Military occupation, foreign aid and the elusive quest for a viable Palestinian economy

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The piece argues that it is simply an illusion to purporting the current Palestinian growth as a promising step towards economic sustainability. It is not, and in fact reading the data suggests that the Palestinian economy is growing more dependent, less industrialised and less able to export. That is hardly surprising given the external constraints the economy is subject to. The utter failure of the donor community to deal with any of these inherently political constraints goes a long way to explain why the external assistance which has become massive in the last few years has failed to deliver any sustainable improvements in the Palestinian economy. On the contrary it has probably helped to harm the viability of the Palestinian economy, by hurting its tradable sector. The piece concludes with some suggestions on how to bring politics back into the donors' picture.

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"A new building in Ramallah, or 100 for that matter, make for good ribbon-cutting ceremonies, but are as far from economic state building as is wrong is from right."
Sam Bahour, Palestinian-American freelance business consultant.

"In all probability, had the international aid organizations used their moral clout earlier and refused to comply with the political restraints imposed on their delivery of relief, the siege [on Gaza] would have been lifted long ago."
Allegra Pacheco, American/Israeli lawyer.[2]

The (myth of) Palestinian growth

The recent news about the substantial growth of the Palestinian, or rather the West Bank, economy in 2009 (and in the first quarters of 2010) has spurred a flurry of hopeful statements on the viability of a future Palestinian state and has increased the support to the Fayyad government especially (or solely) among the international community. Take for instance this Haaretz report:[3]

> *"But cars are only part of the economic development story. A shopping mall has opened on the ground floor of a new Nablus office building. The city center is thriving, the open-air markets, clothing stores and cafes are bustling. In Jenin, not far from the former settlements of Ganim and Kadim, the Dahyat al-Jinan neighborhood is being built. It will have brand-new power and water infrastructure, parks and services, all carefully planned. A new neighborhood, Rehan, is being built in Ramallah. Al-Hafi says his family has bought three apartments in the new neighborhood, which will have private homes as well."*

The idea purported by several observers today is that the Fayyad cure is delivering on improved security, institution building and transparency which are benefiting the Palestinian economy.[4] As this in turn is a key condition to prepare for an independent Palestinian state, the adage goes, we are on the right path towards a two state solution of the conflict.

However scratching the surface of this apparent incipient economic resurgence unveils a very different economic story. That is a story of de-industrialisation and of increased dependence on foreign assistance due to the ever more chronic inability of Palestine to pay for its imports. It is ultimately a story of military occupation which would make it impossible for any economy to be viable on its own, let alone to thrive. The basic contours of this story tell of a quasi-economy, Palestine, with one of the largest trade deficits in the world, which has been rising over the past fifteen years, following the increasing restrictions imposed by Israel and the shrinking of its tradable sector as a whole (see Figure 1). As labour migration to Israel, which has historically been the way in which the Palestinian economy has financed its large trade deficit, has become more restricted over time, Palestine has turned more and more dependent on foreign assistance. In 2008 this

