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#### THE ROLE OF THE PRIVATE SECTOR IN ECONOMIC REVIVAL OF THE OCCUPIED PALESTINIAN TERRITORIES

##### Current Situation

- > The situation in occupied territories is deteriorating at a frightening pace. The economic and social costs of the conflict are reaching unbearable levels. More worryingly, the institutions that we have all put so much effort in building over the last years are in a process of rapid implosion.
- > The last six years of conflict in the West Bank and Gaza have left the Palestinian economy mired in economic crisis. Israeli military and security measures, increased during the Intifada, have imposed major costs on the Palestinian economy, undermining its current and future developmental prospects.
- > The closures regime-i.e. the multi-faceted system of restrictions on the movement of goods and people both within the WBG and through Israel to the rest of the world-along with construction of the separation barrier have fragmented the Palestinian economic space, and further reduced its productive potential.
- > The decision by the Government of Israel to suspend the transfer of clearance revenues collected on behalf of the PA and the decision by western donors to cease budget support to the PA have led to an unprecedented fiscal crisis. Total domestic revenue dropped from around US\$15 million per month in 2006. The absence of liquidity has resulted in monthly wage bills being unpaid for the past ten months. Five partial wage payments have been made to public sector employees from March to December 2006, contributing therefore to avoid social collapse.
- > In the current political context of serious institutional degradation of the PA, key public finance reforms implemented in recent years are now critically compromised. The Single Treasury Account is not operational, due to the refusal by key domestic banks to handle the PA's accounts and to communicate formally with the MoF. No reports on PA's expenditures and revenues have been posted by the MoF since Hamas took power, and no annual budget has been published for 2006.
- > Clearly, the current fiscal position is unsustainable. Based on passive projections, the IMF estimates that a new government would face a budget deficit of more than US\$110 million per month or about US\$1.3 billion (roughly 30% of GDP)

on an annual basis-an amount that would be unlikely to be fully covered by external support and domestic financing. Any new government will therefore need to take strong and politically very difficult measures to address the underlying problems and reduce the fiscal gap.

> The EU has been playing a very active role in providing assistance to mitigate the costs of the conflict. In 2006, the EU has provided the highest level of assistance ever to the Palestinians through the Temporary International Mechanism (TIM) : close to \$700 million [€692 m], out of which €343.5 m from the European Commission alone, which has contributed to curb the most pressing needs and to avert a humanitarian crisis. By the end of December 2006, about 900 000 people have benefited from this mechanism.

## **Outlook and the role of the private sector**

> Looking forward, economic prospects remain grim and highly dependent on political outcomes. Israel's withdrawal from the Gaza Strip in September 2005, with leaving political and economic prospects uncertain, had generated optimism about the attainability of a final status agreement based on the peaceful coexistence of two neighbouring sovereign entities. The current political deadlock has significantly worsened the economic outlook.

> We will agree that the solution is ultimately political and the policy options for the PA to address the crisis are rather limited at this stage. However, there are a few actions which would contribute to improving the situation already in the short run.

> First, improving the business environment : this should be a top priority for the PA. Indeed, the revival of the Palestinian economy will depend to a very large extent on the dynamism of its private sector, particularly SMEs. Several limits to the free movement of people and goods imposed by Israel and unpredictable closures of Palestinian borders have impeded the regular flow of Palestinian exports and imports and led to massive distortions in the economy, including the loss of external markets, shrinkage and fragmentation of internal markets major cities, as well as increased transaction costs, risk and uncertainties. But beyond these restrictions, the business environment in the OPT is bad. The World Bank Doing Business 2007 report ranks the OPT in the 13th position in a list of 17 MENA countries in an index measuring the ease of doing business. OPT rankings do not get better when expanding the sample. The OPT are basically the worse place worldwide to start a business (ranking 173 rd position) only surpassing Chad and Guinea-Bissau, and ranking also very low in the ease to close a business (151st position). But there are positive spots that show that there is potential: the level of petty corruption is low, the bureaucracy is relatively efficient and the financial markets are well developed.

