3. Private Investment Under Uncertainty in the West Bank and Gaza Strip

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There is a broad consensus that the weak private investment performance in the West Bank and Gaza Strip in recent years can be attributed largely to the unfavorable external environment and to adverse political developments, notably the general border closure imposed since 1993, the intermittent total or "intensified" closures triggered by security incidents, and the uncertain prospects for progress in the peace process. At the same time, there is a growing recognition that, especially in view of what are perceived to be "political constraints" on liberalizing the West Bank and Gaza Strip’s external trade environment, there is a need to formulate and implement appropriate economic policies and institution-building measures that would to some degree compensate for the effects of the trade-related constraints. This paper is structured as follows:

- The first section focuses on “the way it used to be” prior to the onset of the peace process, and makes clear the key role of the external trade environment in influencing both the magnitude as well as the composition and quality of private investment. The role of other important factors that have affected private investment, including the influence of the financial and institutional frameworks, is also examined.

- The next section assesses the potential of the economic system envisaged under the Oslo accords to relieve the constraints on private investment that hitherto existed, in particular by offering unprecedented opportunities for the implementation of measures to liberalize the external trade environment, to develop the financial sector, to improve the quality of infrastructural and institutional support to investors, and to reduce uncertainties relating to the stability of incentives facing investors.

- The present key constraints on private investment in the West Bank and Gaza Strip are then examined, taking into account the important institutional weakness and other economic handicaps inherited from the period of military occupation, and employing the “peace as a turning point” scenario as a benchmark for an assessment of the “way it turned out.”

The Way It Used to Be

Key Features of Private Investment

The evolution and composition of private investment in the West Bank and Gaza Strip has historically reflected to a large extent changes in the volume and pattern of trade in goods and services between the West Bank and Gaza Strip and Israel. Following the Israeli occupation, the West Bank and Gaza Strip’s external trade, which had been previously directed mostly toward neighboring countries of comparable wealth and level of development, was swiftly reoriented toward the economically more advanced Israeli economy, which had a GNP about 20 times as large.1 The opening of Israeli markets to Palestinian employment and, to a lesser extent, to commodity exports, was reflected in remarkably high rates of real GNP growth, which averaged 30 percent per year over the decade 1969–79. This high rate of

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income growth was accompanied by a rise in private investment as a share of GDP from about 14 percent in 1969 to 30 percent in 1979, with real private investment growing at an average of 25 percent per year (Figure 1).

Although this surge in private investment appears impressive, the composition of the increase in investment was heavily skewed in favor of investment in construction. The increase in private investment consisted almost entirely of increases in construction investment, largely in housing, which represented an average of 85 percent of total private investment over the period. In contrast, real investment in machinery and equipment grew by a yearly average of less than 1 percent, while as a share of GDP it fell steadily from about 10 percent of GDP in 1969 to 5 percent of GDP in 1979.

The concentration of private investment in residential construction, along with the virtual stagnation of investment in machinery and equipment, suggests that investment was being largely driven by growth, while making a relatively limited contribution as a potential source of growth for subsequent periods. Reflecting the limited “feedback effect” running from investment to growth, the tapering off of the initial boost to growth provided by the “integration effect,” in particular the slowing of the pace at which labor shifted from low-productivity agriculture to higher-wage employment in Israel, resulted in a sharp deceleration of real GNP growth to a yearly average of about 5 percent in 1980–91. As a result, private investment was virtually stagnant during the latter period, growing at a yearly average of less than 1 percent, while its pattern remained heavily skewed in favor of residential construction.

The predominance of housing investment in overall private investment, and in particular the limited increase in investment in machinery and equipment, can be explained by a number of important factors. The first and key factor is the skewed pattern of trade between the West Bank and Gaza Strip and Israel, which suppressed the development of a large part of the domestic productive base, in particular of agriculture and industry, while encouraging services. Second, the absence of a developed system of financial intermediation reinforced the bias of the private investment pattern in favor of the housing sector and against the industrial and agricultural sectors. Third, the Israeli authorities provided little support to private investment in the form of public investment in infrastructure, nor did they create a favorable legal and regulatory environment. Fourth, the uncertainty with regard to political stability further stifled private investment in the productive sectors.

The Key Role of the Trade Environment

The trade regime with Israel was characterized by the absence of barriers to Israeli exports to the West

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2Empirical evidence from developing countries on the contribution of different types of capital goods to economic growth strongly suggests that investment in machinery and equipment plays a key role as a source of growth. See for example De Long and Summers (1991) and Romer (1989).
3. PRIVATE INVESTMENT UNDER UNCERTAINTY

Bank and Gaza Strip, but with restrictions on Palestinian agricultural and industrial exports. This was reflected by large trade deficits in both agricultural and industrial products with Israel, ranging from about 25 to 30 percent of GDP since 1969, financed to an important degree by the export of labor services. The asymmetries in the external trade environment resulted in an agricultural sector oriented largely toward domestic production, using mostly traditional techniques. Similarly, trade and licensing restrictions on industrial exports, along with the impact on labor costs of the demand-pull effect of employment opportunities in Israel, constrained the development of the industrial sector, which consisted largely of family-based microenterprises, with more than 90 percent of all enterprises employing eight or fewer workers. The share of industry in GDP stagnated in the range of 6–8 percent starting in 1969, well below the range of about 20 to 30 percent of other countries with comparable income levels. The asymmetric trade regime with Israel thus contributed to a strong bias in the composition of investment against agriculture and industry, representing the main potential outlets for investment in machinery and equipment, and in favor of investment in housing, which became the preferred vehicle for savings.