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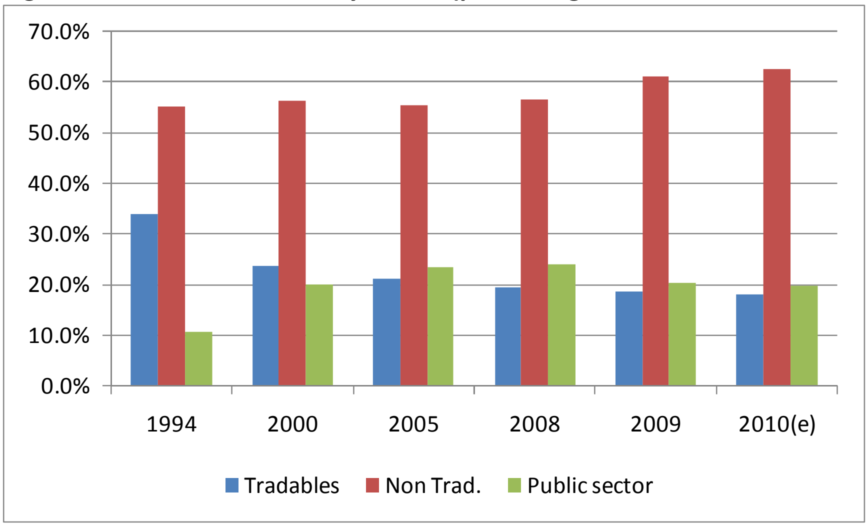
[2] The first quote comes from Bahour (2010), "Growth that Palestine can believe in", Guardian, 1 March 2010. The second quote comes from Pacheco (2010), "Hobbled by political constraints", Haaretz, 4 June 2010.
[3] Avi Issacharoff, "In the West Bank, new cars signal the good life", Haaretz, 16 July 2010. Other positive news reports of economic growth in Palestine can be found here:
http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aXCfAuLgGPFA
http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052970203863204574348292035667088.html
http://www.reuters.com/article/idUSTRE58C1RI20090913
[4] Former IMF representative Oussama Kanaan was explicit to attribute the growth for the West Bank in part to "improved security, institution building and transparency from the government of Fayyad". The other factors responsible for the growth were an Israeli easing of restrictions on movement and access and substantial donations from foreign governments (http://www.nytimes.com/2010/04/08/world/middleeast/08palestinians.html).

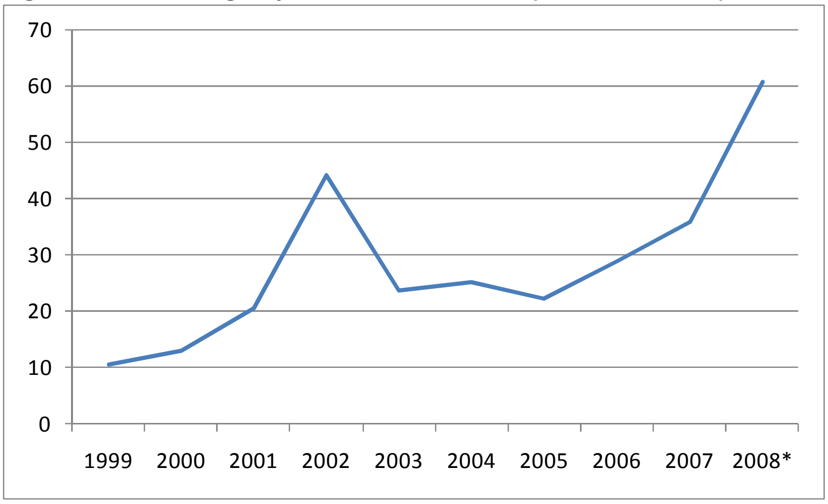
represented over 60% of Gross National Income (GNI), with this share almost trebling since 2005 (Figure 2). Moreover external assistance in the form of budget support funded around 53% of the Palestinian Authority's (PA) budget in 2009, with a steep rise from the 20% funded in 2003. These figures make Palestine one of the most aid dependent countries in the world, on par with other post-conflict countries, such as Liberia.[5]

Figure 1: GDP contribution by sector (percentage based on US$ constant)



