

# THE IMPACT OF THE GLOBAL FINANCIAL AND ECONOMIC CRISIS ON THE PALESTINIAN ECONOMY

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## *Introduction*

The Palestinian economy suffers from profound distortions and structural imbalances created by more than four decades of occupation. The most serious distortions are characterized by the heavy dependence on Israel in terms of trade, labor and public finance. These distortions are perpetuated and intensified in recent years by Israel's continuous aggression and systematic destruction of the Palestinian economy, which has been exacerbated since the since September of 2000 in response to *Al-Aqsa Intifada*. Notwithstanding the slow recovery in 2004-2005, the situation deteriorated further following Hamas victory in the Parliamentary elections in early 2006 due to the escalating Israeli restrictions and the boycott of the Palestinian unity government by Israel and donor countries.

Although sanctions were eased on the West Bank after a caretaker government was formed in June 2007, the siege persisted and intensified on Gaza, and the economic conditions deteriorated in both Gaza and the West Bank. GDP per capita contracted by nearly 5% in 2006, and by a further 2% in 2007. Even before the global financial crisis erupted in mid 2008, and despite the \$7.7 billion of aid that donors pledged in Paris Conference in December 2007, the Palestinian economy continued to suffer during 2008 due to the escalation of Israeli measures.<sup>1</sup> Real per capita GDP declined by more than 1%, unemployment rate has increased from an average of 30% in 2007 to an estimated 40% in 2008 in Gaza and from 18% to 19% in the West Bank during same period, and the number of Palestinians living in poverty soared. In 2008, around 80% of households in Gaza were living below the poverty line compared to 45% in the West Bank. The

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<sup>1</sup> For example, the number of identified obstacles blocking internal Palestinian movement in the West Bank has increase from 580 in February, to 611 in April, and to 630 in September 2008. See International Monetary Fund (2009).

situation has worsened after the Israeli brutal invasion of Gaza in late December 2008 and Israeli restrictions on the transfer of cash from the West Bank to Gaza.

### ***Impact of Global Crisis on the Palestinian Economy***

It may be too early to assess the full impact of the global financial crisis on the Palestinian economy at this stage for at least three reasons. First, the crisis is not over yet, the snowball is still rolling amongst fears that it may continue for months, and may be years. Second, many dimensions of the crisis are not fully identified and understood as new numbers of economic indicators are released and more cases of institution failures are discovered. Third, the impact of the crisis, in many cases, cannot be isolated from the impact of other events or crises. In the Palestinian case in particular, the impact of Israeli policies and practices has an overwhelming effect on the Palestinian economy and overrides the impact of the global financial crisis.

There are, however, concerns that the recent global financial crisis may aggravate the catastrophic conditions facing the Palestinian economy, whether directly or indirectly. The direct impact of the crisis includes the loss of individuals, financial institutions and business firms due to the deterioration in the value of securities held in their investment portfolio. Due to lack of data on the financial investment of individuals and private businesses abroad, we shall focus on the financial sector, including commercial banks, the Palestinian Monetary Authority (PMA) and the stock market. The indirect effects of the crisis emanate from its impacts on GDP and income in other countries which affect foreign aid, remittances, foreign direct investment, exports and prices in Palestine. This indirect impact depends on the degree to which the global financial crisis hits other economies and the type and size of possible changes in the behavior of such economies toward the Palestinian economy.

***Financial Sector.*** It is believed that the impact of the global crisis on the Palestinian financial sector is not significant because this sector is small and has very limited exposure to international financial markets. There are no cases of bank failures or liquidity crises. Commercial banks operating in the Palestinian territories usually pursue conservative financial policies, thanks to the PMA regulation which prohibit commercial banks from dealings in high-risk instruments. About 95% of the foreign assets of banks operating in West Bank and Gaza are placed in overseas government-guaranteed bank

deposits. The remainder is invested in securities, shares and foreign loans, with a broad diversification across both financial institutions and countries.<sup>2</sup>

There has been no risk of liquidity due to the global crisis; on the contrary, banks operating in the Palestinian territories enjoy high liquidity. However, declining private deposits and credit reflect banks' conservative lending practices and limited investment opportunities in the West Bank and Gaza due to the deterioration of security conditions, rather than impact of global financial crisis. These risks have increased lately due to internal conflict between Palestinian political parties.

The PMA itself has a diversified investments portfolio in 22 banks outside Palestine, mostly as deposits and sometimes as government bonds in Jordan. It has no investments in USA for political and legal reasons. Hence the impact of crisis on PMA investments is not significant.<sup>3</sup>

The impact of the crisis on the Palestinian stock exchange (PSE) is also not pronounced because it has little degree of exposure to the international financial system. The size of foreign investment in the PSE does not exceed 20% of total investment, which reduces the risk of sudden withdrawals of foreign capital. Furthermore, the Palestinian stock market lacks sophisticated financial instruments such as bonds, option, futures, and other derivatives which were the main causes for the current financial crisis. However, there have been nominal losses due to falling stock prices in the PSE, most of it is a result of panic and concerns about possible collapse of international financial system. Al Quds index fell from around 650 points in early September to around 420 points by the end of November 2008, a drop of more than 35% in three months before it bounced back to reach 510 points in January 2009.

