
ECONOMIC ASPECTS OF PEACE IN THE MIDDLE EAST: HM TREASURY INTERIM PROGRESS REPORT
Executive Summary

- An opportunity exists for the international financial community to play a significant role in the effort to support the regeneration of the Palestinian economy.
- Economic regeneration will give Palestinians a greater economic stake in the future and help secure the prospects for a lasting peace.
- The need for economic regeneration to raise Palestinian living standards is urgent, particularly in light of high unemployment, increasing poverty and rapid population growth.
- The recent "Agreement on Movement and Access" provides a foundation for the resumption of economic interaction between Israel and the Palestinian Territories, and between the Palestinian Territories and the outside world.
- In the short term, action should concentrate on:
 - implementing the "Agreement on Movement and Access";
 - creating employment in the Palestinian Territories;
 - strengthening reform and development planning to create an enabling environment for business; and
 - marshalling financial support in line with the recommendations of the Quartet's Special Envoy, James Wolfensohn.
- G8 Finance Ministers have a role to play in creating momentum, providing support, helping to deploy and direct the activities of the international financial institutions in the region, and maintaining oversight of progress.

Present opportunity

Recent and forthcoming events present an opportunity for the international community to play a role in supporting Palestinian economic regeneration and so enhancing the prospects for peace:

- Israel's disengagement from Gaza and parts of the northern West Bank has changed the environment;
- The Quartet's Special Envoy, James Wolfensohn, has been working to ensure that progress is made on the economic aspects of peace;
- More recently his work and the intervention of US Secretary Rice and EU High Representative Javier Solana has resulted in the "Agreement on Movement and Access".

Both Israelis and Palestinians recognise that prospects for medium term peace and security are inextricably linked with improved economic conditions. And all parties recognise the need to address the economic effects of the conflict alongside work to achieve a political solution.

There have been, and continue to be, opportunities for deeper engagement with economic issues. On 13 December there was a conference in London to promote economic growth through the private sector. On 14 December there was a meeting of the Ad Hoc Liaison Committee for donors to discuss coordination and medium term development. Following elections for the Palestinian Legislative Council on 25 January the Palestinian Authority will present its medium term development plan ahead of a meeting of donors.

The need for Palestinian economic regeneration

The need for economic regeneration in the Palestinian Territories is urgent:

- GDP per capita is projected to be US \$1,119 in 2005, approximately 30 per cent lower than in 1999. In Israel GDP per capita is US \$17,170.
- Unemployment is 25 per cent (and 35 per cent in Gaza).
- Youth unemployment (for those aged 15 – 24) is approximately 40 per cent.
- Poverty rates are rising with nearly 45 per cent of Palestinians living below the official poverty line of \$2 a day (64 per cent in Gaza) and are expected to rise to 62 per cent (76 per cent in Gaza) by 2008.

It is not just a short-term need: currently some 55 per cent of the population in Gaza is aged under 15. Given the high population growth in the Palestinian Territories, economic growth of approximately four per cent per year is needed simply to maintain current standards of living.

Economic improvement and the prospects for peace

High levels of unemployment (particularly amongst young people) and persistent poverty create an environment that is inimical to security. Rebuilding the Palestinian economy will create prosperity and employment for the population and so aid progress towards a viable political and security agreement. It will give Palestinians an economic stake in the future. Progress on the economic side should go hand-in-hand with, and reinforce, the political process. Action to create economic opportunity must accelerate now to support progress on the political process over the coming months.

Pre-intifada, the Palestinian economy was closely integrated with Israel. At its peak almost one-third of Palestinian workers were employed there; and Israel was the destination for the great majority of Palestinian exports. Following the second intifada, conflict and restrictions on movement and access have created a very different situation, one in which there has been only very limited economic interaction between the two economies.

The medium term development of the economic relationship between Israel and the Palestinian Territories is a key issue for both sides. This can only be resolved alongside the political and security process. Security concerns on the Israeli side and the wish by many in the Palestinian Territories to reduce economic dependence on Israel make it unlikely that levels of integration experienced pre-intifada will resume – in the short term at least. This will have significant consequences for Palestinian employment and trade.