Source: PCBS

Figure 2: Increasing dependence: Aid flows (disbursements) as % of GNI



** Estimates. Source: DeVoir and Tartir (2009) and World Development Indicators*

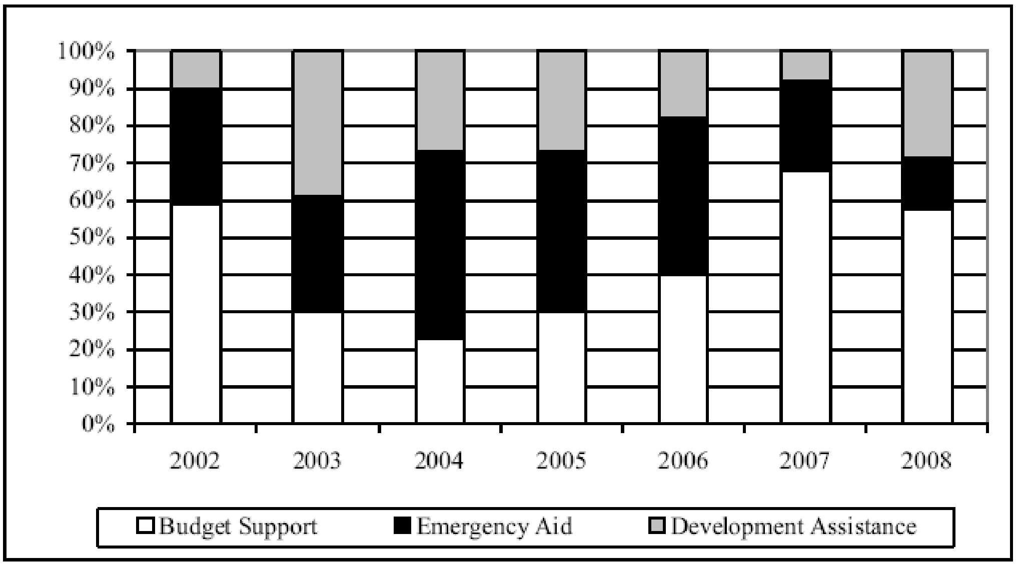
The controversial contribution of foreign assistance

The problem of aid dependency is compounded by another critical problem: the current (and past) nature of the foreign assistance provided to Palestine. Far from tackling in any substantial way the root of the economic (and obviously not economic) problems of Palestine, i.e. the Israeli occupation (in the case of Gaza under the form of a siege), foreign assistance has concentrated predominantly on short term emergency relief and increasingly on budget support to provide a lifeline to an

[5] In 2008 West Bank and Gaza had the largest aid (both in terms of disbursement and commitments) over GNI ratio in the world after Liberia (based on DeVoir and Tartir, 2009 for WBG data and on OECD/DAC data for the other recipient countries).

otherwise bankrupt PA (see Figure 3). Both of these types of assistance have been surging due to the impossibility of the Palestinian economy to develop its own means of subsistence, because of the occupation and the lack of a sovereign state. They have generated a dependency, which is going to be difficult to break.

Figure 3: Aid inflows (disbursements) to West Bank and Gaza, by main type



Source: DeVoir and Tartir (2009)

But even the other main component of foreign aid, i.e. development expenditure, consisting of inter alia spending on education, health, infrastructure, has not meaningfully tackled the root political problem of the sluggish performance of the Palestinian economy. In fact various development projects even start from the acceptance of the occupation as a potentially permanent feature of the Palestinian economy and society, and operate within the limits of a constant occupation framework. Far from challenging the Israeli occupation, these projects tend to provide a sort of legitimisation of it. Hamoudeh (2008) documents a number of such examples in the West Bank, including the Jenin industrial estate project and JICA's development proposals for the Jordan Valley.

Aside from these troubling examples, the vast majority of development assistance to Palestine keeps avoiding any direct (or indirect) activities aimed to tackle the major barrier to Palestinian development, while contributing to the growth of the non tradable sector vis-à-vis the tradable one. That is well exemplified by the construction sector, which has been booming in the past few years, mainly in West Bank urban areas and predominantly thanks to the (direct or indirect) support of foreign aid. The flurry of new buildings enthusiastically described by the Haaretz quote above has been funded mainly as a by-product of the surge in foreign aid. That is where most of the new money is coming from in the West Bank essentially financing the growth of the non tradable sector (including the public administration). As a matter of fact the entire economic growth in 2009 comes from the non tradable sector, with construction and real estate services alone being responsible for roughly a third of it.[6] The foreign aid money comes into the economy in the form of salaries for the PA, for the local staff working on the projects funded by the development cooperation, in the form of guarantees for expanding the credit lines of the domestic banks (which in turn fund construction projects, car imports, etc.), and so on. This multiplier effect of foreign aid may be good for short-run economic performance, but it is as far as helping to build a viable economy as one can imagine. First

