

Uncertainty Deters Private Investment in the West Bank and Gaza Strip

The accords signed by Israel and the PLO in 1993 and 1994 heralded greater prosperity for Palestinians. But an adverse external trade environment has discouraged private investment, and economic conditions have deteriorated.

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IN SEPTEMBER 1993, Israel and the Palestine Liberation Organization (PLO) signed the Declaration of Principles on Interim Self-Governing Arrangements, which outlined the gradual handover to the Palestinian Authority of responsibility for the West Bank and Gaza Strip. The advent of self-rule and the easing of political and social tensions were expected to usher in a period of rapid economic growth and higher living standards for Palestinians. Expectations were buoyed by the Protocol on Economic Relations agreed in April 1994, which outlined the Palestinian Authority's responsibilities in key economic areas and envisaged close economic cooperation between Israel and the authority, as well as by the authority's commitment to institution building and to a private sector-led, outward-oriented development strategy. Donors pledged generous support, which was gradually to shift away from emergency aid and toward public investment projects.

The hopes aroused by the accords have been frustrated, however. Economic conditions in the West Bank and Gaza Strip have deteriorated sharply since 1993. The unemployment rate for Palestinians has increased to about 30 percent; external trade has contracted; and the public investment program has been disrupted. By 1997, the unemployment rate was 13 percentage points higher, and real per capita income about 20 percent lower, than in 1993, and only modest efforts had been made to develop the domestic productive base and upgrade the physical infrastructure. Particularly disturbing is the erosion of confidence of the private sector, which was to have been the primary engine of economic growth. Between 1993 and 1997, private investment's share in GDP is estimated to have dropped from 19 percent to 10 percent (Chart 1). What went wrong?

History

The evolution and composition of private investment in the West Bank and Gaza Strip have, to a large extent, reflected changes in the volume and pattern of trade with Israel. After the Israeli occupation began in 1967, the West Bank and Gaza Strip's external trade, previously limited mostly to neighboring countries of comparable wealth and level of development, was swiftly reoriented toward Israel, an economically more advanced country with a GNP about 20 times as large. The opening of Israeli markets to Palestinian employment and, to a lesser extent, to commodity exports, was reflected in the West Bank and Gaza Strip's remarkably high rate of real GNP growth, which averaged 30 percent a year during 1969–79. This growth was accompanied by a rise in private investment as a share of GDP from about 14 percent in 1969 to 30 percent in 1979, with real private investment growing at an average of 25 percent a year.

Although the increase in private investment seems impressive, it was devoted almost entirely to residential construction, which represented, on average, 85 percent of total private investment over the period. In contrast, real investment in machinery and equipment grew by less than 1 percent a year, decreasing to 5 percent from about 10 percent of GDP.

The concentration of private investment in residential construction, along with the virtual stagnation of investment in machinery and equipment, suggests that, although investment was driven largely by growth, it contributed little to growth. The initial boost to growth provided by the "integration effect" tapered off (owing, in particular, to a slowing of the pace at which labor shifted from low-productivity agriculture to higher-wage employment in Israel), and real GNP



growth slowed to about 5 percent a year during 1980–91. Private investment was virtually stagnant during this period, growing less than 1 percent a year, in real terms, and remained heavily skewed in favor of residential construction.