There were also other important factors, in addition to the key role of the trade environment, that tended to reinforce the skewed pattern of private investment.

Absence of a Developed System of Financial Intermediation

The financial sector in the West Bank and Gaza Strip prior to 1992 consisted of two or three banks offering a limited range of services, with low levels of domestic lending, operating alongside a wide system of moneychangers. There were no markets for equity, long-term debt, or government securities, and no instruments or vehicles for risk management. This absence of developed formal channels of financial intermediation encouraged the channeling of savings toward investments that could more easily be self-financed or financed by a small group of savers through informal channels, in particular in residential construction, and away from investments in sectors that required longer-term risk capital, notably in modern farming and industry.

Inadequate Infrastructural Support and Absence of a Supportive Legal and Regulatory Framework

Public expenditure by the Israeli authorities in the West Bank and Gaza Strip consisted largely of military and security-related current expenditure, providing little in the way of infrastructural support for private investment. Public capital investment stagnated in the range of 3–6 percent of GDP throughout the 1969–91 period, well below levels in other developing countries (Figure 1). In the same vein, the Israeli authorities did little to provide a supportive legal and regulatory framework for private investment. Private investors were faced with a confusing amalgam of British Mandate, Jordanian, and Egyptian laws, periodically amended or suspended on an ad hoc basis by Israeli Military Orders. In effect, the framework provided strict controls on the entry of foreign funds, imposed strict restrictions on the repatriation of earnings and capital, and did not provide for adequate dispute resolution mechanisms. In addition, the authorities implemented a cumbersome and non-transparent system for the allocation of investment licenses. Such an environment encouraged household-based investments that required little infrastructural support, and that minimized the degree of interaction between investors and the authorities, an important attribute of nonentrepreneurial investments in residential construction and of investments in family-based microenterprises.

Political and Economic Uncertainty Associated with the Military Occupation

Insofar as private investors viewed the state of military occupation as a source of perpetual social and political tensions, they also perceived the overall political and economic environment associated with the occupation as inherently unstable. There

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3Restrictions on agricultural exports consisted of quotas on vegetable exports, while restrictions on industrial exports consisted of strict licensing requirements. In addition to these direct trade restrictions, the production of exportables was stifled by the Israeli policy of subsidizing Israeli agriculture and industry, including through subsidies on factors of production, credit at concessional rates, export finance, and minimum price supports through marketing boards. For a discussion of asymmetries in the external trade regime in the West Bank and Gaza Strip, see Nashashibi and Kanaan (1994).
was thus a "strategic" uncertainty with regard to the duration of the prevailing "status quo" (in particular with regard to the nature of economic relations between the West Bank and Gaza Strip and Israel and the West Bank and Gaza Strip's access to external markets) and to the corresponding structure of incentives affecting the profitability of investments. This uncertainty, which was especially high during the period of the Intifada, induced entrepreneurs to postpone investments in order to acquire key information on the structure and stability of incentives expected to prevail in the longer term. It tended in particular to discourage larger-scale investments in capital-intensive projects with significant "sunk" costs and long gestation periods. This uncertainty had a more limited adverse impact on smaller-scale, family-based investments, such as in housing and microenterprises, whose profitability was less vulnerable to market disruption.

The Peace Process as a Potential Turning Point

The peace accords signed in the early 1990s between the Israeli and Palestinian authorities promised an economic and political environment that had the potential to substantially relax or eliminate all of the constraints on private investment discussed above.

The Liberalization of External Trade

The Economic Protocol on Economic Relations signed in 1994 envisaged a trade regime for the West Bank and Gaza Strip in the interim period that was highly conducive to the expansion and reorientation of the economy's productive base toward agricultural and industrial export production, and that gradually reduced its dependence on the export of labor services. From the viewpoint of private investors, an important attractive feature of the Protocol lies in the envisaged removal of most restrictions on Palestinian commodity exports to the Israeli market, thereby increasing the profitability of investments in agricultural and industrial production. It also allowed Palestinians more flexibility, albeit on a very limited scale, in determining their own import policies and tariff structure with regard to specific products and countries, including raw materials and capital goods from neighboring Arab countries, with potential favorable effects on investment costs.