[6] The rest of the growth comes mainly from transport storage and communication (18%), wholesale and retail trade (10%), public administration (10%) and education (9%) – author's calculation son PCBS data.

it is likely to benefit only a fairly restricted elite in the territories, who is able of accessing these funds directly and of satisfying the demand generated by such funds. This is typically the urban middle class, which is particularly concentrated in Ramallah (no surprise then that the agricultural sector has shrunk even in a period of high growth as 2008-09). A corollary of this is that questions may arise as to the extent to which these benefits to the West Bank urban elite may distort their incentives towards changing the political status quo. Consistently with these distorted incentives the high dependence on external assistance threatens to break up the system of accountability of the government towards its own electorate. Therefore it should not come as a surprise that Prime Minister Salam Fayyad recently pledged continued reforms if additional external assistance is forthcoming.[7] He needs to promise reforms to donors rather than his own people, as donors are those footing the PA's bills.

Second, the growth of the non tradable sector engineered by the inflow of foreign aid has obscured the zero growth in 2009 of the tradable sector (essentially agriculture and manufacturing), which should be the backbone of any viable economy. That is the story of all successful economies in modern history, which have developed through healthy competitive tradable sectors. But that is not what has been happening in Palestine, where the development of the tradable sector has been (and still is) harmed by the Israeli occupation as well as by the large inflows of foreign aid (which is itself motivated by the occupation). The main problem again is that the so-called development aid, just as the rest of the foreign assistance to Palestine, has hardly tackled the constraints posed by Israeli policies in Palestine. As explained below the Israeli occupation is the main reason why real incomes per capita have declined in West Bank and Gaza during this decade despite the unprecedented inflows of foreign assistance.

On top of the failure to address the root cause of Palestinian under-development (or "de-development" in the famous definition of Sara Roy, 1995), another problem, which is hardly recognised, brought about by these massive and (until recently) rising aid flows is the overvaluation of the real exchange rate (RER), that is the ratio of non tradable to tradable goods and services' prices. The huge surge in aid inflows raises the price of domestic inputs of production (the non tradable sector), contributing to make the Palestinian tradable production, whose price is set internationally independently of what happens in Palestine, less competitive internationally. That is a classic problem known as 'Dutch disease' and has been proven to be at play in many aid-dependent economies which have seen their manufacturing growth hindered by the aid inflows (Rajan and Subramanian, 2010). As argued below, this problem is also likely to be part of the explanation as to why the tradable sector in Palestine has been shrinking considerably (in relative terms) in the past fifteen years.[8] The ratio of the RER in West Bank over that in Jerusalem provides a rough indication of the evolution of the relative competitiveness of the tradable sector in the West Bank. As Figure 4 shows this ratio has been gradually increasing since 1999 (except for the 2005-08 period), suggesting a deterioration of the tradable sector's competitiveness vis-à-vis its main trading partner Israel.

Figure 5 suggests that part of this increase has been due to the aid inflows flocking to Palestine. Once controlling for the effects of the second Intifada there is a remarkable positive and statistically significant association in the period 1999-2009 between the ratio RER in West Bank/RER in Jerusalem and total aid disbursements to Palestine a year earlier.[9] As aid allocation to Palestine can be hardly influenced by the ratio, this is prima facie evidence of a detrimental effect of aid on the

