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The Palestinian Economic Crisis: A Loud Wake-Up Call

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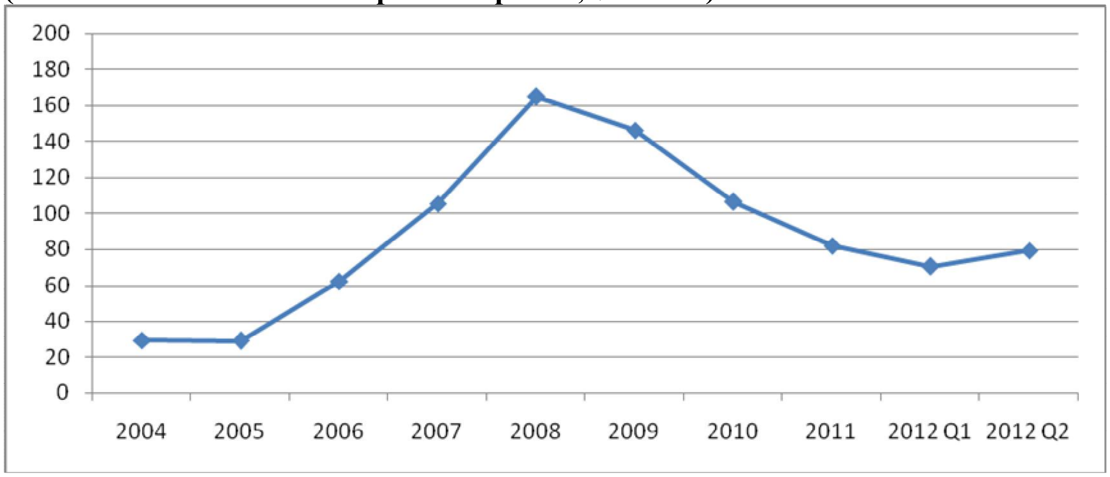
Recent demonstrations in the West Bank were an expression of popular rage resulting from the fiscal and economic crisis facing the Palestinian Authority (PA). This has dangerous social and political consequences (see Iqtisadi, September 2011 and July 2012 in www.dayan.org).

The immediate cause of the crisis is the decline in external financial support to the PA, since 2009 that accelerated in 2010, as shown in Chart 1. The underlying causes of the crisis are the structural weaknesses of the Palestinian economy that are related to the complexity of Israeli-Palestinian relations, and the impediments those relations impose on the economy. As the crisis unfolds, macro-economic damage against the background of political impasse may well develop into an uncontrollable wave of violent protests. This could threaten the PA with chaos; and drag Israeli –Palestinian relations back to a vicious circle of violent confrontations, stricter Israeli restrictions on movement and access, and delays in transfer of Palestinian tax revenues collected by Israel, which would further deepen Palestinian destitution and despair, and enflame more violent confrontations.

Another threat is the insolvency of the PA; which could precipitate disintegration, and possibly even its dissolution. Recent Palestinian demands for revision of the economic agreements with Israel (the "Paris Protocol" of 1994, under which the Palestinian economy remains integrated with Israel and practically subjected to Israeli control and regulations)[1], and talks about unilateral abolition of the Oslo Agreements, indicate to the severity of the situation, and the urgency of changing course.

[1] The Paris protocol created a "customs union" which makes Palestinian external trade subject to Israeli customs and external trade regulations; a monetary union which makes the Palestinian financial system subject to Israeli monetary policies and fluctuations; and Israeli direct or in-direct control on almost all other main aspects of Palestinian economic life.

Chart 1: External Support to the PA Budget, 2004 – 2012, Monthly Averages (aid for recurrent and development expenses, $ million)



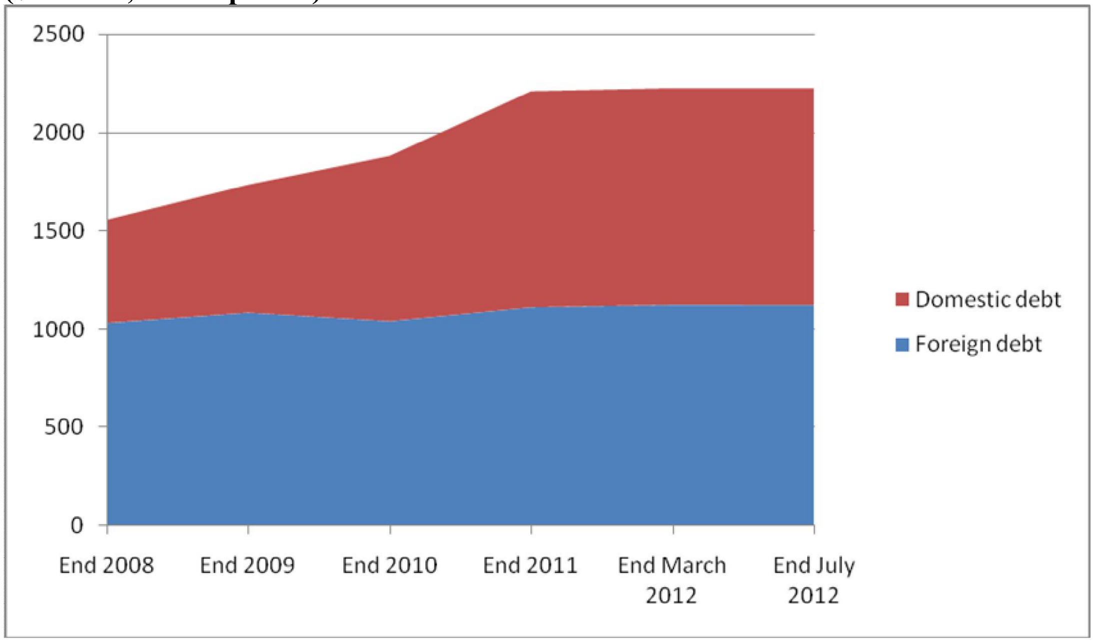
Source: PA, Ministry of Finance and Palestinian Monetary Authority