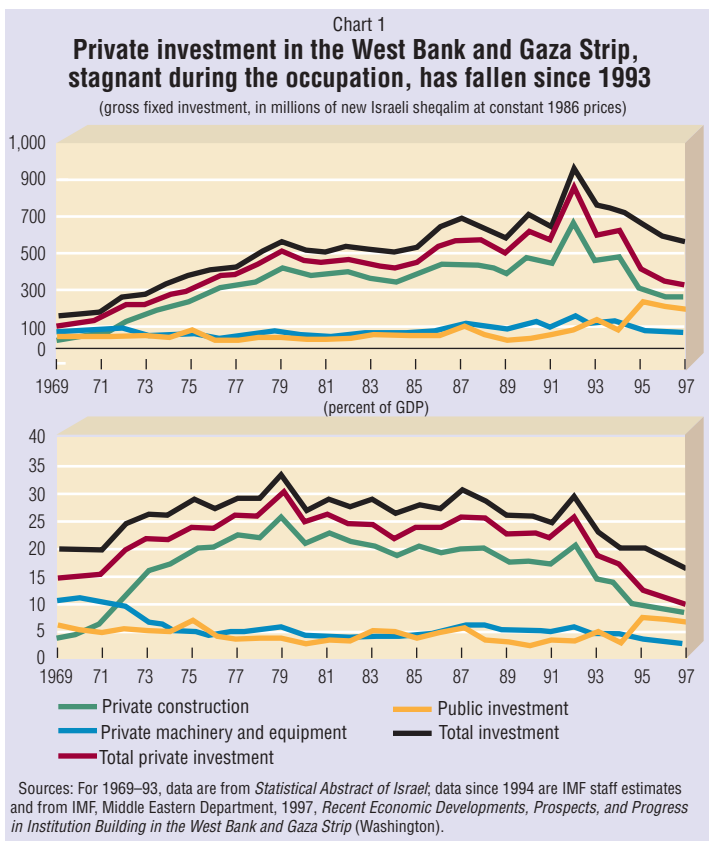
The skewed composition of private investment can be attributed to several factors. The first and most important was the absence of a level playing field in trade between the West Bank and Gaza Strip and Israel: there were no barriers to Israeli exports to the West Bank and Gaza Strip, but Palestinian exports of agricultural and industrial products to Israel were restricted. This suppressed the development of a large part of the West Bank and Gaza Strip's domestic productive base (agriculture and industry) while encouraging services. Second, the financial sector in the West Bank and Gaza Strip was underdeveloped, which encouraged the channeling of savings toward investments (for example, in residential construction) that could be self-financed or financed by small groups of savers through informal channels, and away from investments in sectors (notably, modern farming and industry) that required longer-term risk capital. Third, the Israeli authorities provided little support for private investment; public investment in infrastructure was inadequate; and a legal and regulatory environment favorable to private investment was not developed. Fourth, the threat of political instability further stifled private investment in the productive sectors.

The peace process

The peace accords of the early 1990s promised to usher in an economic and political environment in which constraints on private investment would be relaxed or eliminated. The trade regime envisaged by the Protocol on Economic Relations would encourage the expansion and reorientation of the West Bank and Gaza Strip's productive base toward agricultural and industrial export production and gradually reduce dependence on the export of labor. From the viewpoint of private investors, one of the attractive features of the protocol was the removal of most restrictions on Palestinian commodity exports to Israel, which would increase the profitability of investments in agricultural and industrial production. The protocol also gave Palestinians greater—albeit still limited—flexibility in determining their own import policies and tariff structures with regard to specific products and exporting countries—for example, those applying to raw materials and capital goods imported from neighboring Arab countries—with potentially favorable effects on investment costs.

Despite these advantages, the protocol had a number of limitations. In addition to setting up an import policy with limited flexibility, it did not address important obstacles to external trade (in particular, the absence of outlets, such as seaports and airports) or to trade within Palestinian areas, in particular between the West Bank and the Gaza Strip. Nevertheless, although consideration of such key issues was postponed until the permanent-status negotiations scheduled for 1996–99, expectations were raised simply by the fact that such issues were put on the table.

In addition to heralding a favorable trade environment, the accords of 1993 and 1994 had the potential to open up business opportunities by removing impediments to private investment. First, because of the dearth of banks in the West Bank and Gaza Strip during the Israeli occupation, a large part of Palestinian households' savings had been held in financial institutions abroad, stored through informal domestic financial channels, or hoarded in cash. An improved trade environment and other positive changes likely to ensue from the accords were expected to lead to a boom in domestic private investment demand, creating lucrative domestic outlets for a large stock of savings. Second, although physical infrastructure had become extremely dilapidated during the occupation, leading to higher investment costs, particularly with regard to transportation, these costs were expected to decline as a result of the public investment program, to which donors committed about \$1.2 billion. Finally, the rapid initial progress of the peace process and the transfer of control over important economic spheres to





the Palestinian Authority signaled improved prospects for political and economic stability.

Dashed hopes

Private investment did not surge as expected, however, largely because of an extremely adverse trade environment. The situation was exacerbated by weaknesses in the financial sector, slow implementation of the public investment program, and an inadequate legal framework.