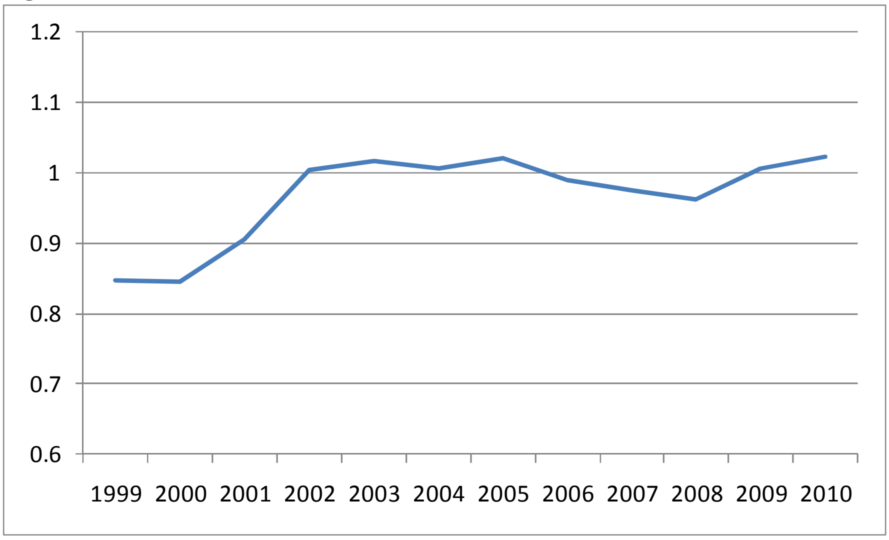
[7] See http://www.haaretz.com/news/diplomacy-defense/palestinians-seek-more-international-aid-pledge-reforms-1.314837

[8] See the Appendix for a more complete treatment of the Dutch-disease effects of aid on West Bank's tradable sector.

[9] See the Appendix for a more detailed explanation of the data and the methods used to generate the figure.

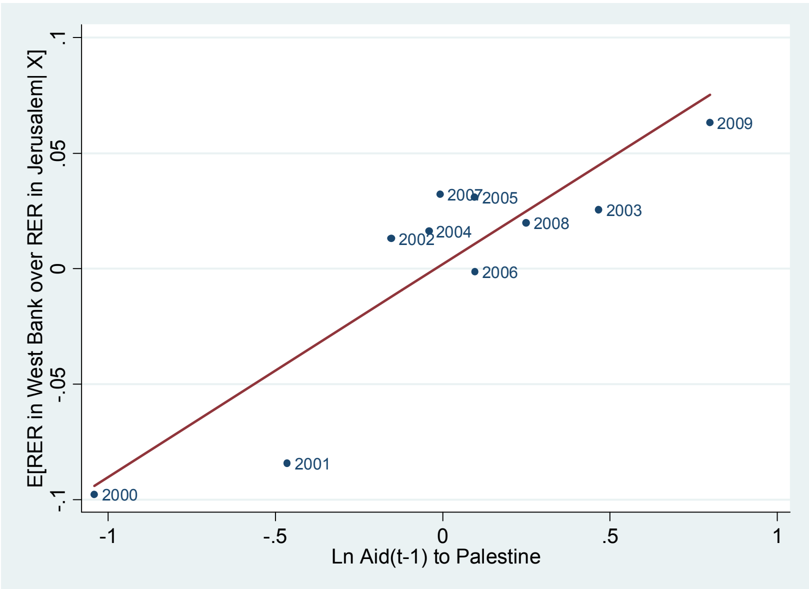
competitiveness of the tradable sector in West Bank, which currently represents the almost the entire tradable sector in Palestine.

Figure 4: Ratio RER in West Bank over RER in Jerusalem



Source: Author’s calculations on PCBS

Figure 5: Real exchange rate and foreign aid in West Bank



Source: Author’s elaboration on PCBS and DeVoir and Tartir (2009)

The (impossible) dream of a sustainable economy under occupation

The controversial impact of aid on the tradable sector is obviously of second order importance relative to the constraints imposed by the Israeli occupation, which let us reiterate is the first and foremost root cause of the lack of Palestinian economic progress. The kinds of external constraints imposed on Palestine by Israel would make it impossible to build a viable economy for any country in the world. Those imposed on the Gaza strip are so evident (e.g. prohibition of exports, de facto prohibition of people movement in and out of Gaza, severe restrictions on imports) that is not even necessary to argue about their role in Gaza's developmental deterioration. But the restrictions imposed on the West Bank are also devastating for its development and impose a burden on the economic prospects that cannot be hidden by any reported rates of economic growth. It is worth recapping some of the most draconian ones. 60% of the land in the West Bank is area C controlled directly by Israel, land on which Palestinians cannot build (UN estimates that building for Palestinians is possible only on 1% of that land); 23% of the land is area B, where also a permit is necessary to build. According to a recent report by B'tselem (2010) 42% of the West Bank land area is controlled by more than 300,000 settlers, who live in 121 settlements and about one hundred outposts. This portion of the West Bank is larger than the combined area A and B land areas. Such a division of the land has produced what has come to be known as the 'banthustanisation' of the West Bank: a collection of 'islands' separated from one another by land controlled by Israel, which restricts the connection between the Palestinian 'islands' via a variety of ways, including checkpoints, road blocks and earth mounds.