**Foreign Aid.** The Palestinian economy relies heavily on foreign aid for its budget financing, including public investment. Such aid reached about 30% of GDP in 2008. There are concerns that the global recession could adversely affect the willingness (and ability) of major donors to provide financial assistance to the Palestinians, especially that the donors who provide major financial assistance to the PNA are those who suffered most from the crisis, including USA, Europe and Gulf countries. Cuts on foreign aid from those countries would put the PNA in serious difficulty as it may not be able to pay

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<sup>2</sup> International Monetary Fund (2009).

<sup>3</sup> Odeh.

salaries, cover operating expenses, make purchases from the private sector, let alone undertake development projects.

So far, however, donors have indicated that domestic and political factors continue to dominate their disbursement decisions.<sup>4</sup> In fact, more than \$1.8 billion have already transferred to the PNA last year (2008). Thus, the impact of the global financial crisis on foreign aid is most likely limited due to the political nature of these funds. Donors are not expected to freeze their commitments, totally or by a large portion, due to the crisis, especially that those funds do not represent enormous burden for those countries. Some donors may put more restrictions or may delay payments for political reasons, but not because of the crisis.

***Remittances*** The Palestinian economy is also dependent on remittances from Palestinian expatriates. There are no accurate data on the size of these remittances, but the World Bank estimates them to be around \$600 million in 2005 and 2006, which represent around 15% of GDP.<sup>5</sup> The true size of remittances, including unrecorded flows through formal and informal channels, is believed to be larger. There have been concerns that a deep recession in the Gulf countries, due to the global financial crisis and the fall in oil prices, will result in massive lay-offs among Palestinians and would reduce their ability to transfer money to their home countries. However, there are no indications of a significant decline in Palestinian workers' remittances so far. Similarly, there are no indications that the number of Palestinians working in Israel has declined significantly due to the slowdown in the Israeli economy.

***Foreign direct investment (FDI)***. Both domestic and foreign private investments in Palestine are weak due to high economic and political uncertainties, slow economic growth, and continued Israeli restrictions on movement and access. Net FDI inflows to Palestine in 2006 were estimated at merely US\$ 38 million, representing less than one per cent of GDP.<sup>6</sup> Despite the improvement in the second half of 2007 (after the formation of caretaker government in the West Bank), private investment remained sluggish, even before the global financial crisis. This situation is expected to be worse after the Israeli invasion of Gaza and the deadlock in the peace process.

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<sup>4</sup> International Monetary Fund (2009).

<sup>5</sup> Source: [www.worldbank.org/prospects/migrationandremittances](http://www.worldbank.org/prospects/migrationandremittances).

<sup>6</sup> ESCWA (2008).

**Exports.** Israel is the main importer of Palestinian products. Exports to Israel account for around 90% of total Palestinian exports. There are signs of economic slowdown in the Israeli economy due to the global financial crisis, which would have an adverse impact on the Palestinian exports. However, the share of total exports in the Palestinian GDP is relatively small due, mainly, to tight Israeli restrictions on exports from the West Bank and the blockade on Gaza. In the last four years, total exports ranged between 11.5% (in 2004) and 16% of GDP (in 2007). Thus, the impact of the global financial crisis on the Palestinian exports is likely to be limited. Intangible exports, mainly tourism which represents a major source of income in Palestine, may be affected by the lower income of pilgrims and tourists from the United States and Europe.

**Prices and Inflation.** The fall in the prices of oil, food and other basic commodities due to global recession may have positive impact on the Palestinian economy due to, first, an increase in the real income of Palestinian household and, second, reduction in production costs for Palestinian manufacturers. The appreciation of exchange rates (especially dollar and dinar) against other currencies, including the shekel, may have another positive impact on the economy in general, especially for those who get paid in dollars or dinars. This may also be good for the government who receives large part of donors' aid in US dollars and pay salaries, rent, and other expenses in shekel. However, the decline in global oil prices implies that the revenues of OPEC countries, especially Gulf countries, have declined significantly, which may have negative impact on their assistance to the Palestinian people, and further reduction of transfers of Palestinian workers in those countries to their families in Palestine.

## ***Policy response***

The policy response of the PNA to the global financial crisis is constrained by the limited policy space available to it under the terms of the Paris Protocol.<sup>7</sup> Under this Protocol, a de facto customs union was established between Israel and the Palestinian territories, which practically preserved the economic relations that existed until then, i.e., integration and dependency of the Palestinian economy on the Israeli economy. The Protocol gives the Israelis sole control over the external borders and allows them to collect customs and tax receipts on Palestinian goods and to remit these receipts to the PNA (through

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<sup>7</sup> The Paris Protocol is the framework establishing the interim-period economic relations between Israel and the Palestinian Authority. The Protocol was signed in April 1994 and is part of Oslo 1, which was signed a few days later.

specified clearance arrangements). This mechanism enables Israel to withhold or delay the transfer of revenues it collects on behalf of the PNA as a means of pressure or punishment, which has occurred several times. According to the Paris Protocol, Palestinian trade with other countries is limited to specific lists of goods, subject to predetermined quantities, and is handled through Israeli sea and air ports, or through border crossings between the PNA and Jordan and Egypt, which are also controlled by Israel. In the field of taxation, the PNA is given independent control of direct taxation but much less control over indirect taxation. In terms of labor, the Protocol asserts that the parties should attempt to maintain normal labor movement between them subject to each side's right to determine from time to time the extent and conditions of labor movement into its area, which gives Israel the right to prohibit any Palestinian workers from entering Israel any time it decides so, a situation that happened for many extended periods of time. The Paris Protocol does not allow the Palestinian Authority to issue a national currency, although a Palestinian monetary authority was established to oversee the local banking system and to manage official foreign currency reserves for the PNA.

