

TWO YEARS OF *INTIFADA*, CLOSURES AND PALESTINIAN ECONOMIC CRISIS

An Assessment

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*This is a summary of a report which is currently under review by the
Palestinian Authority, the Government of Israel and the donors, and
will be published in mid-March 2003.*

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Palestinian Economic Crisis Continued Sharp Deterioration

The second year of the *intifada* witnessed a further steep decline in all Palestinian economic indicators. Gross National Income (GNI)¹ in 2002 mounted to 40 percent less than in 2000. With a 9 percent growth in the population of the West Bank and Gaza over the past two years, real per capita incomes are now only half of their September 2000 level. Unemployment stands at 53 percent of the workforce².

Physical damage resulting from the conflict jumped from US\$305 million at the end of 2001 to US\$728 million by the end of August 2002. Between June 2000 and June 2002, Palestinian exports declined by 45 percent in value, and imports contracted by a third.

Overall GNI losses reached US\$5.4 billion after 27 months of the *intifada*. Given that GNI amounted to US\$5.4 billion in 1999, the opportunity cost of the crisis is now equivalent to one full year of Palestinian wealth creation.

The Palestinian Authority (PA)'s fiscal position remains precarious. As a result of rising unemployment, reduced demand, and the withholding by the Government of Israel (GOI) of taxes collected on the PA's behalf, monthly revenues fell from some US\$91 million in late 2000 to just US\$19 million by mid-2002. A collapse of the PA has been averted by emergency budget support from donor countries, which averaged US\$40 million per month through 2002 -- a half of total PA budget outlays over the period³. In this context, the recent decision by GOI to resume the monthly transfer of the PA revenues is a highly positive step.

The domestic private sector has absorbed much of the shock to the economy. Well over 50 percent of the pre-*intifada* private workforce has been laid off. Private agricultural and commercial assets have suffered over a half of all physical damage. Bank credit to the private sector is drying up, while the PA currently owes private suppliers about US\$370 million in unpaid bills. In addition, direct donor assistance to private firms has been negligible, despite a consensus that the private sector must drive any economic recovery. Real private GDP (measured at factor costs) declined by some 30 percent between 1999 and mid-2002.

The proximate cause of Palestinian economic crisis is closure -- GOI's imposition of restrictions on the movement of Palestinian goods and people across borders and within the West Bank and Gaza. GOI has regretted the impact of these measures, which they view as necessary to protect their citizens against violent attacks. The restrictions take two major forms: internal restrictions reinforced by curfews, and external closure of the border between Israel and the Palestinian territories, including limitations on the entry of Palestinian workers.

In March/April 2002, following an escalation of violence, IDF operations transformed many West Bank cities, towns and villages into restricted military zones, with residents under sustained curfew for days at a time. The movement of goods inside the West Bank has been seriously interrupted by a new "back-to-back" system, which requires all non-humanitarian goods to be off-loaded from incoming trucks and re-loaded onto local trucks at eight checkpoints near major West Bank cities. In practice, these restrictions are applied more rigorously to manufacturers and traders attempting to move goods out of Palestinian cities than to those bringing goods in from Israel.

In September 2000, an estimated 128,000 Palestinians worked in Israel and the Israeli settlements. With the outbreak of the *intifada*, GOI at first cut back heavily on the issuance of reduced work permits, but in recent months has begun to provide considerable numbers once again. Some 32,000 were being issued by the end of 2002, though only about a half of these were being used -- internal closures make it hard for many workers to move through the West Bank and Gaza to the designated workplace.

Averting Economic Collapse

A year ago, many observers feared that the Palestinian economy was on the brink of collapse. Although battered, the economy still functions.

One key reason is that the PA still operates. Thanks in large measure to donor budget support, 125,000 people receive a regular monthly salary and provide essential services to the population. Today the PA employs one third of those still working, and pays a half of all wages earned in the West Bank and Gaza. These wages have helped to support the livelihoods of the other two-thirds still employed, and have made the difference between the halting survival of the domestic private sector and its virtual disappearance.

Another reason is that high levels of donor assistance continued. In 2001, donor disbursements doubled from pre-*intifada* levels to US\$929 million, and in 2002 rose again to US\$1,051 million.