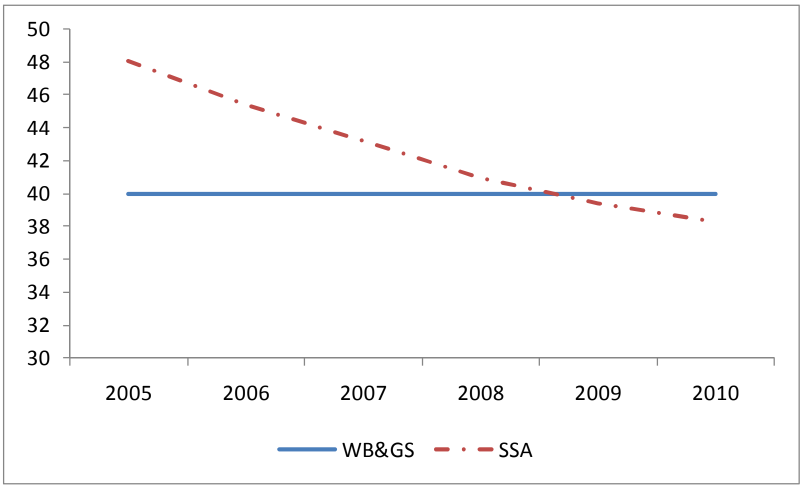
OCHA (2010) reports a partial easing of such restrictions in the last twelve months, and the IMF (2010a) recognises that this partial easing has contributed to the positive performance of the West Bank economy in 2009. But by no means have these restrictions stopped being a key binding constraint to the competitiveness of the economy. The most recent World Bank report on the Palestinian economy argues that "the obstacles facing potential private investors in WB&G remain manifold and myriad, primarily resulting from restrictions put in place by the GoI [Government of Israel]" (World Bank, 2010, p.13). Such obstacles in the West Bank include among others the lack of access of Palestinians to areas beyond the Separation Wall, and to land and rural communities in the Jordan Valley, poor access to water resources, the severed links to East Jerusalem, the most important market for West Bank's goods and services, the difficulty and uncertainty of obtaining visas for foreign investors and technical staff (see PalTrade, 2010), and the restrictions on importing into WB&G due to the "dual-use" importing system for the vast majority of the items. For example, per capita water withdrawals for Palestinians in the West Bank are about one quarter of those available to Israelis, and have declined over the last decade. Palestinians have the lowest access to fresh water resources by regional standards. The time to clear imports provides another example of the devastating impact of the restrictions imposed by Israel on the functioning of the Palestinian economy. As figure 6 shows that the time taken to import, a key cost of trading indicator for an importing economy like Palestine, is now higher in West Bank and Gaza than the average time taken in sub-Saharan Africa, the region with the highest importing time.[10]

Aside from the actual restrictions, it is also the lack of information over the frequency, types and duration of the restrictions that undermines any security of economic activity in the West Bank, thus diminishing the potential return and security of any investments. The rather outspoken tone of the report (and of the preceding ones as well) for an organisation like the World Bank usually known to be fairly measured in its statements confirms the gravity of the constraints imposed by the Israeli occupation on Palestinian economic development.

The impact of these restrictions on the market operations in Palestine cannot be over-estimated and all other independent organisations analysing the Palestinian economy agree that these represent by far the most important constraints to Palestinian development today (e.g. UNCTAD, 2010, IMF, 2010a, 2010b).