Despite the advantages outlined above, the Economic Protocol still had certain limitations. In addition to the restrictive import policy, it did not address important disadvantages to the trade environment in the West Bank and Gaza Strip, in particular the absence of significant outlets to external markets, including of seaports and airports, and the prevalence of significant impediments to trade within Palestinian areas, in particular between the West Bank and the Gaza Strip. Nevertheless, although such key trade-related issues were postponed to later negotiations, high expectations were formed simply by such issues being placed on the negotiating table. Investors' expectations were further buoyed by the Palestinian Authority's stated resolve to minimize distortions in market incentives and to pursue a "private-sector led outward-oriented export promotion strategy" (a phrase cherished in official declarations) once it is granted powers over key economic spheres.

The peace process and the associated agreements, in addition to heralding a favorable trade environment to investors, had the potential to promote private investment opportunities by relaxing other important constraints.

Development of the Financial Sector

The dearth of banks in the West Bank and Gaza Strip during the period of occupation resulted in a large part of household savings being held in financial institutions outside the country, stored through informal domestic financial channels, or hoarded in cash. There was thus a large pent-up demand for formal financial channels of intermediation that would provide more profitable or convenient channels for such savings. The very rapid expansion of the banking sector and the fast rise in banking deposits even in the early stages of the peace process was a reflection of such conditions. At the same time, the absence of formal financial channels constrained access to finance by investors in need of long-term risk capital. There was thus an anticipation that, as an outcome of
the change in the trading environment and other favorable implications of the peace process, there would be a boom in domestic private investment demand that would offer lucrative domestic outlets to a large stock of financial savings.

Substantial Infrastructural and Institutional Support

The very low levels of public capital investment undertaken by the Israeli authorities during the occupation resulted in a dilapidated state of physical infrastructure, which increased an important component of investment costs, in particular those related to transportation. Such costs were expected to decline as a result of the implementation of the public investment projects, to which donors committed about $1.2 billion for the period 1994–96 in the form of fixed capital investment, an important part of which were given in support of physical infrastructure. This represented a formidable increase compared to past public investment levels, which averaged $150 million per year in 1990–93. Private investors also hoped for a supportive institutional framework, in particular a transparent legal and regulatory framework that would, in line with the Palestinian Authority’s stated “market-friendly” stance, minimize the scope of government “meddling” in private sector activities. The productivity of private physical capital and the strength and quality of institutions (including the quality of public services) in the West Bank and Gaza Strip were also expected to benefit from an anticipated large inflow of human capital into the West Bank and Gaza Strip, embodied in a large pool of highly skilled Palestinians living in the diaspora, which would be attracted by the liberalization of the political and economic environment under Palestinian self-rule.

Reduced Uncertainties Relating to the Overall Economic and Political Framework

The rapid progress in the peace process at its earlier stages, and in particular the transfer of control over important economic spheres to the Palestinian Authority, signaled improved prospects for a stable political and economic environment and an associated stable structure of incentives facing investors. Although the “incremental approach” adopted in the peace accords, and in particular the postponement of key issues governing the nature of the trade environment to a later stage, maintained some degree of uncertainty for private investors, sources of social and political tensions appeared substantially diminished in the period immediately following the peace agreements.

The Way It Turned Out

The peace process thus had the potential to yield substantial welfare gains, largely through rapid growth in private investment and a reorientation of the investment pattern toward the economy’s outward-oriented productive base. However, a look at the evolution of private investment since 1993 reveals a radically different and disturbing picture (Figure 1). In 1993–97 real private investment is estimated to have declined by an average of 10 percent per year, and private investment’s share in GDP to have declined from 19 percent of GDP in 1993 to 10 percent of GDP in 1997. What went wrong?

The External Trade Environment

As we have seen earlier, the dominant role played by external trade in goods and services in the Palestinian economy makes the profitability profiles of investments especially vulnerable to changes in the external trade environment. The trade regime that prevailed in the West Bank and Gaza Strip since 1993 was characterized by the imposition since 1993 of strict controls at the borders, including stringent security requirements and procedures on goods and labor, and the recurrence of intermittent “total” or “intensified” closures that impose a transient state of virtual autarky of uncertain timing and duration. The regime of closures operated in the context of very limited access to markets outside Israel due to the absence of functioning seaports and airports.

Before looking closely at the effects of the regime of closures on investment incentives at the microeconomic level, it would be useful to first take a “bird’s-eye view” of the implications of the closures on production and investment at the economywide aggregate level.5

5See the Appendix for an illustration using the two-good trade theoretic model.
The regime of closures and the corresponding trade restrictions induce a distortion of incentives faced by producers and consumers in the West Bank and Gaza Strip, which leads to reductions in the standard gains from trade and losses in the efficiency of resource allocation and social welfare. As the profitability of the export sector is reduced relative to that of other sectors, a "distorted" pattern of resource allocation and production emerges, with a corresponding shift in the composition of investment away from the "socially optimal" allocation. In the presence of adjustment costs and price rigidities, the regime of closures has a further depressing effect on aggregate investment induced by the adverse effects on aggregate income and demand. The demand for exports of goods and services is directly reduced by export barriers inherent in the regime of closures, whereas the demand for the output of other sectors is indirectly depressed due to aggregate income losses. The restrictions on the import of production inputs and factors of production, and the increase in transportation costs, induce an additional adverse effect on aggregate investment by raising production costs in all sectors. Finally, the "stop-go" cycles that characterize the regime of closures compound the adverse effects on investment of the changes in "average levels" of openness, aggregate and sectoral demand, and production costs.