An adverse trade environment. Given the dominant role played by external trade in the Palestinian economy, the profitability of private investment is particularly vulnerable to changes in the external trade environment. Since 1993, movements of goods and labor into and out of the West Bank and Gaza Strip have been subject to strict security controls and, on several occasions, the borders have been totally closed following security incidents in Israel, imposing autarky on Palestinians, who have few outlets to export markets other than Israel, for periods of uncertain duration.

The border closures have had a dual effect: they have dampened *average* demand and driven up production costs while sharply increasing the *variability* of demand and costs. This dual effect is illustrated in Chart 2, which depicts the impact of the closures on exports of labor to Israel in 1996 and 1997.

The border closures also exert strong downward pressures on the net present value of investments. Producers' expected revenues are adversely affected by the decline in the average level, as well as the increased variability, of demand, while higher transportation costs, disruptions of production caused by difficulties in importing inputs, and the need to adjust capacity and output levels to fluctuating demand have increased expected costs.

The adverse effect on the net present value of investments is especially strong in the export sector. In the import-substituting and nontradables sectors, downward pressures on net present value are tempered by relative price changes induced by a shift in domestic demand that favors domestic goods over imports. Thus, border closures both depress the

profitability of investments in all sectors, with adverse effects on *aggregate investment*, and induce a shift in the *composition of investment* away from the export sector, by changing the relative profitability of investments across sectors.

An underdeveloped financial sector. As anticipated, the West Bank and Gaza Strip's banking system expanded rapidly after the accords were signed; the deposit base rose from less than \$500 million in early 1993 to about \$1.9 billion by the end of 1997. Less than a third of these savings have been lent to the domestic private sector, however. Creditworthy investors with good projects have often been unable to gain access to bank credit or have found credit too expensive because of institutional weaknesses in the financial sector.

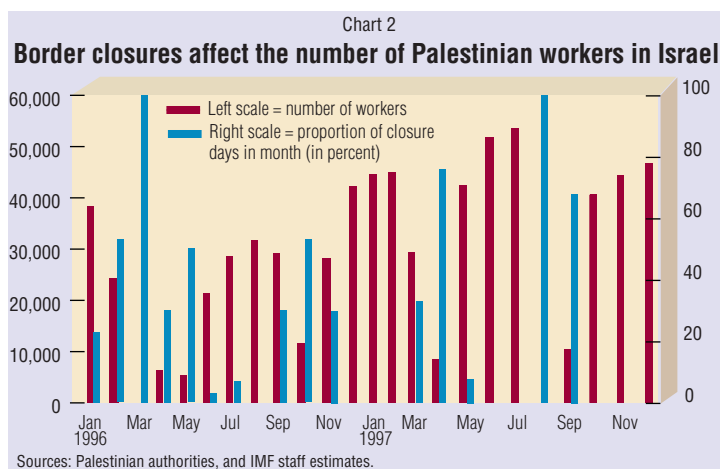
Why has this happened? First, information on the risk-return profiles of investors was highly imperfect. This was due, in large part, to the virtual absence of banks in the area for more than 25 years; the microenterprise nature of many potential borrowers, which had no previous experience in borrowing from banks; and the lack of a credit appraisal and rating system. Second, the legal framework did not encourage the use of collateral in bank lending. Third, the short-term nature of most bank deposits and the absence of secondary markets for long-term debt increased the liquidity risk of long-term lending. Moreover, equity markets, which could have been another source of long-term financing, are underdeveloped in the West Bank and Gaza Strip because of depressed private investment demand and the fact that most Palestinian enterprises are small, family-owned ventures.

Delays in implementing public investment projects. Private investors have been particularly disappointed by the sluggish pace of the public investment program: of the \$1.2 billion committed by donors to public investment projects for 1994–97, only about \$600 million has been disbursed. More important, there has been relatively little investment in physical infrastructure, in particular in the transportation sector.

An inadequate legal framework. The confusing array of laws that had characterized the occupation was expected to give way gradually, with the advent of self-rule, to a transparent and supportive legal and regulatory framework. However, a key component of the legal framework as of March 1998 was the Investment Law, which introduced a great deal of uncertainty with regard to costs. In particular, this law granted considerable discretionary powers to the Palestinian Higher Agency for the Encouragement of Investment, including the approval of all investments through cumbersome and ill-defined procedures.

What can be done?