Third, Palestinian society has displayed great cohesion and resilience. Despite violence, economic hardship and the daily frustrations of living under curfew and closure, lending and sharing are widespread and families for the most part remain functional. Even with a dependency ratio⁴ of over 18 in Gaza and a dearth of formal safety nets, outright destitution is still limited -- those who have income generally share it with those who do not. The West Bank and Gaza has absorbed levels of unemployment that would have torn the social fabric in many other societies.

Even though the rate of economic decline is slowing down, it would be a mistake to think that a stable equilibrium has been reached. The combination of political insecurity and closure continues to choke the economy, and each passing month makes ultimate recovery more difficult. Industrial and human capital continue to erode, impairing Palestinian longer-term competitive prospects -- total investment has contracted from about US\$1.5 billion in 1999 to some US\$140 million in 2002, and declining health and educational standards are eroding the skills base of Palestinian youth.

Impact on Ordinary Palestinians

The economic crisis has seriously compromised household welfare. Many families have endured long periods without work or incomes, and despite the various employment generation efforts of the PA, donors and NGOs, many now depend on food aid for their daily survival. Coping with the situation has meant

selling assets, borrowing from families, neighbors and shopkeepers and cutting consumption, including food.

Using a poverty line of US\$2 per day, the World Bank estimated that 21 percent of the Palestinian population were poor on the eve of the *intifada*, a number that increased to about 60 percent by December 2002. Accounting for population growth, the numbers of the poor have tripled, from 637,000 to just under 2 million. The poor are also getting poorer. In 1998, the average daily consumption of a poor person was equivalent to US\$1.47 per day. This has now slipped to US\$1.32. More than 75 percent of the population of the Gaza Strip are now poor. The high rate of Palestinian population growth (4.35 percent per annum) is fuelling the growth in poverty.

The health status of the Palestinian population has deteriorated measurably. Real per capita food consumption has dropped by up to 30 percent since September 2000. A recent survey⁵ indicated that 13.3 percent of the population of Gaza suffer from acute malnutrition, similar to levels found in Zimbabwe (13 percent) and Congo (13.9 percent).

The crisis has affected different social groups differently. Adolescents are particularly vulnerable. Of an age to understand the economic hardships that their families face, but generally too young and inexperienced to be able to help much, they are particularly susceptible to trauma and to feelings of powerlessness and rage. Teachers are reporting an increase in violent behavior at school; many adolescents see no sense in continuing their education, and drop-out rates in this age group have risen markedly during the *intifada* although teenagers have a very limited chance of finding employment in the formal labor market. Many of these adolescents may find themselves locked into a life-long poverty trap, with poor prospects of escaping it even if the economy recovers. International research shows how devastating protracted unemployment can be in patriarchal societies, and how this can translate into domestic violence. A range of social and human rights organizations working at the household level in the West Bank and Gaza have noted an increase in violence against women as the crisis has lengthened.

What Can Be Done?

World Bank analysis shows the limited power of donor assistance under such conditions. If donor disbursements were doubled to US\$2 billion in 2003 -- something which there is no reason to believe is feasible - the poverty rate would only fall to some 54 percent by the end of 2004⁶.

The situation remains one of protracted conflict and political crisis. Donor funds can cushion the impact of the crisis and maintain a modicum of essential services -- but they do not amount to a solution. An agreed framework for political progress is indispensable for the resumption of economic and social development in both Israel and the Palestinian territories.

Challenges for the Palestinian Authority

The main service providers - the Ministries of Health and Education and the municipalities - have maintained a basic network of sound public services in an environment beset by curfews, closures, periodic violence and severe fiscal compression. These institutions have continued to do their job thanks to the commitment of thousands of Palestinians who work in schools, clinics and municipal service departments, supported in the field by the UN system (in particular UNRWA) and by Palestinian and international NGOs.

At a strategic level, however, the PA has not managed to communicate to the public how it is coping with the crisis. Partly as a result of this, the PA's emergency efforts are undervalued by the public. The PA needs to develop a National Emergency Plan, and to use the process of plan formulation to energize a collective social effort to cope with continuing crisis. The possibility of regional war and further economic hardship make this all the more urgent.