For much of the past 16 months, the PA has not been able to pay the salaries of public-sector employees on time and in full. Since May 2011 salary payment has been erratic; dependent on delayed "emergency aid" from donors, or waiting for the next transfer of tax revenues collected by Israel.

The economic and social effects of this have been far-reaching. State employees account for well over a quarter of Palestinian purchasing power, and their salaries are a mainstay of economic and social stability in the West Bank. As these salaries have not been paid on time and in full, the shock waves spread to the West Bank society at large. Furthermore, Palestinian banks have aggressively marketed loans to public-sector employees over the past few years, and many of these public-sector employees have large mortgage loans, as well as large loans taken to buy cars or for other purposes. Their ability to service these loans depends on the orderly payment of salaries by the PA.

In recent months, the West Bank business sector has been affected by a sharp decline in government's non-salary spending. Suppliers' bills totaling close to $500 million have been affected. This has threatened thousands of businesses and service providers with bankruptcy, and has reduced confidence in the economy. The fall in external support has forced the PA, to borrow money from the local banking system to financing its deficit. By the end of 2011, public domestic debt exceeded $1.1 billion, and was twice its 2008 level; in addition to foreign debt of more than $1 billion. With this level of debt, the PA is unable to take more loans; and by 2012 it became completely dependent on external aid from donors and transfers from Israel.

Chart 2: The PA Public Debt by Main Components 2008 – 2012 ($ million, end of period)

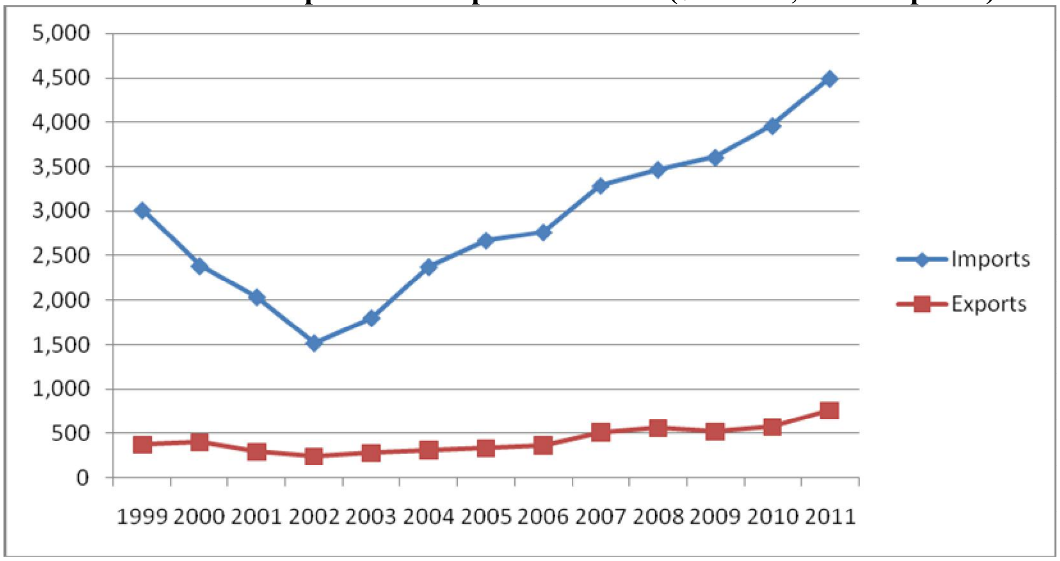


Source: PA, Palestinian Monetary Authority

The severity of the fiscal crisis stems from fundamental weaknesses of the Palestinian economy, and highlights the fragility and unsustainable nature of the West Bank economic growth in recent years; as was analyzed in our article of September 2011.
The IMF has emphasized that recovery cannot be sustained without further easing by Israel of restrictions on movement and access. The World Bank has warned that "growth does not appear sustainable. It reflects recovery from the very low base reached during the second intifada and is still mainly confined to the non-tradable sector and primarily donor-driven". The Palestinian development plan for 2011 – 2013 noted that economic development under the present conditions cannot be sustained because "continued impediment of trade and investment would inhibit private sector growth, while public sector investment plans would continue to be stalled; … and economic growth would falter… Budgetary revenues and external aid would be depressed. Rising unemployment and escalating poverty would necessitate increased expenditure on social transfers."

