

Laying the Foundation for Peace: Challenges for the Palestinian Economy

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Brief Analysis

On the heels of renewed direct political negotiations between Israel and the Palestinian Authority (PA), the World Bank and International Monetary Fund (IMF) reported strong Palestinian economic growth at today's meeting of PA donors in New York. While these economic tidings will be welcomed by both Israelis and Palestinians and provide some breathing room for negotiators, headlines of robust growth mask significant problems confronting the Palestinian economy. In the near term, the PA faces a potential funding shortfall owing to lower-than-expected international assistance. In the longer term, Palestinian officials must grapple with even more formidable problems if they are to make a successful transition from an economy propped up by foreign donors to one fueled by private investment.

High Growth but High Unemployment

In their most recent reports to the Ad Hoc Liaison Committee (AHLIC) of donors to the PA, the World Bank and IMF reported that real gross domestic product (GDP) growth for 2010 is expected to reach 8 percent in the West Bank and 16 percent in Gaza. They also noted a slight decrease in unemployment in the West Bank (from 15.9 to 15.2 percent) and an increase in Gaza (from 36 to 39 percent). In the West Bank, GDP growth has been driven largely by public-sector spending, which is increasingly financed by donor assistance. The growth has also been enabled by the Israeli government's efforts to ease movement and access by removing checkpoints and taking other steps to facilitate commerce, as well as by issuing more permits for Palestinians to work in Israel. In Gaza, the high per-annum growth rate results largely from the low base from which the economy grew this year, due to the near-cessation of economic activity in the immediate aftermath of the Gaza conflict in early 2009. However, significant flows of humanitarian assistance and Israel's recent steps to ease the Gaza blockade have also contributed to growth.

Both the World Bank and IMF praised the PA's performance on institution-building and fiscal management. While judging that much work remains in this area, both deemed the PA to have largely met or exceeded its objectives for the past year. The IMF predicted that if present trends continue -- progress in the peace process, the easing of Israeli restrictions, and the institution-building effort led by PA prime minister Salam Fayad -- growth would continue to accelerate and unemployment would decline in the West Bank and Gaza.

Impending Funding Shortfall

Along with the silver lining of robust growth, declining unemployment, and success in institution-building, however, comes a dark cloud. The impressive results reported by the World Bank and IMF are almost entirely attributable to public-sector spending by the PA, chiefly in the areas of security, health, and education. This spending is in turn financed by external donors; indeed, external financing for recurrent expenditures (as opposed to development projects) as a percentage of Palestinian GDP rose steadily from 1994 to 2008, and is only now beginning to decline.

While donors have been generous, that external financing has been unpredictable and insufficient -- the IMF projects a funding shortfall for 2010 of more than \$300 million. Arab donors have been notably parsimonious this year, with both Saudi Arabia and the United Arab Emirates providing far less assistance than in the past. The shortfalls in external financing have led the PA to incur payment arrears as well as considerable bank debt. The resulting interest payments will put further pressure on future PA budgets, and the uncertainty created by delayed or delinquent disbursements complicates economic planning and consumes the attention of Palestinian officials.

Long-Term Challenges

While the efforts of Prime Minister Fayad and renewed Israeli-Palestinian economic and security cooperation appear to be paying dividends, the positive economic results reported by the World Bank and IMF do not imply that the Palestinian economy has turned a corner. Living standards in the West Bank and Gaza have only recently recovered to their 1994 levels after a long period of decline. Unemployment in the West Bank, despite recent improvements, remains well above 1994 levels. Furthermore, labor force participation rates are quite low, suggesting a large number of "discouraged workers" who are not counted in official unemployment statistics. In addition, while the PA deserves credit for its institution-building successes, the West Bank and Gaza's ranking in the International Finance Corporation's "Doing Business" survey actually slipped by two places in 2010, suggesting that the environment for would-be Palestinian entrepreneurs remains challenging.

The overall shakiness of the Palestinian economy can be attributed to structural imbalances. Sectors in which the economy was traditionally strong, such as agriculture and manufacturing, have declined steadily since 1994, while -- as suggested before -- the role of the public sector has increased. That public sector spending itself is badly skewed, with 23 percent of GDP going to wages alone, a far higher proportion than in comparable economies. Furthermore, massive reliance on external assistance, large numbers of Palestinians working abroad, and constraints on Palestinian business activity resulting from Israeli restrictions have led to a problematic combination of high wages and low-value production relative to comparable economies -- an imposing obstacle to long-term growth.

It is vital that the PA, Israel, and their international partners cooperate to encourage the growth of the Palestinian private sector and end the Palestinian economy's reliance on the public sector for growth. Leaning so heavily on the public sector is inherently untenable, given the PA's dependence on fickle foreign assistance, and raises the specter of PA budgets being weighed down for years to come.

Looking Ahead

For Palestinians, peace and prosperity are inextricably interconnected. Private-sector investment is crucial for the long-term health of the Palestinian economy, and continued economic growth and strong employment are key to sustaining Palestinian support for the peace process. Nevertheless, private capital -- whether from foreign or expatriate contributors -- is unlikely to return in force until prospects for long-term stability between Israel and the Palestinians improve.

To sustain economic growth in the interim, the World Bank and IMF emphasize the need for Israel to further reduce impediments to movement and access in the West Bank. Such reductions are undoubtedly essential, but just as the loosening so far by the Netanyahu government was made possible by a Palestinian commitment to security

performance, a further easing is only likely if the PA redoubles its commitment to security reform and the peace talks. Other critical steps highlighted by the World Bank and the IMF are further regulatory and other reforms by the PA to improve the Palestinian business climate, and more reliable provision and coordination of assistance by international donors.

Unspoken by the World Bank, IMF, or AHLC members is another risk to a long-term Palestinian recovery -- overreliance on the PA prime minister. Fayad has been a godsend for the Palestinian economy, at once bolstering Western confidence and therefore spurring Western assistance, promulgating a credible plan for building Palestinian institutions, and even bucking up Palestinians' hopes for establishing a state in the near future. But such heavy dependence on Fayad on economic matters (like dependence on Palestinian president Mahmoud Abbas in the political arena) is worrisome, and highlights the precariousness of the progress Palestinians have made in recent years. The PA and its international partners must therefore put greater effort into developing a bureaucratic structure to support both Fayad and Abbas and an accountable political system, which require attention to political reform.

Reports of economic growth and success in institution-building are good news for the Palestinians, Israel, and the international community. These developments provide breathing space for negotiators, who require public support and patience if they are to succeed, and suggest that basic building blocks -- such as security, health, and education -- are being put in place for future Palestinian prosperity. Nevertheless, continued success demands that deep-seated economic problems not be neglected amid the diplomatic flurry accompanying renewed peace talks. Indeed, political and economic progress are deeply linked -- GDP growth in Gaza will be for naught if PA rule cannot be restored there, while carefully crafted compromises on the core negotiating issues will unravel if Palestinians cannot be assured of jobs and public services.

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