A key difference from a year ago is the PA's adoption of a serious program of reform. The PA Reform program aims to weed out corruption by enforcing full fiscal accountability, to create a predictable and transparent legal environment, and to build a modern, merit-based civil service. The PA's Ministerial Committee on Reform has committed itself wholeheartedly to the cause. Considerable progress has been made in some areas, in particular the management of the PA's finances. Progress in other areas has not been satisfactory yet -- in particular, the legal and judicial reform domain. All in all, though, much has been done to repair the credibility of the PA in the eyes of the international community. There is now no way back - having acknowledged the need to combat corruption and to transform itself into a democratic, modern and accountable instrument of statehood, the PA must deliver a successful reform program or lose its legitimacy.

Challenges for the Donors

Under the Bank's Base Case economic projection for 2003 - a continuation of the crisis -- donors should aim to disburse at least US\$1.1 billion, or slightly more than in 2002. The bulk of these funds are needed for PA budget support (US\$574 million) and for other emergency and humanitarian programs (US\$375 million⁷). An early estimate suggests that firm commitments amount so far to some US\$700 million, and that a total of US\$1.5 billion in commitments can be expected. This level of commitments should make a US\$1.1 billion disbursement target feasible⁸.

Most critical of all in 2003 is adequate support for the PA budget. This is essential to maintain PA governance, for the continued delivery of basic public services, and to sustain aggregate demand. The 2003 budget support target is ambitious - rather less (US\$450 million) was disbursed as budget support in 2002, and there are worrying signs of donor fatigue in this area⁹. While recognizing that budget support is politically controversial and traditionally unpopular (it is seen as a diversion of funds from growth-oriented investment¹⁰), it remains the most essential contribution that donors can make to sustaining the economy and the structures needed to build a Palestinian state.

The report discusses the relative merits of four donor assistance instruments -- PA budget support, food aid, cash assistance and employment generation programs. They are compared from the perspective of their effectiveness in addressing poverty. Imported food aid has many disadvantages as a welfare instrument, including its negative impact on agricultural GDP. Cash or quasi-cash (voucher) schemes are greatly preferable -- including voucher schemes to purchase locally-produced food. As a pure welfare instrument, PA budget support is superior to all others. Employment generation schemes have a place in the welfare mix, due to their psychological and capital-forming benefits - particularly if designed to maximize labor content and the use of local materials.

Donors should not abandon their medium-term development programs, and should continue to do what they can to help create the institutions and infrastructure of a future state. Indications of intent for 2003 are encouraging in this respect, and show that donors wish to commit at least US\$335 million in medium-term assistance. If these plans can be realized, they will arrest a worrying decline in donor developmental expenditure¹¹.

Challenges for the Government of Israel

The actions of the Government of Israel are the key to the Palestinian economy in 2003. Of far greater influence than the economic policies of the PA or the activities of donors is the application of closure in its various forms. Israel's legitimate right to defend its citizens from attack is unquestioned. The challenge is to find ways of doing so without destroying the Palestinian economy and the livelihoods of ordinary Palestinians. The *sine qua non* of economic stabilization is a significant easing of the current regime of *internal* closures and curfews. As long as Palestinian internal economic space remains as fragmented as it is today, and as long as the economy remains subject to extreme unpredictability and burdensome transaction costs, the revival of domestic economic activity will remain a distant prospect, and Palestinian welfare will continue to decay.

GOI's recent decision to resume the transfer of the PA's monthly clearance revenues is an important initiative¹². If these flows are re-established on a regular basis and segregated from day-to-day political pressures, they will play a vital part in stabilizing the Palestinian economy. If GOI also continues to repay the stock of withheld arrears, this will permit the PA to clear its debts to the domestic private sector. The consequent injection of cash will exert a far greater effect on the failing Palestinian private sector than any other available measure.

The recent increase in the number of permits issued to Palestinians for work in Israel and the settlements is also very positive. If further expanded and couple with a relaxation of internal closure, this will also contribute significantly to economic regeneration.

Donors need GOI to do more to facilitate the work of humanitarian agencies, be they donor, UN or NGO. The report describes the intensified relationship between donors and GOI in the context of the Task Force on Project Implementation (TFPI), and praises the collegial working relationships that have been created between TFPI donors and the Office of the Coordinator for the Occupied Territories (COGAT). The report also points out that significant disconnects still exist between the commitments provided to donors by COGAT and the actions of some IDF soldiers in the field. This not only undermines the efficiency of the humanitarian effort, but also exposes aid staff to appreciable physical danger. Donors have also pointed out in strong terms the need for the IDF to avoid further destruction of donor-financed infrastructure and project facilities¹³.