The effects of the regime of closures could be more concretely revealed by examining the approach of an investor who is making decisions with the objective of maximizing profits, on the basis of an assessment of the profitability profiles of alternative investment projects. The "projects," defined broadly, could consist of capital investments to expand an existing enterprise or to establish a new enterprise. Insofar as the key variable influencing the investor's decisions is the net present value of the project under consideration, the investor needs to form expectations on the path of costs and revenues likely to be realized in the project's lifetime.6

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6The net present value of a project is defined as the sum of the net income streams (revenues minus costs) expected in each period of the project's lifetime, discounted by a risk-adjusted rate. The risk-factor in the discount rate reflects the uncertainty regarding the realization of the expected values of costs and revenues. One measure of the "risk" that reflects this uncertainty is related to the perceived variance of net income streams in future periods.

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The regime of closures can potentially affect producers' revenues and costs both through its effect on the average levels of effective demand and production costs, and by sharply increasing the variability of demand and costs. This dual effect can be illustrated by considering the effects of the regime of closures on the effective demand for Palestinian labor services in Israel. Figure 2 shows the number of Palestinian workers in Israel in each month in 1996 and 1997. Two effects of the closures can be noted. First, the closures had an "average level" effect by reducing the number of Palestinian workers in Israel from an average of more than 100,000 prior to the regime of closures to an average of about 30,000 in 1996–97. Second, the closures introduced cyclical fluctuations in the effective demand for Palestinian labor services in Israel, with the number of workers in Israel declining to a negligible level during periods of closures, then rising back to a peak level as closures are lifted, before dipping again as closures are reimposed. When examining the implications of the regime of closures on the path of costs and revenues, it is thus important to consider the extent to which the cycles introduced by the "stop-go" feature of closures compound the adverse effects on average levels.

Impact on Expected Revenues

From the point of view of the investor in the export sector assessing sales prospects over the project's time horizon, a key question that arises re-
lates to the extent to which export sales forgone during periods of closures can be recouped during periods of open borders, and the effect of the "stop-go" cycle of closures on the permanent level of demand for exports. There are two characteristics of the West Bank and Gaza Strip export sector that tend to limit the degree of recoupment of export revenue losses and to make the sharp cyclical fluctuations in demand especially harmful. First, a large share of export activities is in the agricultural and horticultural sectors, whose output is highly perishable and thus involves high storage and inventory costs. Faced with such costs, farmers in the West Bank and Gaza Strip have often found it necessary to "dump" in the domestic market agricultural and horticultural products targeted at higher income consumers abroad, with adverse effects on prices and sales revenue. Second, whereas the orientation of the West Bank and Gaza Strip's export sector is heavily concentrated toward the Israeli market, with very limited access to other outlets, Israel's trade orientation is much less dependent on the West Bank and Gaza Strip markets, given its well established outlets and access to markets outside the West Bank and Gaza Strip. The costs to Israeli importers of an unexpected interruption of supply during closures reduce the competitiveness of exports from the West Bank and Gaza Strip. These costs, given the flexibility of Israel's import orientation, is prone to induce a "permanent" decline in demand for exports from the West Bank and Gaza Strip, which could persist well beyond the downturns of the cycles of closures.

The effect of the regime of closures on demand for the output of the import-substitutes and non-tradables tends to be less pronounced both in terms of the adverse effect on "average levels" as well as variability, since it operates indirectly through the effect on aggregate income. Aggregate income will be falling during the period of total border closures, and rising during the period of opening. The extent to which these fluctuations would be reflected in shifts in domestic consumer demand, and thus in revenue from the sales of import-substitutes and nontradables, would depend on the extent to which consumers smooth their consumption patterns, in particular through saving/dissaving and recourse to credit markets. However, domestic sales revenue will unambiguously be adversely affected by the decline in "permanent" aggregate income, corresponding to the permanent reduction in the gains from trade compared with the pre-closures regime. The fluctuations in relative prices could induce a "substitution effect" corresponding to the shift in domestic demand from imports to domestically produced goods, which could temper the above "wealth effect."

Impact on Expected Costs

A key channel through which the regime of closures affects production costs is through the unanticipated disruption for uncertain periods of the importation of production inputs, in particular capital goods and raw materials. The recurrence of total closures would be expected to induce firms to raise their levels of inventories of production inputs to serve as buffer stocks in anticipation of closures. Although little data are available to allow the assessment of costs to producers of tying up resources in inventories of imported production inputs, these would be expected to be high on a priori grounds, in view of the high dependence on imported inputs of most commodity-producing activities in the West Bank and Gaza Strip, especially in the industrial and construction sectors.

