) finance and development; and (d) enterprise, investment and competition policy.

36. UNCTAD assistance to the Palestinian people seeks to respond to the PA's goal of building the institutional capacity and infrastructure required for a viable market-based economy capable of generating sustained growth. In coordination with other international agencies, the secretariat has responded positively to PA requests for assistance with specific interventions in its areas of competence, which were effective in supporting the PA's efforts towards achieving its goals. However, the crisis since 2000 and the severe economic difficulties it created have imposed a new reality, which requires promoting dynamic synergies between rehabilitation, reconstruction and strategic development needs. This frame of reference helped to guide UNCTAD’s technical assistance programme in 2002–2003.

37. The intensification of the conflict in the occupied Palestinian territory has interrupted the development process and rendered the provision of technical assistance increasingly difficult, especially in view of the restrictions on the mobility of trainees and project staff and on the field access of UNCTAD experts. Despite these conditions, UNCTAD was able, through a selective and flexible mode of operation, to complete the first phase of a key technical assistance project and achieve concrete progress in four others, as detailed below. Although field conditions forced termination of secretariat research on a "Palestinian master plan for developing trade in services within a multilateral context", in response to a request by the PA UNCTAD contributed to an initiative to support the Palestinian olive oil industry through international trade and targeted market access. Furthermore, at the request of the PA, the secretariat provided advisory services (mainly at a distance), in the form of recommendations, observations, a mission and reports, on several areas of economic policy and trade. Specifically, economic policy advice was provided in the following areas:

- Proposals for "Israeli economic facilitation measures" submitted by the PA as part of confidence-building measures;
- A World Bank study on long-term policy options for the Palestinian economy;
- Trade and development policy studies underway at the Palestinian Economic Policy Research Institute (MAS);
- A PA road map towards compliance with the multilateral trading system;
- Economic Policy Programme (EPP) studies on tariff policy options for Palestine.
B. Operational activities underway

38. **Trade policy and strategy**: Consultations between the secretariat and the Ministry of National Economy (MNE) have intensified, with UNCTAD providing "fast-response" advisory services in the above-mentioned areas aimed at highlighting for Palestinian policy makers the implications of possible alternative trade policy arrangements consistent with present economic conditions and a liberalizing trade policy framework. MNE is also discussing with the secretariat the possibility of implementing the next phase of the PA Economic Policy Programme (EPP IV). Meanwhile, an UNCTAD training programme to support the launching of the PA National Task Force on WTO Accession is the subject of discussions between MNE and potential donors.

39. **Trade facilitation and logistics**: Significant progress was achieved in this area under the Preparations for ASYCUDA – Phase I project for the General Directorate for Customs and Excise of the PA, funded by the World Bank through the Palestinian Economic Council for Reconstruction and Development (PECDAR). The ASYCUDA++ prototype was finalized by the national team in close cooperation with UNCTAD, all planned activities under Phase I thus being completed at the end of 2002. With funding expected from the European Union, preparations are underway to implement Phase II, which entails installation of the prototype system in the customs headquarters in Ramallah and at two pilot border PA customs sites.

40. Moreover, the secretariat continued advisory and mobilization activities with **Trade Point Palestine Ramallah (TPPR)** in cooperation with the Palestinian Trade Centre (Paltrade), the private-sector host organization. Following a request by Paltrade, an advisory mission was fielded to review and further develop TPPR services, and ensure that they are fully integrated into the Paltrade service structure and that they address both the immediate and longer-term needs of the Palestinian business community. Fresh funding is sought for follow-up activities, including training and the extension of the operation of the Trade Point to Gaza and introduction of business trade facilitation tools. In addition, the secretariat completed a technical study, to be published in 2003, on strengthening trade facilitation in the areas of transit trade and maritime transport.

41. **Finance and development**: The UNCTAD secretariat and the PA Ministry of Finance (MoF) have made significant progress in the implementation of the project **Strengthening capacities in debt monitoring and financial analysis (DMFAS)**. Two advisory missions by a senior international debt expert have been undertaken since 2002. The system is now fully operational and the debt database is updated on a regular basis; staff have been trained and have participated in the DMFAS annual meeting in Geneva. The first issue of a debt statistics bulletin has been finalized, draft manuals, regulations and procedures of the General Directory of Loans have been prepared and a Public Debt Bill is being drafted. A comprehensive study on debt strategies and policies to guide the PA policy framework, and efforts in the areas of debt management and loan negotiations, will be initiated in the coming months.