Figure 6: Time to import (average nr. of days), 2005-10

[10] This time includes the operations of offloading the goods from the ship, clearing the import procedures and transporting them to the factory.



Source: World Bank "Doing Business Report"

Exporting goods, labour or the Palestinian 'humanitarian' plight?

All these restrictions undermine one of the key factors determining the sustainability of any economy, i.e. its ability to earn enough foreign exchange to pay for its imports. The usual way to pay for the imports is to export. However this has not been the way followed by Palestine (as the huge historical trade deficit testifies), due to the occupation and earlier to the labour market integration with Israel. The World Bank was wondering five years ago whether the way forward for the Palestinian economy would be to export goods or labour for its sustainability (i.e. to pay for its imports).[11] These options closely resemble the one or the two state solutions to the Israeli-Palestinian dispute. Labour market integration with Palestinians working in the Israeli economy would be a situation likely to arise in a one-state settlement, like it has been the case in the pre-2001 period (in 2000 21% of Palestinian employees were working in Israel, equivalent to 22% of Palestinian GDP) and more so in the pre-Oslo years when there was an (almost) unhindered flow of daily labour from the Palestinian territories into Israel (for instance 45% of the workforce from Gaza and 35% of the West Bank workforce was employed in Israel at the height of the economic interdependence with Israel at the end of the 1980s).[12]

This large inflow of revenues through the export of labour increased the demand for goods and services in West Bank and Gaza, which in turn, exerted an upward pressure on the real exchange rate (i.e. the price of non tradable over the price of tradable goods and services). Consequently, factors were reallocated towards non-tradable activities, imports increased, and exports never took off. This is comparable to the so-called 'Dutch Disease' phenomenon. Moreover, the possibility for Palestinian workers to commute to Israel, where wages were much higher, pulled up reservation wages, in comparison to a situation where access to the Israeli market was impossible.[13] So this situation made the development of a strong Palestinian export sector difficult, but it provided for an independent way for West Bank and Gaza to finance their imports (mainly from Israel).

As the Israelis' restrictions have made the option of exporting labour much more difficult, donors have stepped in to prevent the total collapse of the Palestinian economy ending to fund in 2009 up to 83% of the trade deficit. Thus between the options of exporting labour or exporting goods (and services), Palestine is following (with the lead of the international community and Israel) a third worrying option, i.e. exporting its 'humanitarian' plight, getting foreign aid in exchange, which

[11] Astrup and Dessus (2005).
[12] Aranki and Daoud (2010).
[13] On average wages in Israel were 77% higher than in WBG over the period 1995–1999.

provides a temporary lifeline to a devastated economy. This third way is an implicit refutation of both one and two state solutions, as it neither helps to restore the economic integration with Israel, nor does it promote a viable independent Palestinian economy. On the contrary the lifeline provided by donors generates a dangerous dependency on foreign money (and one could wonder how long the international community will be willing to provide money for) and allows the Palestinians just about to float while their prospects of economic sustainability fade further due to the occupation.

Rethinking about foreign assistance to Palestine

The behaviour of the donor community in West Bank and Gaza resembles that of a government of a drought prone area, which spends all its money and energy in trying to transport water to the suffering local population every time the drought emerges, without tackling the root problem of the droughts, e.g. an inefficient water collection system. Part of that population will die in the process, while its dependency on emergency relief will continue unabated. In the same way the massive and increasing flow of emergency (and development) aid to Palestine has created a conspicuous dependency without tackling the root problem of Palestinian development in any significant way.

In addition, by providing humanitarian assistance and trying to mitigate the damaging socio-economic effects of Israeli policies in Palestine, the donor community has helped portraying the crisis as an emergency, which contributes to depoliticizing the Palestinian development process and normalizing the conflict. This distracts efforts away from tackling the diplomatic challenges and obstacles impeding the resolution of the Israeli–Palestinian conflict by focusing on its socio-economic consequences rather than addressing its political root causes (Le More, 2005).