While the costs associated with the inability to import inputs are incurred only during periods of total closures, producers have witnessed since the imposition of generalized closures in 1993 a substantial rise in transportation costs as a result of very stringent security controls and delays at the borders. While such an increase in input costs affects virtually all

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7 Data on the composition of exports from the West Bank and Gaza Strip are very limited. The most recent available data are from the bulletins of the Ministry of Planning's Statistics Department, which provide information on the composition of exports of goods from the Gaza Strip during the first six months of 1996. These show that out of a total of NIS 60 million exported during this period, about NIS 27 million, or 45 percent, is classified as either "citrus" or "fruits and vegetables." See CBS (1996).

8 Data on the composition of imports of goods to the Gaza Strip from CBS (1996) give some feel to the reliance of the economy on imported inputs. The data indicate that in the first six months of 1996, out of NIS 520 million in total imports, about 17 percent consisted of building materials, 9 percent of machinery and equipment, 9 percent of fuel products, and 4 percent of spare parts.

9 For example, according to World Bank (1997a, chapter 3), the transportation costs for a truckload of goods between the West Bank and Gaza Strip increased from around NIS 500 in 1993 to NIS 1,500 in 1996.
sectors, the export sector bears the additional burden of higher transportation costs on the output side, especially for perishable exports such as agricultural and food products.

The regime of closures can impose other types of production costs due to the unanticipated and pronounced shifts in demand associated with the stop-go cycle. First, firms are unable to fully adjust capacity and the level of inputs to match the cyclical fluctuations of demand, resulting in unused capacity and the retention by firms of unutilized inputs (including labor) during the periods of closures. Second, undertaking unexpected and large changes in production levels can involve substantial costs in cases where firms need to make binding decisions or "plans" with regard to future levels of production on the basis of anticipated demand conditions. To temper such cost effects, firms may resort to "production-smoothing" by accumulating inventories during periods of closures, which are then drawn down after borders reopen. Such production-smoothing itself involves the cost of tying up resources in inventories and of maintaining the quality of inventories. The costs of unanticipated demand shocks would be expected to be especially high for the large share of West Bank and Gaza Strip exports consisting of perishable agricultural and horticultural exports, because decisions on production levels have to be made well in advance of the time of export.

The adverse effects of the downturns of the regime of closures on the cash flows of firms are compounded by the high cost of and limited access to credit due to the important institutional weaknesses in credit markets in the West Bank and Gaza Strip and to induced credit-rationing, as will be examined closely below. Again, the "dual effect" inherent in the regime of closures is operative here. The "average degree" of credit rationing not only increases because of higher uncertainty during closures, but rationing is likely to become more severe during the downturn of the closures cycle, as banks perceive an increase in the lending risk. This "cycle effect" tends to further limit the producer's ability to offset the impact of the reduced net cash flows (as a result of lower sales and the higher production costs discussed above), thus raising the perceived risk of illiquidity and the expected costs associated with such illiquidity over the project's time-horizon.

In addition to the impact of the uncertainty with regard to the timing and duration of the total closures, there is a second source of uncertainty that could inhibit private investment. Investors do not view the current external trade regime as permanent, but one that is subject to change depending on the outcome of the Palestinian-Israeli negotiations, and in particular with regard to permanent status issues. This introduces a "strategic" uncertainty with regard to the duration of the current "status quo" for the external trade environment and the associated structure of incentives facing investors, in particular with regard to the continuation of the current regime of border closures, the size of the "domestic" market (as determined for example by the size of the areas in the West Bank and Gaza Strip under Israeli control relative to that under Palestinian control), and the extent of access to external markets. In the context of such strategic uncertainty, the existence of entry and exit costs could introduce an incentive to postpone investment in order to acquire additional information on the profile of costs and revenues expected to prevail in the medium and long term.

There is one potentially favorable effect of the regime of closures on production costs. During periods of closures, the supply of labor in the domestic market in the West Bank and Gaza Strip increases as a result of the fall in the number of workers employed in the private sector. The "average degree" of credit rationing not only increases because of higher uncertainty during closures, but rationing is likely to become more severe during the downturn of the closures cycle, as banks perceive an increase in the lending risk. This "cycle effect" tends to further limit the producer's ability to offset the impact of the reduced net cash flows (as a result of lower sales and the higher production costs discussed above), thus raising the perceived risk of illiquidity and the expected costs associated with such illiquidity over the project's time-horizon.

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10Miron (1996, chapters 4–5) reviews micro-level evidence from industrialized countries on the costs of changing production levels in response to changing demand conditions as well as evidence suggesting that unused capacity at the firm level tends to increase with the variability of demand. Van Ewijk (1997) discusses the costs in the form of productivity losses at the firm level when demand cycles involve severe downturns during which factors of production are not utilized. The losses in productivity occur as a result of the decay in skills and knowledge during periods of inactivity, in particular in the form of losses in labor skills as on-the-job "learning by doing" is interrupted.