However there has been progress recently. The November "Agreement on Movement and Access" offers a basis in the short term for economic interaction between the Palestinian Territories and Israel through movement of goods, and between the Palestinian Territories and the outside world. The Agreement addresses some issues related to employment and trade for the Palestinian economy. In particular:

- The implementation of the Rafah crossing agreement has provided the Palestinian Authority with responsibility for its border with Egypt and increased access to Arab markets and the outside world.
- The agreement to operate continuous crossings at Kami and Erez will improve movement of goods from Gaza to Israel and increase market access for Palestinian exports, with 150 trucks per day due to cross by the end of 2005, and 400 by the end of 2006.
- The back-to-back system (where all goods are unloaded from Palestinian trucks, passed through the security barrier and reloaded onto Israeli trucks) will be improved through the installation of a new generation of scanners. This will increase the volume of throughput and speed up transit times, helping to reduce transaction costs.
- The construction of the seaport in Gaza and plans to continue discussions to reopen airport access will enhance the transport

structure and links to the outside world.

- Development of an integrated Palestinian economy will be helped by bus and truck convoys to transport people and goods between the West Bank and Gaza.
- Measures to facilitate greater movement in the West Bank will continue and help minimize disruption to Palestinian lives.

While this offers a basis for greater economic activity in the Palestinian Territories, other important changes are also necessary to generate growth and create employment in the short term.

Next steps to deliver growth and employment

1. Full implementation of the "Agreement on Movement and Access" related to Gaza is a key task:

It will be important to implement the Agreement quickly and effectively, including the facilitation of movement within the West Bank, consistent with Israel's security needs. The World Bank¹ estimate that a full lifting of the restrictions on movement and access will result in an 8 per cent increase in GDP in the short term. The longer-term effects could be far more dramatic, even after allowing for other existing constraints.

2. Stimulation of employment in the Palestinian Territories

Currently there are a limited number of Palestinians working in Israel, with 67,000 Palestinians registered for work there in the last quarter. However, this is far below pre-intifada levels and the Government of Israel has said that it plans to reduce this level to zero by 2008. Over the next few years a potential source of employment lies in the rebuilding of the Palestinian infrastructure and industry. This has been recognised by James Wolfensohn who has developed a 'Relieve and Revive' strategy of Quick Impact donor projects to create jobs. In the medium term all are agreed that the private sector is the key to providing employment for the 100,000 jobs lost since the start of the intifada, and as the engine for growth.

3. The creation of a business enabling environment and strengthening economic reform

Removal of movement restrictions and investment in infrastructure on their own will not resolve Palestinian economic problems. There are considerable governance, fiscal and structural issues to be addressed to create an enabling environment for business.

Private sector growth will be crucial in delivering lasting employment and prosperity. The Palestinian Authority must complete its work on a medium term development plan to provide a comprehensive strategy covering governance, economic and institutional reform.

There is scope in the short term to stimulate private sector growth through credit guarantee schemes and micro credit. There is substantial domestic capital available for investment but private financial institutions remain reluctant to lend to business without considerable requirements, such as high collateral, to offset risk. Both lenders and borrowers will benefit greatly from technical assistance. International loan guarantee schemes have an important role to play.

4. Financial support from the international community

James Wolfensohn has called for a large injection of funds for the Palestinian Authority, but only if progress is made on movement issues and capacity to make effective use of the funds. Providing there is progress on both of these, a donors' conference will be necessary to generate funds. To enable this the Palestinian medium term development plan should be ready in early 2006.

Alongside increased resources to create employment and growth, the medium term development plan needs to be supported by increased donor coordination. To accompany efforts to improve local donor coordination, a redesigned budget support instrument is expected to be in place by mid-2006.

5. What Finance Ministers can do

G8 Finance Ministers have a role to play in creating momentum, providing support and maintaining oversight of progress. Their input can also help to deploy and direct the activities of the international financial institutions in support of this agenda.

Preparing the final report

We will continue to closely monitor progress on the short-term priorities and develop ideas on the medium-term conditions for economic growth. To ensure that the final report takes account of changing conditions, and that it has ongoing relevance, we will aim to publish a final report with concrete proposals after the Palestinian elections.

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20 January 2006

¹Based on the "economic recovery" scenario from the World Bank paper "Stagnation or Revival? Israeli Disengagement and Palestinian Economic Prospects", December 2004, The World Bank.