Donors have also asked GOI to permit freedom of movement for the Palestinian officials and parliamentarians critical to the implementation of the Palestinian Reform program, consistent with Israel's own call for the reform of the PA. In addition, it is important that GOI facilitate meetings of the Palestinian Legislative Council so as to enable the passage of critical reform legislation and to provide oversight of the reform process.

Looking Ahead

While any short-term recovery will depend on the lifting of closures, this will not suffice to put the Palestinian economy onto a sustainable growth path. The Paris Protocol, which formalized the *de facto* customs union with Israel that has existed since 1967, has proven extremely costly -- and not only because of the closures that interfered with its implementation. In a structural sense, the long-term growth potential of the Palestinian economy has been stunted by the upward

pressure on domestic Palestinian wages created by wages paid to Palestinian workers in Israel. Domestic wage increases have exceeded any underlying growth in productivity, and have undermined Palestinians' ability to export competitively-priced goods to the rest of the world. Bank analysis shows that a proactive policy of export development, in which a more open and less discriminatory trade regime is adopted, would result in higher incomes by 2010 than a return to previous levels of employment in Israel.

Between 1968 and 2000, Palestinians in the West Bank and Gaza pursued a development strategy which featured the export of labor rather than goods. In June 2000, three months before the current Palestinian *intifada* began, 21 percent of all employed Palestinians worked in Israel, mainly in low-skilled construction and agricultural jobs. Net incomes from abroad provided more than 22 percent of Palestinian GDP, making it one of the most remittance-dependent economies in the world. This is why the loss of jobs in Israel in the past two years has had such a strong impact. Put another way, the *intifada* has demonstrated the vulnerability of a development strategy which relied so heavily on labor export to Israel.

Gains from trade would take time to materialize, and restoring access to Israeli labor market would certainly be the quickest way to boost incomes for a large number of ordinary Palestinians -- but a return to pre-September 2000 employment levels for Palestinians in Israel seems unlikely. It would anyway risk perpetuating a high level of Palestinian economic dependence on Israel, and would hinder the emergence of a more diversified development strategy. It is important, however, to underline that such a policy shift will require the active cooperation of Israel to succeed, and is thus part and parcel of a political *rapprochement*.

Notes

¹Gross Domestic Product plus remittances from abroad.

²If those no longer seeking work are included. Under the more restrictive definition of unemployment, the current rate is estimated at 42 percent.

³A total of approximately US\$ 1.1 billion by the end of 2002, of which US\$840 million came from Arab League countries and US\$230 million from the EU.

⁴The number of those dependent on each employed person.

⁵Nutritional Assessment of the West Bank and Gaza Strip, conducted by Johns Hopkins University/AI Quds University and financed by USAID through CARE International, September 2002.

⁶This is in part because closures dampen the ability of foreign assistance to raise real incomes, with most of the funding translating into imports and inflation rather than domestic production.

⁷Six emergency and humanitarian programs are recommended for donor support in the report: emergency support for the municipalities, direct relief to the private sector, welfare instruments (food aid, cash assistance, employment generation programs), repairs to damaged infrastructure, support to the university system, and funds for UNRWA's Fifth Emergency Appeal.

⁸It is disbursements (i.e. funds received) that ultimately count. A ratio of commitments to disbursements of 1 to 0.73 is required to translate US\$1.5 billion in commitments into US\$ 1.1 billion in disbursements. In 2002, the ratio achieved was 1 to 0.69. These donor financing estimates are currently under discussion with the PA with a view to agreeing a common set of numbers.

⁹The report details the difficulties associated with the burden-sharing formula adopted by the Arab League Summit in Beirut in March 2002, as well as the concerns expressed by European parliamentarians that EU budget contributions may have been diverted to fund attacks on Israelis. The report also points to the fact that GOI has resumed revenue clearances as a vital signal of growing Israeli confidence in the way that the PA's finances are now managed.