12The increase in the degree of credit rationing during severe downturns of economic cycles is discussed in Stiglitz (1993).

13The existence of entry and exit costs to investment (partial or full irreversibility) induces investors to balance the value of waiting for new information affecting their profitability profile with the cost of postponing their investment in terms of profits foregone while waiting. See, for example, Abel et al (1996) and Ingersoll and Ross (1992) for a discussion of the implications on investment of strategic uncertainty in the presence of such costs.
workers allowed in Israel, which could reduce labor costs to domestic producers. Available data from labor force surveys, however, show no significant variations in domestic wage rates commensurate with the wide fluctuations in the number of workers allowed in Israel. On a priori grounds the following two features may be at play. First, even in periods of open borders during which the number of workers allowed in Israel reaches its peak, the unemployment rate in the West Bank and Gaza Strip remains at more than 25 percent. This suggests that equilibrium domestic employment levels may be bound by constraints on the demand side of the labor market, thus limiting the effect of the greater supply of workers previously employed in Israel on domestic wage levels. Second, producers may find it more costly, ceteris paribus, to employ less “reliable” workers who are expected to abruptly revert to the more lucrative employment in Israel whenever borders reopen; this tends to limit the degree of competitiveness and “fungibility” of workers normally employed in Israel in relation to those of other domestic workers with similar skills.

Summing Up: Implications for Profitability of Investments

Viewed from the perspective of a private investor seeking to assess the profitability of projects in the West Bank and Gaza Strip, the regime of border closures has several features that could exert strong downward pressures on the projects’ net present value (NPV). Producers’ revenues are adversely affected by the decline in the average level of demand and the increase in its variability. Costs are raised through higher transportation costs, disruptions of production due to difficulties in importing inputs, and through the adjustment costs incurred in adapting the level of output and capacity to fluctuating demand conditions. The institutional weaknesses in the credit market in the West Bank and Gaza Strip and the induced credit rationing has an adverse effect on the NPV by raising the cost of and limiting access to credit. The existence of strategic uncertainty with regard to the duration of the current “status quo,” in particular with regard to duration and nature of the current external trade environment, in conjunction with entry and exit costs, has a further depressing effect on private investment. The only potentially beneficial side effect of the closures is the impact on labor costs, but even this effect appears to be tempered by the overall depressed demand conditions and the “on-off” cyclical feature of the regime of closures.

The adverse effects on the investments’ net present value is especially strong in the export sector, where the effects on demand conditions are much more direct and pronounced than in other sectors. In the import-substituting and nontradables sectors, the downward pressures on the net present value are tempered by the change in relative prices in their favor induced by the shift in domestic demand from imports to domestically produced goods. The regime of closures thus has features that depress the profitability of investments in all sectors, with adverse effects on aggregate investment, and features that induce a shift in the composition of investment away from the export sector by changing the relative profitability of investments across sectors.

Access to Sources of Finance

As had been anticipated, a rapid expansion in the banking system in the West Bank and Gaza Strip has taken place, resulting in a rise in the banking sector deposit base from less than $500 million in early 1993 to about $1.9 billion by the end of 1997. Contrary to what was hoped for, however, less than a third of this base was lent to the domestic private sector. As we have seen above, the unfavorable external trade environment in the West Bank and Gaza Strip, in particular the regime of border closures, adversely affects private investment demand at the aggregate level by increasing risks and reducing expected returns.

14The results of four labor force surveys conducted by Palestinian Central Bureau of Statistics (1997) in 1996-97 show a 9 percent decline in real daily wages in the West Bank and Gaza Strip in the first quarter of 1997 compared with the average in 1996 (see, for example, UN (1997) for an overview). However, variations in the average daily net wage did not reflect the wide fluctuations in employment in Israel as a result of changing border restrictions. Thus, in the West Bank the daily wage remained stable in the range NIS 47-50 while the share of the West Bank labor force employed in Israel and settlements varied widely between 11 percent and 21 percent; similarly, results for the Gaza Strip show that the daily wage rate remained at NIS 41-43, while the share of the Gaza labor force employed in Israel and settlements varied between 4 percent and 14 percent.
This would be reflected in a wide gap between bank lending capacity and credit to the private sector. At the same time, there are important institutional weaknesses characterizing the financial sector in the West Bank and Gaza Strip, which could potentially, when investment demand picks up, constrain access to, or increase the cost of, bank credit to creditworthy investors with profitable projects by inducing “credit rationing.”

There are several key factors in the West Bank and Gaza Strip that could contribute to credit rationing: (1) the prevalence of imperfect information on the risk-return profiles of investors and on their ability to bear risk; (2) the absence of an adequate legal framework that would encourage the use of collateral in bank lending and thus reduce the high lending risk associated with imperfect information; and (3) the high liquidity risk of long-term lending, given the short-term nature of the bulk of deposits and the absence of markets for long-term debt in the West Bank and Gaza Strip.

