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PROSPECTS FOR SUSTAINED DEVELOPMENT OF THE PALESTINIAN ECONOMY IN THE WEST BANK AND GAZA STRIP, 1990-2010:

A QUANTITATIVE FRAMEWORK

Prepared by the UNCTAD secretariat

CONTENTS

OVERVIEW

The UNCTAD secretariat embarked, in 1990, upon an action-oriented intersectoral project to: (i) examine the current economic and social situation in the occupied Palestinian territory; (ii) investigate the potential for its development; and, (iii) propose alternative options, strategies and policies for its revival and growth. Parallel with the preparation of 25 field studies on specific sectors/issues within the scope of this project, the secretariat also embarked upon the preparation of a quantitative framework aimed at investigating under alternative scenarios future growth paths of the Palestinian economy in the West Bank and Gaza Strip. The relevance of such an outlook has acquired increasing importance as a result of the accord concluded between Israel and Palestine and the emergence of the Palestinian Interim Self-Government Authority.

The methodology followed for the preparation of the framework is based on a macroeconomic analysis of resources availability and use. Given the paucity of data, emphasis was placed on ascertaining, through parametric exercises, the internal consistencies among major aggregates by, inter alia, investigating gaps between labour force and employment, savings and investments, and imports and exports. The quantitative framework thus established uses a series of identities and functions based on the behaviour of key variables during the 1970-1990 period to project trends for the period 1991-2010 under different scenarios.

The data base supporting this exercise was compiled from statistics for the period 1970-1990 released by the Israel Central Bureau of Statistics (CBS) in three major publications. Preparing and reconciling the required historical time series presented a number of technical constraints, not all of which were amenable to acceptable solution. The choice of the technique used in designing and structuring the quantitative framework was influenced by a number of factors, namely: (a) the economy of the occupied territory was unsophisticated and had been subject to the severe shocks of erosive forces; (b) the statistical limitations of the historical period prevented the structuring of a detailed approach without compromising its specificity and the validity of subsequent analysis; and, (c) the resources available to undertake the exercise were limited.

Accordingly, the framework is organized in three recursive blocks, involving demographic, labour force and macroeconomic variables.

The demographic block: Although expressed as a single equation, this block is the most detailed and comprehensive part of the framework. While the available demographic statistics are less than wholly reliable, the nature of this form of analysis renders the results quite robust. However, migration remains the most intractable variable to deal with in any form and is subject to many unpredictable forces which are difficult to envisage in such an exercise.

The labour-force block: This block is fairly straightforward, with the labour force being primarily a function of participation rates by age, sex and the age-sex structure of the population, as determined in the demographic block. Some effort is made to provide details by economic sector for both labour-force size and productivity. However, as the scenarios were developed on the basis of derived assumptions regarding the total labour force productivity, the sectoral aspects of the framework are not fully exploited.

The macroeconomic block: This block consists of a simple supply system driven by productivity and labour force, on the one hand, and a straightforward set of demand equations governing the main economic aggregates. The gap between the two represents excess capacity and unemployment. Exports were treated as exogenous in the first instance, determined by historical trends.

In the scenario analysis, the **baseline scenario**, which relies on a "minimum policy intervention" hypothesis, addresses the question of what the consequences would be of a continuation into the future of the trends and behavioral patterns that prevailed in the recent past. The main results emerging from this illustrative scenario were: (i) the labour force growth rate rapidly outpaced the growth rate of population; (ii) the dependency structure of the economy (reflected in the ratio of GDP to GNP) remained prevalent; and, (iii) unemployment reached 50 per cent by the end of the projection period. The conclusion was that the baseline scenario represented a grossly untenable socio-economic situation. The results were not only unacceptable but were also highly unrealistic. Indeed, given the nature of developments since September 1993, both the assumptions and the results of the scenario have come to appear improbable.

In a variant to this scenario the impact of a gradual easing of policy constraints and disturbances in economic activity associated with the 1988-1991 period was reflected in higher absolute levels and growth rates of most indicators. However, these did not signify notable changes regarding key features of the economy, namely, its distorted and fragile structure, its sluggish performance, poor interaction between key aggregates and its inability to break with patterns and relations engendered by prolonged occupation. Accelerated population and labour force growth coupled with limited job opportunities did not ameliorate the employment gap. Despite rapid initial increases in GDP, the saving/investment gap as well as the merchandise trade gap both widened.

