Digging

Out

The Economics of Palestinian Independence

By Glenn Yago and James Prince

When there's too much of nothing, it just makes a fella mean.
Oh, when there's too much of nothing, no one has control.
— Bob Dylan

Every American president since Harry Truman has cobbled together a plan to resolve the Israeli-Palestinian conflict, and each of these plans has ended up in the ashcan of history. President Bush, the latest American leader to play the optimist on Israeli-Palestinian relations, conceived the current "road map" to peace as leading toward a two-state solution and peaceful coexistence. This map's prospects differ from its predecessors, in part because what's happening on the ground below the diplomats' radar may have more to do with outcomes than the ongoing vagaries of Palestinian and Israeli politics will. While the idea of physical disengagement goes against the grain for some, it is the best hope for the sort of economic development that will give Palestinians a powerful stake in an enduring peace.

By its very nature, the impending Israeli disengagement plan changes the status quo, creating opportunities to lessen political friction by helping the devastated Palestinian economy move toward sustained viability. An economic road map defined by common Palestinian-Israeli interests could, as a practical matter, make a bigger difference than another toss of the political dice.

Donor and public-sector investments – at the top of the agenda of ways to buffer the political pain of compromise for the Palestinians – are hardly optimal vehicles for aiding enduring economic expansion in a market economy. Donor grants are usually made with administrative strings intended to replace market discipline, but do little to help private investors to build a knowledge base or management expertise.

©LARRY TOWELL/MAGNUM PHOTOS

Additionally, they are often undermined by bureaucratic imperatives that lead to slow, inefficient allocation of funds; in recent years, one-fourth of some $1.2 billion in donor money for the Palestinian Authority has gotten stuck in the pipeline. One issue for Palestine, then, is how to get the money tap turned on without damaging efforts to impose market-like discipline on development projects.

Engaging the private sector in shaping regional economic development could overcome the limits of dependence on central governments. While political negotiations are often viewed as zero-sum games – what we win, you lose – economic cooperation can benefit both sides and enhance trust. Moreover, the private sector can have a timelier impact where it counts most: creating jobs and income.

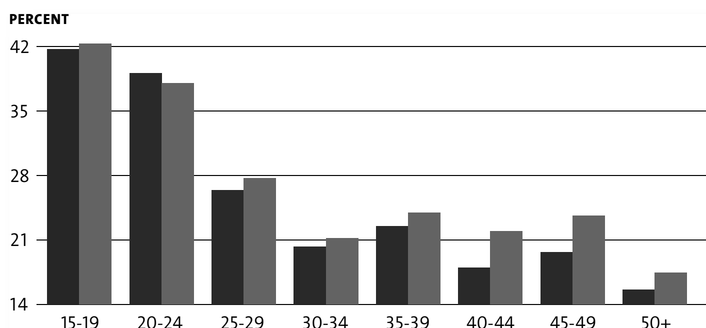
The past four years have been dismal for the Israeli economy. But Palestinians have suffered far more than their Israeli counterparts, experiencing a one-third decline in average incomes. When the history of this long, low-intensity phase of the Israeli-Palestinian conflict is written, the accounts will emphasize how tribalism led to politics trumping basic human necessities. Time is running out to create economic arrangements to save the two-state solution to the conflict – the solution to which the principals are, in theory, committed.

PALESTINE'S DREADFUL NUMBERS

	1999	2000	2001	2002	2003	2004	2005 (est)
GDP ($billion U.S.)	4.2	4.1	3.3	2.8	3.1	3.3	3.4
GDP per capita ($US)	1,590	1,410	1,090	880	930	930	900
Real GDP growth (%)	8.8	-5.6	-14.8	-10.1	6.1	2.7	1.8
Cumulative real GDP per capita change since 1999 (%)	–	-9.6	-26.5	-37.2	-36.8	-38.2	-40.0
Poverty (%)	20	27	37	51	47	48	54
Unemployment (%)	12	14	26	31	26	27	28

SOURCE: World Bank

PALESTINIAN AUTHORITY UNEMPLOYMENT, BY AGE GROUP



SOURCE: Palestinian Authority – PCBS

THE ECONOMICS OF THE INTIFADA

The Palestinian recession that began in 2000, the result of a fresh round of open conflict, was the worst in its modern history, driving one resident in two into poverty. Meanwhile the population was growing at a 5.2 percent annual rate, adding new dependents to the destitute economy at an astonishing rate. Over one-third of Palestinians now survive on cash remittances from friends and family abroad.