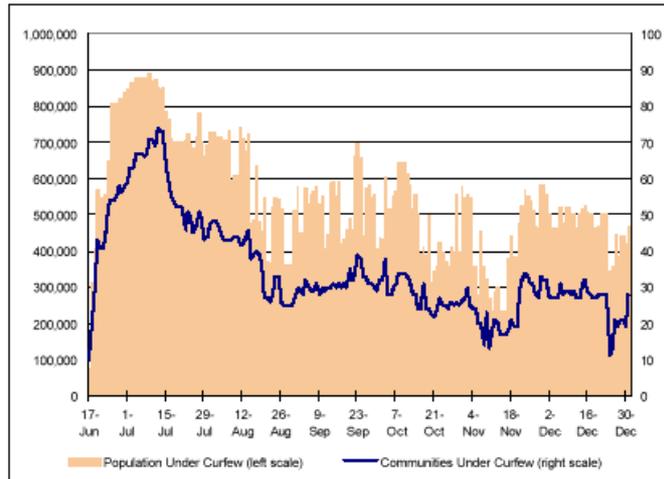
¹⁰Under current economic conditions this argument is not valid. Returns to capital are now only about a half of what they were on the eve of the *intifada* - while maintaining a minimum level of consumption is essential to future economic recovery.

¹¹Commitments to infrastructure and capacity-building work with a medium-term focus fell from US\$482 million in 1999 to US\$279 million in 2001 and to US\$197 million in 2002. In 2000, the ratio between development and emergency assistance was approximately 7:1 in favor of development assistance. By 2002, the ratio had shifted to almost 5:1 in favor of emergency assistance. Although overall commitments increased by 57 percent in the period, development assistance declined by 70 percent, while emergency assistance increased by a factor of 10.

¹²To date, GOI has paid NIS 460.5 million in monthly tax clearances (for October, November and December 2002) and NIS 410 million in arrears.

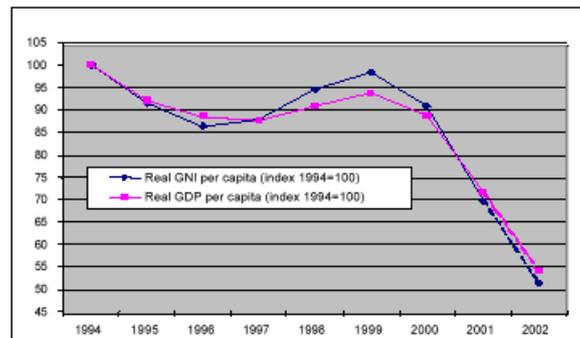
¹³The World Bank estimates that some US\$ 150 million in damage to donor-financed infrastructure and project facilities has taken place since September 2000.

The West Bank under Curfew, June 17 – December 31, 2002



Source: OCHA Humanitarian Information Center, Curfew Monitoring Database.

Real GNI and GDP per Capita, 1994-2002



Source: World Bank staff calculations. Data excludes East Jerusalem.

Summary of West Bank and Gaza Estimated Macro Economic Trends and Projections

	1999	2000	2001	2002
Gross National Income (GNI), US\$ mill.	5,166	5,419	4,501	3,273
Gross Domestic Product (GDP), US\$ mill.	4,289	4,607	4,012	2,951
<i>Real annual change:</i>				
GNI per capita	3.9%	-7.5%	-23.2%	-26.4%
GDP per capita	3.1%	-5.3%	-19.5%	-25.5%
Private Consumption	7.5%	-5.6%	-15.5%	-17.0%
Public Consumption	20.3%	31.0%	-2.1%	-7.7%
Total Fixed Investment	-8.3%	-28.3%	-76.9%	-84.2%
Export	2.3%	-8.8%	-13.4%	-34.8%
Import	5.4%	-16.2%	-29.0%	-17.3%
Other items				
Poverty, share of population below poverty line	20.1%	30.7%	45.7%	60.0%
NIS/US\$, annual average	4.14	4.08	4.21	4.75
CPI, annual change	5.5%	2.7%	2.1%	7.6%
Population, mid-year (1,000)	2,842	2,966	3,096	3,231

Note: All data excludes East Jerusalem. Sources: World Bank Staff Estimates, PCBS.

Donor Commitments and Disbursements, 1998-2002 (US\$ Million)

	1998	1999	2000	2001	2002
Commitments of Regular (Development) Support	667	692	852	473	261
Commitments of Emergency and Budgetary Support	0	0	121	755	1266
Total Commitments	667	692	973	1228	1527
Total Disbursements	419	482	549	929	1051

Source: World Bank staff calculations