What can be done to reverse the decline in private investment and reduce the distortion in its sectoral allocation to promote the export sector? Clearly, one key to the improvement of investment incentives and the achievement of a more balanced pattern of investment lies in stabilizing and



liberalizing the external trade environment. The border closures have had a particularly adverse impact, both because of their direct effect on investment incentives in the context of an already weak productive base, a small domestic market, and the weakness of trade links with non-Israeli markets, and because they divert attention from the other significant impediments to private investment in the West Bank and Gaza Strip and slow efforts by the Palestinian Authority and donors to address these impediments.

Improving the trade environment. Given the slow progress of the peace process, an early lifting of the border closures and the opening of outlets to external markets appear unlikely.

Ways therefore need to be found to insulate the Palestinian economy, at least partially, from the current, very restrictive trade environment. For example, through special arrangements with the Israeli authorities, free-trade and industrial zones could be set up that would be subject to fewer security controls and trade restrictions. Private investors would benefit from a favorable legal and regulatory framework that would be easier to develop and administer, faster implementation of donor-supported public investment projects, and less exposure to weaknesses in the West Bank and Gaza Strip's credit markets, because the projects would initially be financed largely by external private sources. High priority should be given to improving access to markets outside Israel through the development of seaports and airports, to strengthening transport links with Jordan and Egypt, and to furthering economic integration of the Palestinian territories through the establishment of a safe passage between the West Bank and the Gaza Strip.

Accelerating the public investment program. In the presence of political constraints on liberalizing the external trade environment, it is especially important to implement economic policies and institution-building measures that can blunt the impact of trade constraints. An important immediate objective is the acceleration of the public investment program. The Palestinian Authority recently prepared a detailed development plan that presents a coherent strategy for public investment for the years 1998–2000; donors have indicated their intention to commit \$750 million in support of the plan. The pace of implementation could be accelerated by reducing disruptions caused by recurrent border closures, improving coordination between the Palestinian Authority and donors, and having closer follow-up, on a project-by-project basis, by the authority of the plan's implementation.

Developing the financial sector. There is also an urgent need to eliminate imperfections in credit markets and develop financial institutions. To this end, a number of donor projects are currently being implemented, notably as part of the World Bank's Financial Sector Project. Several



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projects aim at channeling funds from donors to banks to be on-lent for long-term investments and at establishing facilities that would allow banks to refinance long-term loans. An important component of this project, which has been undertaken by the International Finance Corporation (IFC), is aimed at the microenterprise sector; the IFC will assist banks in screening and monitoring loans to microenterprises while helping the latter to acquire the skills required to apply for loans and report to banks. In parallel with efforts to develop the banking sector, donors should continue to promote direct equity investments; one recent example of this was the IFC's start-up and partial financing of the

Peace Technology Fund, which seeks to channel funds from Palestinian and Israeli investors to small- and medium-scale industries in the West Bank and Gaza Strip. The establishment of a strong legal foundation for domestic securities markets—in particular, a regulatory framework that is consistent with international practice and establishes adequate accounting and auditing standards for enterprises—would also be helpful.

Strengthening the legal framework. The IMF and the World Bank have been working with the Palestinian Authority on strengthening the legal and regulatory environment for investors, in particular by drafting a new investment law that was recently approved by the legislature. In the meantime, to allay investors' concerns about the stability of the legal and regulatory framework, donors are establishing a Guarantee Trust Fund for Private Investments—a project undertaken by the Multilateral Investment Guarantee Agency. The fund will provide investors with guarantees, notably against the risks of expropriation and of breach of contract by the authorities.

It is important to stress, however, that investors will not be swayed by new laws and regulations, in particular those affecting private sector activity, if government actions are not seen as being constrained by them. In view of the short track record of the Palestinian Authority, investors currently have limited information on which to base expectations of future government interventions in private sector activity. To reduce uncertainty, it is important for the Palestinian Authority to build a solid track record of working within the legal and regulatory framework and to avoid measures that would increase the perceived risk of future arbitrary interventions in private activities. **F&D**

This article is based on a paper by the author entitled "Private Investment Under Uncertainty in the West Bank and Gaza Strip," which appears in The Economy of the West Bank and Gaza Strip: Recent Experience, Prospects, and Challenges to Private Sector Development, by Steven Barnett, Nur Calika, Dale Chua, Oussama Kanaan, and Milan Zavadzil (Washington: IMF, 1998).