These terms of the Paris protocol severely constrain the PNA's ability to respond to any challenges facing the Palestinian economy, including those imposed by the current global financial and economic crisis. On the monetary side, the absence of a national currency makes monetary and exchange rate policies impracticable. The use of many currencies, instead, imposes excessive risk on banks and investors due to fluctuations in various exchange rates. These risks have increased in recent months following Israeli tight restrictions on the entry of cash from banks in the West Bank to their branches in Gaza. Thus, instead of applying monetary policy tools during the global financial crisis to stimulate the economy, the PMA focused on protecting the financial sector through directives which reiterate PMA's prohibition of dealings in high-risk financial instruments such as margin trading, forwards, swaps and other derivatives. The PMA instructions also prohibit banks from investing in non-bank financial institutions and limit the ratio of real estate loans in banks' portfolios. The PMA has also set ratios for geographical and institutional diversification of financial instrument that banks should consider in their portfolios, and applied strict supervision and tough penalties for violators. These measures have minimized the risk and losses of the banking sector due to the current global crisis.

In terms of fiscal policy, the limited control of the PNA over taxes, the heavy reliance on external sources for revenue especially clearance revenue from Israel which represents 60–70 per cent of PNA's total revenues, and the ability of the Israeli government to withhold tax receipts for political reasons make the PNA fiscal policy vulnerable,

ineffective, or at least limited. As a UNCTAD report points out, what is left for the PNA is “a limited, volatile and vulnerable fiscal policy space. If anything, the PA can do little more than allocate public expenditure, which is less than the policy space available to local governments in many countries.”<sup>8</sup>

During the 2008, the PNA has taken some measures to improve its fiscal position in response to pressure from donor countries. These measures included a freeze on employment and wages, reduction of utility subsidies, and repayment of arrears on wages and to the private sector. The recurrent fiscal deficit is estimated to have declined from 24% of GDP in 2007 to 19% in 2008 (on a commitment basis). Nevertheless, the irregularity and unpredictability of transferring clearance revenue by Israel have mitigated the ability of the PNA to pay salaries and other expenses in time, and increased PNA’s reliance on foreign aid for budget support. This aid, however, is also unpredictable and subject to political fluctuations, which render the Palestinian fiscal policy hostage of the goodwill of international donors and Israelis.

## ***Conclusion***

Without underestimating the impact of the financial crisis, the Israeli measures and policies have a more devastating impact on the Palestinian economy such that the marginal impact of the global financial crisis seems to be insignificant. The deep and prolonged depression in the Palestinian territories is not the result of the global financial crisis, but it is rather the result of aggressive and destructive Israeli occupation, and it will continue as long as occupation policies and restrictions last. As an IMF recent report asserts, “...economic growth in the West Bank and Gaza has been mostly a function of the varying severity of these [Israeli] restrictions”.<sup>9</sup>

The PNA tries to use what is left of the fiscal policy options it has to manage its public finance (freeze employment, improve collection of utility bills, shift in the composition of spending away from wages and subsidies toward public investment, etc.). The draft 2009 budget envisages a growth rate of 5% in 2009 which will reduce the budget deficit to 18% of the GDP and will result in a substantial reduction in external recurrent financing requirements by one third, to \$1.2 billion. However, the Israeli aggression against Gaza has increased the demand for financial aid to overcome the humanitarian disaster and

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<sup>8</sup> UNCTAD (2008).

<sup>9</sup> International Monetary Fund (2009).

massive destruction that resulted from this aggression. The PNA prepared a supplementary budget to include spending for Gaza's reconstruction and rehabilitation, and called on donor countries to extend more financial aid for this purpose.

An international conference took place in Sharm el-Sheikh, which was concluded with pledges amounting to \$4.4 billion over two years. However, there are growing concerns that this is not more than hot air. Many Palestinians believe that the aid will not be delivered and the conditions in Gaza will remain depressed. Furthermore, these pledges will not solve the main problems facing the Palestinian economy. What is needed is a political solution. International community should pressure Israel to remove restrictions on movement and access in the West Bank and to end its blockade on Gaza, as a first step to end its occupation to the Palestinian territories. This is a necessary, though not sufficient, condition to undertake policies that can promote development and overcome the problems facing the Palestinian economy. Under Israeli occupation, the policy space available to the Palestinians to mitigate the adverse effects of the global financial crisis, or any other crisis, is very limited.

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