> It is clear that the severity and unpredictability of restrictions on trade and movement of people (closures), in terms of both timing and location, reduce the potential importance of reforms to improve the business and investment climate. However, measures aimed at reducing the cost of doing business are urgent and must be addressed in any case.

> Among the most important measures are: (1) improving the effectiveness and independence of the judicial system to enforce court decisions and contracts (2) improving mechanisms for the resolution of commercial disputes (3) easing of procedures for the registration of businesses, particularly foreign-owned companies (4) streamlining labour regulations and re-introduce short-term contracts.

> (5) Access to credit. Access to credit does not seem to be a fundamental constrain for Palestinian enterprises. Yet, a deeper analysis of Palestinian firm's reality shows that many firms simply do not ask for credit, prohibitive collateral requirements having severely restricted demand; indeed, during the last five years, only 13% of SMEs have applied for credit although 66% of them declare to be in need of financing. Of those SMEs which succeeded in obtaining a loan, almost three quarters stated that credit was not enough to cover more than 75% of their capital requirement. Unmet collateral requirements and lack of guarantees have forced firms to turn to traditional sources of funding such as retained earnings and family sources; but in the current context of economic distress traditional sources will reveal insufficient to cover firms' financing needs. According to the Palestine Economic Research Institute (MAS), the financing needs of the Palestinian SMEs in 2006 amounted to some USD647 million, and estimations place needs at USD900 million over the period 2006-2010. Clearly, donors have a role to play in the creation of collateral guarantee schemes aimed at improving SME's access to credit. In that spirit, the European Commission has supported with €15 million the creation of a

Euro-Palestinian Credit Guarantee Fund, which issued its first guarantees in September 2006. This project is managed by KfW.

> Second, implement the Agreement on Movement and Access (AMA): Prospects for economic revival are doomed to failure without considerable relaxation of the Israeli security regime. For Palestinian enterprises, better access to market remains the key priority. Over the medium-term, expanding access to the Israeli market remains private sector best chance for growth.

> While the AMA offers a lot of prospects for turning around the continuing Palestinian economic decline, in practice its entire success is+ hostage to unilateral Israeli decisions on its implementation.

> In order for the AMA implementation to reap all its potential benefits, all areas of the AMA need to be implemented simultaneously. A piecemeal approach (e.g. crossings but not internal movement) will not be enough to stop the ongoing economic decline. However, one of the problems is that the AMA does not provide for any enforcement mechanism.

### **Working with the private sector**

> The private sector is the main vehicle for growth and development in Palestine, more so in view of the poor endowment in natural resources. Palestinian SMEs play a fundamental role in rehabilitating the economy and as an engine for long-term and sustainable growth. Between 2000 and 2005, private sector employment grew from a 61% share to a 67% share helping to partially absorb growing numbers of Palestinians who lost employment in Israel.

> Several Palestinian private sector institutions are providing services to the private sector with the goal of improving business conditions but they are facing sustainability problems linked to fragmentation and overlapping. The EU is of the opinion that the Private Sector Coordination Council (PSCC) should be the right framework to assist the institutions in the preparation and implementation of joint programs in the field of management training, foreign trade support, trade affairs, information dissemination, etc.

> The EU has invested a significant amount of financial and human resources in strengthening relations with the Palestinian private sector. The establishment of a European-Palestinian Business Council (EPBP)

> Constitutes the major specific initiative taken by Palestinians to promote relations between the EU and Palestinian private sectors. The EPBP is the latest private sector business association to be created in Palestine. The Council has various objectives to help promote economic co-operation through identifying projects and activities to provide investment opportunities both locally and in Europe.

> The EU has also launched other initiatives such as a technical assistance for the establishment of an European Information Correspondence Centre (EICC), and the establishment of a Palestinian Shipper's Council (PSC) which would provide Palestinian companies access to good advice about transporting their goods to international markets and to assist decision-makers at the regional and international level in negotiations to overcome economic and transport obstacles. In addition, the EU is supporting the implementation of the Euro-Mediterranean Charter for Enterprise in the OPT. The key Charter areas for the PA are administrative simplification, better access to markets and the promotion of strong and independent business associations.