Imperfect Information

In the West Bank and Gaza Strip the following sources of imperfect information have prevailed: (1) the virtual absence of banks for more than 25 years, and the consequent lack of experience of banks with lending in the specific conditions of the West Bank and Gaza Strip; (2) the large pool of potential borrowers with no previous experience in borrowing from banks, and no “track record” or bank credit history that can be used by banks to adequately assess a proposed investment project’s prospects; and (3) the absence of a credit appraisal and rating system that would facilitate banks’ assessment of the credit risk of borrowing enterprises.

A number of donor projects are currently being implemented, notably as part of the World Bank’s Financial Sector Project and Microenterprise Project, that aim to alleviate such sources of imperfect information by: (1) assisting in the implementation of loan screening and monitoring systems; (2) providing technical assistance to microenterprises to help form basic skills in interacting and reporting to banks, including through the preparation of business plans; and (3) encouraging banks to lend to microenterprises by enhancing skills in cash-flow and character (or reputation)-based lending. This would help banks base their lending decisions on an assessment of borrowers’ business prospects and on reputation, rather than only on the availability of acceptable collateral.

Constraints on Collateral-Based Lending

The consequences of imperfect information, in particular in the form of increased lending risk and induced credit rationing, can in principle be alleviated through collateral-based lending. However, this has been inhibited by: (1) difficulties in establishing a legal basis for ownership and registration of collateral; (2) uncertainty with regard to the effectiveness of the legal framework and judicial system for enforcing foreclosure; and (3) the rationing of credit to small-scale businesses through excessive collateral requirements. These weaknesses are currently being addressed through the strengthening of the legal framework to facilitate the use of collateral, and through the development of information systems for the registration of assets.

Constraints on Long-Term Finance

There are indications that banks tend to perceive a high liquidity risk in long-term lending due to the short-term nature of most bank deposits and the high uncertainty with regard to the stability of the deposit base. To help reduce this type of risk, several programs supported by the World Bank are being implemented to channel long-term funds from donors to banks, which would be on-lent for long-term investments (such as through subordinated debt facilities), and to establish facilities that would allow banks to refi-

15See Chapter 4 for a discussion of credit rationing in the West Bank and Gaza Strip and Chabrier and Kanaan (forthcoming) for a discussion of the links between economic policy, institutional weaknesses, and access to credit by the private sector.

16Important laws under preparation include the Property Law, which defines ownership rights and the recording of encumbrances; the Secured Lending Law, which allows banks to take security on movable property, and the Condominium Law, which establishes ownership rights for apartments. In the area of information systems, good progress has been made in developing a register for movable assets (including vehicles and machinery), although registers for fixed assets (including for land) are still inadequate.
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Although a market for equities currently exists in the West Bank and Gaza Strip, its contribution to the financing of investments is limited both by the depressed level of private investment demand, as well as the small-scale or “microenterprise” nature of most West Bank and Gaza Strip enterprises. Nevertheless, some steps to establish a strong legal foundation for the equity market are needed, including through the implementation of the Securities Law, which would provide a framework for the regulation of the equity market’s operations in line with international practice, and establish adequate accounting and auditing standards for enterprises to enable a sound assessment of profitability. In the meantime, the IFC and other donors are playing an active role in promoting direct equity investments, most recently by helping to start up and partially finance the Peace Technology Fund, which will seek to channel funds from Palestinian and Israeli entrepreneurs into small- and medium-scale industries in the West Bank and Gaza Strip.

Infrastructural and Institutional Support

Private investors were disappointed with the limited public infrastructural support since 1994, especially in view of the formidable sums that had been committed by donors for public investment projects. The progress of implementation proceeded at a much slower pace than anticipated. Out of about $1.2 billion committed by donors to public investment projects for the period 1994–97, only about $600 million has been disbursed. More important, from the viewpoint of the private investor, the disbursements resulted in relatively limited investment in physical infrastructural projects that would have had the most favorable effects on the productivity of private capital investment. The implementation of public projects in the transportation sector was particularly slow, with the disbursement-to-commitments ratio in that sector averaging about 10 percent for 1994–97, compared to the overall ratio for the public investment projects of about 50 percent.17

The Legal and Regulatory Framework

With the advent of self-rule, the confusing array of laws that had prevailed under the occupation was expected to gradually give way to a transparent and supportive legal and regulatory framework. From the investors’ viewpoint, a key component of the framework as it prevailed as of March 1998 was the Law on the Encouragement of Investment (the Investment Law).18 The Investment Law had several features that adversely affect the profitability of investments, especially by introducing a great deal of uncertainty with regard to costs. In particular, the Law granted considerable discretionary powers to the Palestinian Higher Agency for the Encouragement of Investment, including the approval of all investments through cumbersome and ill-defined procedures. The Investment Agency also had the power to cancel or suspend all licenses, with no possibility of recourse to the judicial system or to independent arbitration; the investor had recourse only to the President of the Palestinian Authority to dispute such decisions.