This gloomy situation was demonstrated, in our September 2011 article, by analyzing the components of the West Bank's growth. Between 2005 and 2009, private consumption in the West Bank grew by 80 percent, government consumption grew by 136 percent, and investment in buildings (mainly for residential uses) increased by 120 percent. On the other side, investment, excluding that in construction, was even lower, in 2008 and 2009, than in 2005.
The fast growth in consumption has been reflected in a huge increase of imports, while that of exports has been relatively modest. Between 2005 and 2011, the gap between Palestinian exports and imports grew by 60 percent, and expected to reach $4 billion in 2012.

Chart 3: Palestinian Exports and Imports of Goods ($ million, current prices)



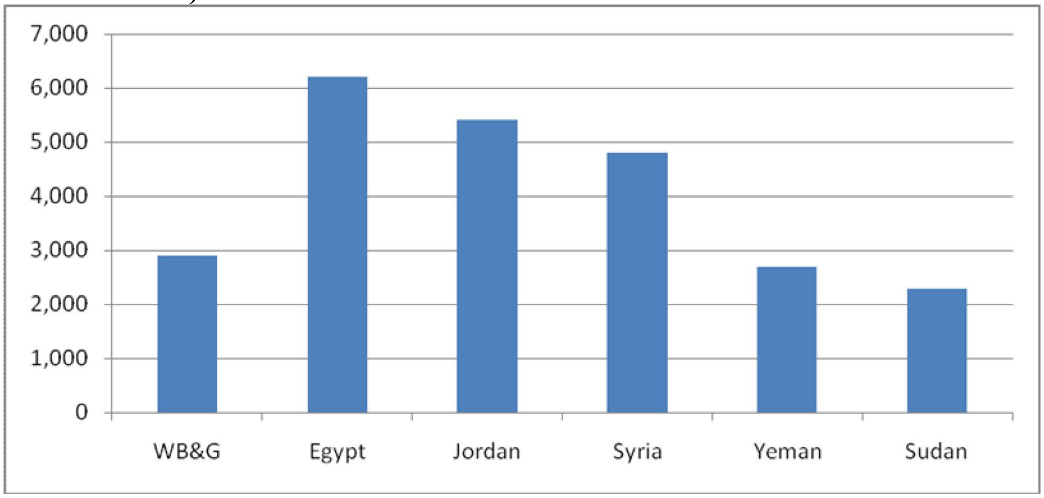
Source: PCBS, Foreign Trade Statistics

This pattern of growth and external trade development mirrors the weaknesses and vulnerabilities of the Palestinian economy. It has an under-developed economic infrastructure; it operates under a complex array of constraints related to the economic regime and restrictive trade arrangements with Israel; access and movement restrictions and other physical constraints; as well as overwhelming demographic, labor-market and social pressures. The trade deficit has made the Palestinian economy desperately dependent on external sources of income and aid.

A most important facet of these vulnerabilities relates to purchasing power and standard of living. Economic integration with Israel, under the "Paris Protocol", is reflected in price levels similar or close to Israeli ones**,** while Palestinian wages are much lower than in Israel. As a result, the real purchasing power of Palestinian households is much lower than the nominal level shown in national accounts and household income statistics. International comparisons show that Palestinian GDP per capita, when adjusted to local purchasing power, is far lower than that of neighboring Arab counties, and is only slightly higher than that of countries as poor as Sudan or Yemen.

Though the PA has greatly advanced in the process of state-institution building, based on the "bottom up" approach outlined by Prime Minister Fayyad, these achievements were based on strong donor support. Furthermore, as emphasized in the Palestinian development plan for 2011 – 2013, state-institution building must go hand in hand with long-term economic development, and cannot be sustained unless international aid continues at a generous level in coming years.

Chart 4: West Bank & Gaza GDP per Capita, in Comparison to Selected Arab Countries($, adjusted to local purchasing power according to the PPP method, 2010 estimates)



Source: CIA World Fact Book; Country Comparison: GDP per capita, as per the PPP method.

International aid to the PA is politically motivated; and as the international community sees it as one of the pillars of the Israeli-Palestinian peace process, the prolonged impasse in the peace process has weakened donors' commitment. Given growing internal economic pressures on the main donors—the US and the EU—it is very unlikely that the sharp cut in the volume of aid in 2010 – 2012 will be reversed without a revival of the peace process.

In conclusion, if present trends are not changed, declining external aid will combine with economic weaknesses to put the economic and social stability of the PA at risk. Economic and social risks would increase if the combination of political impasse and social grievances result in violent confrontations. This might trigger tightened Israeli restrictions on movement and access, and delays in transfer of Palestinian tax revenues collected by Israel. This, in turn, would deepen the economic crisis and further de-stabilize the PA.