42. The secretariat is preparing to implement a new technical assistance project for MNE and the Ministry of Labour, in close cooperation with the International Labour Office (ILO) and MAS, to build capacity in the use of quantitative and econometric modelling techniques to inform the design of national trade, labour and macroeconomic policies. The integrated
analytical and quantitative framework to be produced by this collaborative project will be installed in PA economic planning and policy research institutions in 2004.

43. **Enterprise, investment and competition policy:** The secretariat has made steady progress under support for small and medium enterprise (SME) development (Empretec) with the holding of two Entrepreneur Training Workshops (October 2002 and July 2003) and completion of a statistical survey of Palestinian SMEs in close cooperation with the Palestinian Central Bureau of Statistics (PCBS). The results of the survey will be used by the secretariat in a comprehensive study on the development prospects of the Palestinian enterprise sector, to be published soon. The study will be used by the Empretec team for defining the Palestinian entrepreneurial profile, adapting follow-up services to the local business environment and sectoral needs, and assisting the PA in designing support policies for this sector. The secretariat has also consulted with the PA on technical assistance needs in the area of competition policy.

C. **UNCTAD response to the Palestinian economic crisis: Proposed new activities**

44. As indicated earlier, realities on the ground require promoting dynamic synergies between rehabilitation, reconstruction and strategic development – a bridge between relief and development processes. Combined with international efforts to ensure implementation of the Road Map, this imperative will guide UNCTAD’s assistance activities for the Palestinian people. In close consultation with the PA, the secretariat has prepared for the undertaking of targeted technical cooperation in the following areas, for which donor support is sought:

45. **Food security through international commodity trade:** Building on UNCTAD expertise, sustainable food security can be addressed through promoting financing mechanisms for farmers’ export activities; access to international market information and channels; international trade finance facilities; and developing commodity storage facilities.

46. **Trade promotion, logistics and facilitation:** In collaboration with the International Trade Centre UNCTAD/WTO (ITC), UNCTAD can assist the PA in developing appropriate strategies for improving supply-chain management. UNCTAD will also continue to assist, through Paltrade/TPPR, in preparing and disseminating information on export opportunities and linking Palestinian enterprises with regional and international export promotion agencies. Furthermore, the secretariat could examine options for routing Palestinian trade through neighbouring regional seaports; establishing a temporary maritime landing facility in Gaza; and installing automated security clearance systems to reduce clearance time at borders.

47. **Trade policy, preferential market access and regional cooperation:** UNCTAD could assist the PA in developing an agenda for obtaining the special and differential treatment accorded to the least developed countries (LDCs). Meanwhile, as Palestine considers the possible benefits of observer status at the WTO and membership of the Arab Free Trade Area, UNCTAD’s previous advisory services to the PA in trade policy can serve as a useful basis for any further technical assistance that it may require.

48. **Investment promotion:** UNCTAD could cooperate with the Palestinian Investment Promotion Agency (PIPA) to design and implement an investment retention programme aimed at providing services to existing enterprises in coping with and surviving the present crisis.
49. **Institutional capacity of the domestic insurance sector**: In association with the MoF, the secretariat could develop a programme to support the regulatory, institutional and human capacity of the insurance sector in Palestine.

**D. Resource mobilization, coordination and harmonization**

50. In the design and implementation of its work programme, the secretariat has maintained close contacts with relevant international organizations, especially ITC, the United Nations Relief and Works Agency for Palestine Refugees (UNRWA), the United Nations Special Coordinator for the Occupied Territories (UNSCO), the International Labour Office (ILO) and the World Bank, as well as with research centres and civil society institutions. UNCTAD technical assistance to the Palestinian people has benefited from generous extrabudgetary support to UNCTAD from the Governments of Belgium, Italy, the Netherlands, Norway and the United Kingdom, as well as from UNCTAD's LDC Trust Fund and the World Bank. Meanwhile, the United Nations Development Programme (UNDP) has continued to extend indispensable logistical and liaison field support to UNCTAD staff, experts and project personnel.

51. In its most recent effort to build strategic partnerships with other international agencies involved in assistance to the Palestinian people, UNCTAD is collaborating actively with ESCWA, ILO, UNDP, UNSCO, LAS and other agencies in preparing for an Arab and international “Palestine Rehabilitation and Development Forum” aimed at mobilizing Arab Governments and civil society in Palestinian reconstruction and development programmes and State-building efforts. ESCWA plans to convene the Forum in early 2004 and a preparatory process involving Palestinian, Arab and international organizations and experts is well underway. UNCTAD also continues to contribute to UNSCO inter-agency activities, and in November 2002 the secretariat provided substantive observations on the United Nations Humanitarian Action Plan of Action for the Occupied Territories.