As part of efforts to strengthen the legal and regulatory environment, the IMF and the World Bank have been working with the Palestinian Authority on a new Investment Law designed to address the above shortcomings (the new law was approved by the legislature in April 1998). In the meantime, to allay investors’ concern about the stability of the legal and regulatory framework, especially in the context of the high political uncertainty, donors are currently working on establishing a Guarantee Trust Fund for Private Investments (the “MIGA Project”). The Fund’s purpose is to provide investors with guarantees against the risks of losses due to expropriation, to the breach or repudiation of contracts by the authorities, to the inability to transfer currency, and to damage to physical property due to politically motivated acts.

The drafting and adoption of laws and regulations, no matter the extent to which these are “in line with international standards and practice,” would be viewed by investors as merely “pieces of paper” if they perceive that government actions, in particular those affecting private sector incen-

17See Chapter 5 for a discussion of the implementation of the public investment projects.

18Although the Law has not yet been approved by the Legislative Council, the Palestinian Authority views the Law as de facto applicable since its approval by the Cabinet of Ministers on April 30, 1995. For detailed assessments of the Law see Fidler (1996) and World Bank (1997a).
Appendix

In this appendix we employ the two-good comparative statics neoclassical model to illustrate the economic implications of the regime of border closures examined earlier.

In Figure 3 we first depict an initial situation with a given stock of capital and labor and the associated Production Possibilities Frontier (PPF), represented by AB. Under free trade, the economy would produce at point F, the point of tangency of the free-trade price line with the PPF, which would maximize the value of domestic output at free-trade prices, and consume at a point yielding social utility UF. Under autarky,
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Figure 3
West Bank and Gaza Strip: Implications of the Regime of Border Closures

The economy produces and consumes at point K, the point of tangency between the price line under autarky and the PPF, yielding lower social utility UK.

Consider first the implications of the "generalized" closures. In the context of the two-good model, we can represent the effect of generalized closures by making the "melting ice" assumption often used in the trade theoretic literature. This would be effectively reflected in a lowering in the economy's rate of transformation in trade, leading to a shift in the price line away from the free-trade price line and toward the autarky price line. In Figure 3, the effects of generalized closures have induced a rotation in the price line from the pre-1993 price line dd' to gg', closer to the autarky equilibrium. Generalized closures have then led to a shift in the production pattern (path 2), corresponding to a decline in social utility in the West Bank and Gaza Strip depicted by the shift from UD, the utility prior to 1993, to UG.

Let us now examine the case where the investor is assessing the impact on future income streams of intermittent shifts in the trade regime between free trade and autarky. Consider first the optimal policy response with the assumption of no production rigidities. If the economy is producing under free trade and a closure is imposed, the optimal policy would be to move instantaneously to the optimal autarky point K and remain there until the closures are lifted, after which the economy moves back to the free-trade production point F. Thus the economy oscillates between the two target points F and K in Figure 3 (paths a and b).

Consider now the case of an economy with adjustment costs, as examined earlier in the chapter. It can be shown that in this case the optimal policy is characterized by movements between two target points M and N, which lie in between the free trade optimal point F, and the autarky optimal point K (Figure 4). The intuition behind this outcome is as follows: Since the policy objective is to maximize not only present levels of welfare but welfare levels in future periods, the optimal policy under open borders consists of balancing the gains of being close to the free-trade optimal point, with the future costs of shifting resources back toward the autarky equilibrium after the closure is reimposed. Thus, in the "open border" regime, the highest level of welfare and income that could be enjoyed by the economy, which corresponds to utility level UM associated with production at M, will be lower than utility UF under the free trade equilibrium. Similarly, with the border closed, the optimal policy is to balance the present gains from being close to the optimal autarky point, with the future costs of reallocating resources toward the free-trade equilibrium when the border reopens, thus leading to lower levels of aggregate welfare and income than under the optimal autarky point.

Even when borders are open, the economy does not enjoy free trade, but a situation of generalized closures. Because of the "melting ice" conditions that operate when borders are open, trade takes place at a lower rate of transformation, which effectively tilts the price line from the free-trade line ff' and closer toward the autarky price.

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19Samuelson (1954) originally used the "melting ice" assumption in the two-good comparative statics model in which it is assumed that, in certain types of trade, part of the traded goods perishes, as if ice is being transported and is melting away in transit. This assumption was also used in an interesting two-good model by Bhagwati and Hansen (1973) of the effects of illegal trade, in which smugglers of goods across borders, in fear of detection, tend to mishandle and damage part of their merchandise. An analogous phenomenon may be occurring in the West Bank where traders tend to take advantage of the borders' porosity and opt for unusual passages to avoid the delays and stringent controls at checkpoints.

20For a proof of this dual solution in the context of "on-off" intermittent trade disruptions, see, for example, Cheng (1989). Other models of trade disruptions include Loury (1983), Arad and Hillman (1979), and the seminal contribution by Bhagwati and Srinivasan (1976).
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