Crisis upon crisis linked to violence led to a significant decline in production. Manufac-

GLENN YAGO is director of capital studies at the Milken Institute and Senior Koret Knesset Fellow supervising financial-reform projects in Israel. JAMES PRINCE is president of the Los Angeles-based Democracy Council and consultant to the Palestine Investment Fund.

turing output in the Palestinian territory is down 52 percent since 2000, while labor productivity tumbled by 47 percent over the same period. With borders intermittently closed and business disrupted by both fighting and shortages of critical supplies, exports declined by 45 percent. Unemployment among men 15 to 24 stands at 43 percent even after the modest economic uptick since 2003, while roughly 70 percent of males who reached working age during the intifada are now jobless. The Palestinian Authority has become the employer of last resort, with 22 percent of the work force on its rolls. Yet the Authority's cash crunch limits the ability to pension off excess employment.

The ill-developed financial sector, already burdened by nonperforming loans to commercial banks equivalent to 7 percent of GDP, is further strained by a failing pension system. Loans relying on land for collateral are often unavailable because title to much of the land is poorly documented. Banks, short on capital, are loath to bear risks, leaving most businesses with no place to borrow.

Crisis-driven economic deterioration is self-reinforcing. With little money to spend on infrastructure, the quality of drinking water is being compromised, aquifers are being depleted, and wastewater treatment is becoming ever more problematic. By the same token, budget constraints have cut higher education spending by more than one-third.

The Palestinian economy, it should be noted, would have to grow at a spectacular rate just to sustain current living standards. Total fertility rates – the average number of births for women of child-bearing age per woman – are 6.9 in Gaza and 5.6 in the West Bank, among the highest in the world. Indeed, the mathematics of Palestinians' population boom is daunting: the cohort that will be entering the labor force over the next 10 years is seven times larger than the cohort that will be exiting. Thus, without rapid economic growth, the fate of both Palestinians and Israelis looks grim.

©NAYEF HASHLAMOUN/REUTERS/CORBIS

The Palestinian economy would have to grow at a spectacular rate just to sustain current living standards. Total fertility rates are among the highest in the world.

SEPARATION VERSUS INTEGRATION

If the collapse of the Oslo accord represented

the death of the liberal dream of reconciliation between Israelis and Palestinians, the apparent success of the Sharm el Sheikh summit last February seems a step toward separation – if not divorce. One big question, then, is how to accomplish this separation without undermining a peace built on mutual economic self-interest.

Almost all Oslo-driven visions of a Palestinian state as a viable economic entity were premised on the eventual integration of the Palestinian and Israeli economies. A political settlement, it was assumed, would lead to a free flow of goods, labor and capital between Israel and the Palestinian state. But the intifada has led to a reconsideration of the united-we-stand-divided-we-fall assumption that was really driven by the long occupation of the West Bank and Gaza. And, in our view, it would serve neither Israelis nor Palestinians to cling to the integration idea. Indeed, we believe that the normalization of economic relations between two independent states will depend on an agreement that facilitates trade and capital flows, but does not attempt to integrate labor markets.

Look closely, and it becomes clear that Palestinians' economic dependence on Israel before the intifada was a mixed blessing. During the Oslo period (1993-2000), real GDP of the Palestinian economy grew by 20 percent – a seemingly reasonable number until one remembers that explosive population growth actually led to a reduction in output per person of 8 percent. By the same token, the higher wages paid to Palestinians by Israelis certainly pleased the recipients. But it also put pressure on both wages and prices within the territories, making it more difficult for homegrown Palestinian enterprises to take root or for Palestinian businesses to compete in foreign markets other than Israel.

Prior to the intifada, Palestinian garment workers earned the equivalent of $300-350 per month, far more than their counterparts in Jordan ($110 per month) and Egypt ($60-80 per month) earned. These wage differences could not be justified by productivity differences. Indeed, labor productivity in Palestinian firms was just 40 to 45 percent of that of countries on other continents at comparable stages of development.

SOURCES OF COMPETITIVE ADVANTAGE

We believe a future Palestine could find advantage in its weaknesses – as Israel has long done. Like Israel, Palestine lacks natural resources, but has a wealthy diaspora, a cultural commitment to education and strong entrepreneurial and trading traditions vital to a modern, skills-based economy. Palestine could also capitalize on the good will and proximity of the Arab world; if it built efficient capital markets, Palestine could become a financial and commercial-services center for the Arab East.

With peace (and external funding), the construction and construction-materials industries could be jump-started through investment in roads; buildings; and infrastructure, including desalination plants, sewage works and water transport. By the same token, the country has favorable conditions for high-value agriculture – fruits, vegetables and the like. Technology transfers from Israel, a country that has figured out how to grow food and fiber in unlikely places, could dramatically improve Palestinian agricultural productivity.

It's important here to emphasize that developing strong economic ties between a new Palestinian state and Arab countries would serve the interests of the Israelis as well as the Palestinians. A trade and aid commitment from other Arab nations would lessen the de-

©JOCK FISTICK/THE IMAGE WORKS

Palestine lacks natural resources, but has a wealthy diaspora, a cultural commitment to education and strong entrepreneurial and trading traditions vital to a modern, skills-based economy.

pendence on Israel that, in the long run, limits Palestine's economic prospects. Arab states, along with the United States and Europe, could also institute preferential trade and tariff agreements to spur employment and production.