A more activist approach was called for to improve prospects for the economy, primarily through a careful consideration of feasible policy options aimed at addressing the salient problems depicted under the baseline scenario and its variant. Accordingly, a set of five alternative scenarios were developed, moving from the least desirable to the most feasible and acceptable scenarios from the viewpoint of growth and development objectives and their policy options. Key policy variables and variations in each were selected following a careful process of sensitivity analysis. The variables involved in the first three alternative scenarios are exports, imports, private investments, government consumption and investment and net transfers from abroad.

Alternative I: Constrained unemployment with net external transfers as the instrument. As a first step in the process of addressing the major structural problems of the Palestinian economy, the framework was focused on an effort to reduce the employment/labour force gap. Assuming an overriding need to address unemployment, a target rate of maximum unemployment was fixed (at 10 per cent of labour force) and external transfers adjusted upwards so as to meet that target and maintain a semblance of economic stability. As the economy operates with the same structure, there is no adjustment process conceived. The increase in production and demand required to reduce unemployment to the designated level is assumed by net transfers. Similarly, the growth expected in both government and private consumption and investment is dependent on external transfers. The savings-investment gap would thus reach 62 per cent of GNP by the year 2010. The trade gap would equally widen, reaching -70 per cent of GNP by the end of the period.

As such, while the scenario is sustainable from a purely technical point of view, this is at the cost of several billions of dollars in additional external support as of the sixth year of the projection period, reaching US$4.5 billion by the year 2010. More importantly, at the end of the period the economic structure will remain essentially unchanged and will be less viable and more dependent on external support. Therefore, in the absence of serious policy measures to address the structural problems and operational constraints, a massive inflow of unrequited external transfers would be required to sustain high income and consumption levels.

Alternative II: Intensified trade-oriented investment programme. Under this scenario, explicit policy options and changes in the behaviour and growth of key variables are introduced with a view to addressing the problem of structural transformation of the economy. These are primarily intended to reduce the trade gap, increase production, and restructure demand away from consumption and in favour of investment. This general aim is translated into the following policy measures; accelerating private investment in the productive sector and encouraging its orientation towards export promotion and selective import substitution, while also expanding government consumption and investment. Obviously, the effective realization of these fundamental changes implies the lifting of constraints that have come to stifle the economy and the emergence of an indigenous authority committed to development and capable of formulating and managing a set of policy measures aimed at improving the situation.

In this scenario, the impact of the policy measures on key variables in the economy is encouraging. The unemployment situation witnesses a dramatic improvement, falling respectively to 5 and 2 per cent in the Gaza Strip and the West Bank by 2010, reflecting greater attention paid to domestic employment generation. The latter part of the period is especially underpinned by strong growth in sectoral production, particularly in industry and construction. The importance of private consumption and imports is reduced in favour of investment and exports. Both private and government investment achieve impressive rates of growth. As a result of extra investments, export performance shows marked gains. Despite an increase in the merchandise trade deficit, the trade gap in terms of both GDP and GNP narrows substantially, to -27 per cent of GNP by the year 2010.

While the national savings ratio initially shows a decline, in terms of GDP a net amelioration is perceived indicating a significant improvement in the ability of the economy to mobilize domestic savings. However, this remains insufficient, particularly in the face of the acceleration of investment required for structural transformation. Similarly, the financing of increased government expenditures (consumption and investment) remains uncertain and dependent on various policy options. Despite these limitations, the results of this scenario show that it is possible to rebuild a vigorous economy. Nevertheless, medium term costs associated with unemployment are high and it is difficult to conceive of reasonable means of supporting the additional investment from domestic sources alone.

Alternative III: Intensified trade-oriented investment with substantially increased net transfers from abroad. Under this scenario, the relatively constrained level of external transfers is relaxed in order to allow for the increased levels of investment and narrow the gaps much more rapidly than would otherwise be the case. Thus, a combination of the macroeconomic policy measures used under Alternative II and a less constrained level of external transfers linked to a target level of unemployment is applied. The main strength of this alternative is that it illustrates the sensitivity of the Palestinian economy to the availability of external financial support and investment during a period of intensive domestic policy efforts for structural transformation.

The availability of extra finance gives the economy a substantial and immediate boost to its employment generation capacity which subsequently becomes self-supporting. By the end of the projection period, unemployment could return to historically low levels (well under 5 per cent). While consumption grows so does investment at both the private and public sector levels. In the 1996-2010 period, private investment grows by 12.5 per cent annually, while public investment is intended to grow at around 8 per cent per annum. Increased investments (of a total of some $1 billion over the period) lead to a growth in production, a more rapid improvement in exports and a reduction in imports, bringing the trade gap down to -26 per cent by the year 2010. While imports still remain important in the consumer basket, their significance in aggregate demand is diminished.