52. The secretariat has also continued to make contributions at relevant seminar and symposia, including the MAS "Conference on enhancing the local capacity of the Palestinian economy and improving economic cooperation with Arab countries", Ramallah, 10–11 June 2003; the University of Aix-en-Provence and European Union "Seminar on the potential for economic cooperation in the Middle East: The Israeli-Palestinian perspective", Paris, 13–15 June 2003; and the United Nations "Seminar on assistance to the Palestinian people", Geneva, 15–16 July 2003.
Notes

1 In accordance with the relevant General Assembly resolutions and decisions, the term "Palestine" in this report refers to the Palestine Liberation Organization, which established the Palestinian Authority (PA) following the 1993–1994 accords with Israel. References to the "State of Palestine" are consistent with the vision expressed in Security Council Resolution 1397 (2002) and the "Road Map".

2 In accordance with the relevant General Assembly resolutions and decisions, references in this report to the occupied Palestinian territory pertain to the Gaza Strip and West Bank, including east Jerusalem. For purposes of brevity, the term "Palestinian territory" is also used as appropriate. Unless otherwise mentioned, data on the Palestinian economy in this report apply to the Gaza Strip and West Bank, excluding east Jerusalem.

3 From the wide selection of relevant literature on this topic, the most recent contributions may be found in F. Stewart and V. Fitzgerald (eds), *War and Underdevelopment*, Oxford, Queen Elizabeth House, 2001; and T. Brück., A. Grigsby and V. Fitzgerald, "Enhancing the private sector contribution to post-war recovery in poor countries", Working Paper Number 45 (1). Oxford, Queen Elizabeth House, July 2000. This section draws mainly from the latter.

4 UNCTAD, "The Palestinian war-torn economy: Bridging relief and development", forthcoming.

5 Brück, Grigsby and Fitzgerald, op. cit., pp. 10–11.

6 On the basis of the UNCTAD Palestinian integrated database, estimated 2002 real GDP in 1997 US dollars was $2,514 million, while that of 1986 was $2,930 million.

7 According to the more restrictive (ILO) definition of unemployment, which excludes those no longer seeking work, the annual average rate for the West Bank and Gaza in 2002 was around 31 per cent, which is also a new peak.


9 Domestic absorption is total domestic (as opposed to aggregate) demand: the sum of private and public consumption and investment. A ratio of domestic absorption to GDP larger than one means that the economy's productive capacity is unable to satisfy domestic demand and the gap is filled by imports.

10 "Leakage" reflects the degree to which economic resources are channelled out of the economy to the rest of the world through the persistence of the current account deficit. The larger the deficit, the higher the degree of leakage and the higher the degree of dependence on imports to satisfy domestic demand. The important issue in the case of Palestine is that a substantial portion of this leakage is in the direction of Israel.

11 With Israeli per capita GDP 15.4 times larger than the Palestinian level in 2000, this gap had widened from its level of 13.5 in 1995.


15 Ibid.


17 PCBS, op. cit.


20 UNCTAD, "The Palestinian war-torn economy: Briefing relief and development", forthcoming.

22 PCBS, "Number of establishments and employees by employment size category in the Palestinian Territory", unpublished data, Ramallah.
24 Based on PCBS/UNCTAD survey of Palestinian SMEs. The survey covers a stratified random sample of SMEs involved in mining and quarrying, manufacturing activities, construction, hotels and restaurants and real estate activities. The sub-sectors were selected on the basis of their contribution to total employment and output. The sample size comprised 782 enterprises, representing 21 per cent of total SMEs involved in these activities (3,762 enterprises). The results of the survey will be published in a forthcoming study on the development prospects of Palestinian SMEs.
26 Palestine Trade Center (Paltrade), "Palestinian exporting companies: Assessment of damage incurred by the Palestinian exporting companies during the 2000–2002 period", Ramallah, September 2002.
30 For example, the cost of transporting goods from Ramallah to Nablus using an Israeli-registered vehicle tripled from NIS 400 per shipment in early 2000 to NIS 1,200 in February 2003. See UNSCO, "Closure, Palestinian productive activities and short to medium-term policy options", annual report 2002, Gaza, April 2003.
34 PCBS, unpublished statistics.
35 FPCCIA, "Role of small businesses in the Palestinian economy and impact of recent Israeli economic sanctions and measures", Jerusalem, December 2001.
38 PCBS, unpublished statistics.
39 This was particularly the case of Mozambique, where the manufacturing sector was unable to compete with the flood of imports resulting from the rapid and radical trade liberalization during the early stages of reconstruction efforts. Brück, Grigsby and Fitzgerald, "Enhancing the private sector contribution to post-war recovery in poor countries", Working Paper Number 45 (1), Oxford, Queen Elizabeth House, July 2000.
40 Ibid.
41 Ibid.