Arms-length tourism agreements between Israel and Palestine, which made it convenient to visit both Israel and Arab sites in single trips, could also play an important role in driving economic development and job creation. Tourism is, after all, a labor-intensive industry with great potential for mopping up the large and rapidly growing numbers of unemployed Palestinians.

Finally, we believe that industrial border parks (inside Palestine) would facilitate technology transfers without integrating the two economies and would help to absorb redundant Palestinian labor. These parks might well focus on intermediate and finished products with export potential for global and regional trade.

GETTING PRACTICAL

At the April 2005 Milken Institute Global Conference in Los Angeles, we asked a spectrum of business and political leaders from

the United States and the Middle East to brainstorm ways in which business could effectively privatize the peace process. They identified a series of concrete development projects designed to set precedents for Israeli-Palestinian cooperation.

"Ring fencing" – the walling of specific assets or liabilities in a financial transaction – offers a useful metaphor here. Ring-fencing measures are typically intended to insulate a corporation from the potentially riskier activities occurring elsewhere in the market, thereby permitting productive activities to take place.

The creation of markets for primary and secondary mortgages would stimulate homeownership and urban renewal.

Traditional donors and government bureaucracies are simply not capable of facilitating profit-making endeavors. Far better, then, to leverage donor funds by using them to wall off private projects from the systemic risks of attempting to make peace between Israelis and Palestinians. To this end, donors could prove credit enhancement and risk insurance, as well as underwriting the planning for private investment.

A wide variety of donor-enhanced initiatives was suggested at the Global Conference discussions.

Water Infrastructure. A handful of specific river basin projects would have an immediate impact on living standards in Palestinian cities and villages, as well as provide water for agricultural and industrial needs.

Infrastructure. Natural gas production, electricity co-generation, and alternative-fuels production would all decrease Palestine's energy costs and reduce the need to spend scarce foreign exchange on imports. These projects would also generate stable, predictable revenues that could be used to finance capital costs through private borrowing.

Trade, Tourism and Transportation. Here, we would include interurban rail, sea, and, eventually, air facilities, as well as destination tourism at religious, archeological and recreational sites.

Housing Construction and Finance. The creation of markets for primary and secondary mortgages would stimulate homeownership and urban renewal, as well as mop up unemployed construction craft workers.

CAPITAL IDEAS

Even carefully refined projects, designed to harvest the low-hanging fruit first, won't get off the ground unless the current credit crunch in the Palestinian territories is ended by giving banks both the tools for coping with risk and the profit incentives to resume lending. At the moment, there is no coordination of training and technical assistance, post-loan monitoring or underwriting standards and procedures in the credit markets.

By the same token, there has been little effort to date to employ the many successful models for raising investment funds in high-risk environments. Among the possibilities: partnerships with international companies for private concessionaires to run public facilities, privatization of public utilities ranging from power generation and distribution to border-logistics management and venture capital funds for targeted growth sectors like pharmaceuticals and food processing. One bright spot: with support from Washington, the Palestine Investment Fund and Palestin-

ian Authority Finance Ministry will soon launch a new investment fund to place risk capital into the region. The fund may commence operations as early as summer of 2005. It is expected that the Palestine Investment Fund will contribute as much as $100 million to support projects such as those suggested above.

Establishing a strong legal and regulatory infrastructure for the Palestinian Authority's financial markets is, of course, a prerequisite for leveraging donor funds for project finance. And there is much to be done – for example, companies based in Gaza are not listed on the Palestinian Securities Exchange. Creating diverse securities that could be traded at low cost, possibly with enhanced credit via donor funding, would increase the total pool of cash for development projects. Note, moreover, that investors in Israel, Palestine and Jordan have already responded favorably to the expectations of peace and uninterrupted commerce. Stock prices have more than tripled in the former two since the April 2003 road map agreement, and risen by more than half in Jordan.

©LARRY TOWELL/MAGNUM PHOTOS

THE WINDOW OF OPPORTUNITY

Despite good intentions, donor-driven development programs in the context of war and Israel's tight embrace of the Palestinian economy offer little evidence of past progress – and, for that matter, little evidence that they can make much difference in the future. But disengagement will soon be a reality, and with it, perhaps will come the final opportunity to identify and support specific development projects for the Palestinian economy. The question now is whether the parties to the attempt to build lasting peace on the rock of economic development will be up to the challenge. Success, we believe, lies in the pragmatic use of the economists' toolbox to facilitate growth, plus an understanding that the Palestinian economy must be able to stay afloat without tethers to Israel. M