Under this scenario, the economy emerges with a stronger productive base able to absorb the majority of its labour force. The injection of a total of $9 billion (i.e. an extra $5.4 billion of transfers as compared to scenario II) for the whole period of 1996-2010 should be seen in the light of some of its beneficial effects, viz. significant gains in employment, narrowing of both saving-investment and trade gaps, and improvement of the current account deficit. The additional external transfers enable the economy to generate $4.6 billion more of GDP during 1996-2010, thus allowing a much more rapid take-off with all domestic human and material resources mobilized. It is important to note that such an extra transfer will only be required in the first decade, after which a vigorous economy will emerge that should not require extra external financial support. If the total amount of external resources required is not met by unrequited transfers, the magnitude of operations envisaged may have to be scaled down or borrowing resorted too. The latter option has its own drawbacks under the present circumstances. The Palestinian economy does not yet have the international standing to acquire loans. Moreover, the burden of any loan obtained is placed on the export sector to generate even more foreign exchange to finance increasing imports and provide for debt repayment.

Alternative IV: Absorption of returning population without external transfers. While the results emerging from the previous scenarios depict a gradual improvement in prospects for the revival and sustained growth of the Palestinian economy, they fall short of satisfying the broader objective that can be envisaged bearing in mind the total potential that the Palestinian people and their economy can muster. Under the previous scenarios, it was assumed that the Palestinian people presently living in the West Bank and Gaza Strip would constitute the future population of these areas on a de facto basis. This excludes three categories of Palestinian refugees who have resided outside these areas since 1948. These constitute an important stock of the de jure population, some of whom may be able to return to the territory should the future political and economic conjuncture permit. Therefore, an attempt has been made to inject this additional dimension into the picture. The assumptions and the emerging results are not prescriptive in nature. They merely serve as a rough indication of the scale of transformation the Palestinian economy will need to undergo in order to successfully absorb an increased population. A tentative figure of returning Palestinians is assumed and the annual number of returnees is expressed as a declining proportion of resident population.

Accordingly, Alternative IV is structured in the same manner as Alternative II with a main difference being that the changes brought about in the variables concerned and policies applied are accelerated and intensified so that projections with additional population yield similar results. As a result of the population influx, the role of growth in labour force is doubled during the period. Thus, unemployment will reach a low level under 5 per cent only by the end of the period from a level of 15-20 per cent during the period 1996-2000. Both GDP and GNP will register impressive rates of growth allowing per capita income to reach levels comparable to those under Alternatives II and III. Private consumption and investment equally show high rates of increase. A relatively higher rate of the extra investment is allocated to export promotion and import substitution in order to reduce the trade gap, hence more effort to boost productive activities. While this boosts exports, the current account deficit worsens as a result of higher imports of raw materials as well as consumption and investment goods. This suggests the need for more vigorous policies to further rationalize imports and diversify and expand exports. The savings-investment gap will also widen, calling for an intensification of policy measures and development of efficient mechanisms aimed at mobilizing domestic resources at levels needed to accommodate the returning Palestinians.

It can be concluded that the returning population at the specified rate can be successfully integrated into the economy, at least as far as the implications of the macroeconomic aggregates are concerned and provided the requisite policy measures and mechanisms are initiated, sustained and intensified. In fact, the results indicate that it is the very absence of relevant policy measures and mechanisms and the much needed structural transformation rather than rapid population dynamics that prevent the Palestinian economy from attaining a desirable path of sustainable growth. Nevertheless, the modest growth rate of GDP coupled with high unemployment rates prevailing during much of the early period following recovery needs to be addressed by a combination of intensified domestic policies and increased external support.

Alternative V: Absorption of returning population with external transfers. Based on the structure of Alternatives III and IV, the purpose of this exercise is to ascertain the scale of external support needed to boost production and reduce domestic unemployment levels, thus putting the economy on the path of sustained growth and accommodating the returning population. Although the values that the main macroeconomic indicators reveal by the end of the period are not significantly different from those obtained under Alternatives III and IV, the increased level of additional external resources amounting to $9.6 billion over the period 1996-2010 (for a total external resource flow of $14.9 billion) will allow the economy to initially operate at a higher percentage of its potential capacity, including higher rates of private and public investment.

This additional external support and investment will make it possible to maintain unemployment at a rate lower than 10 per cent and to generate higher values for GDP especially during the interim period of 1996-2005. This speeds up the pace of structural transformation and growth as of a relatively early date. By the year 2010 some 94 per cent of GNP is accounted for by GDP, as