As noted by Le More (2005) the main justification for this donor strategy has revolved around the elusive notion of ‘supporting the peace process’. In the mid-1990s, the fear was that worsening economic conditions would lead to the political radicalization of Palestinian society and a derailment of the peace process. The massive increase in foreign assistance during the current decade has been similarly motivated: to avoid a total collapse of the PA and of the Palestinian economy, alleviate human suffering so as to ensure a minimum level of stability, and prevent more violence and a further degradation of the situation. Not only has this policy utterly failed to revive the peace process, but as argued in this note it has also undermined the long-term viability of the Palestinian economy, increasing its dependency on foreign assistance and penalising its tradable sectors, without tackling the root political problems of Palestinian under-development. In this respect the recent call of Prime Minister Fayyad for more international aid as a necessary condition for statehood seems to be consistent with a development model based on external assistance rather than on private sector led resources mobilisation.[14]

This is a call for a substantial re-thinking of the donors’ assistance strategy to the Palestinian people. One way in which this could be done is by focussing more than it has been done so far on creating the conditions for a sustainable growth of the tradable sector. This involves the strengthening of its productive capacity with a careful choice of assistance to lift *non-occupation related* constraints to trade.[15]

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[14] See http://www.haaretz.com/news/diplomacy-defense/palestinians-seek-more-international-aid-pledge-reforms-1.314837

[15] UNCTAD (2010) suggests a (temporary) corrective intervention to neutralize the effects of an uncompetitive RER (which UNCTAD attributes mainly to the strength of the Israeli currency) in the form of a tax/subsidy scheme whereby imports are taxed and the revenue thus raised is used to strengthen the entire tradable sector (export-oriented and import-competing activities). However this scheme would ultimately penalise consumers through higher prices. Moreover the small size of the Palestinian economy would make the production of most tradables uncompetitive even under a protectionist regime,

But this also implies the avoidance of massive scale-up of aid inflows especially towards the non tradable sectors, as this puts upward pressure on the real exchange rate. Palestine does not need new fancy buildings and cars in order to thrive economically, it rather needs more factories producing exportables which can be easily shipped to foreign markets, more trained professionals that could freely sell their consultancy to foreign countries without cumbersome procedures to obtain a permit to leave the Palestinian territories, more foreign and domestic capital that can be productively invested without the fear that a road closure will hamper the viability of the investment itself, better access to water resources and agricultural land which could allow the (re-)development of the agricultural export sector.

These examples point to the other and, I would argue, more important way along which donors' assistance to Palestine needs to be re-thought, i.e. by tackling the root constraints to Palestinian economic development. These are inherently political and have to do with the military occupation of the West Bank, the siege on Gaza, and the isolation of East Jerusalem. It is this political dimension that needs to be brought into the centre-stage of foreign assistance to Palestine in order for donors' intervention to be meaningful. While this is a sensitive matter for the donors' community as well as for both parties involved in the conflict, one needs to understand that without tackling the political dimension of the conflict, foreign assistance is bound to fail to improve the welfare of the Palestinians in a sustainable manner (just as it has failed in the last 62 years). So what does this political dimension mean in practical terms?

This is a thorny question and there are no magic bullets available to tackle it. Moreover any proposal in that direction is likely to be met by harsh opposition by some parties. But 60 years of failures in dealing with the Palestinian question may be a good enough argument to put forth a few such ideas. Without the intention to be in any way exhaustive, I put forth some (and not necessarily the most effective) of the many possible ways along which foreign assistance to Palestine could be re-shaped to incorporate a more pronounced political dimension. The hope is that this small set of suggestions may hep to generate a lot more of much needed discussion around the various options for reform of the aid industry in Palestine.

First, the donors should stop funding projects which explicitly accept the occupation as a potentially permanent feature of the Palestinian economy and society, thus developing interventions which operate within the limits imposed by the occupation in the long-run.

Second, as a large part of the implementation of the foreign funded programmes of assistance to the Palestinians are hindered by constraints posed by the Israeli occupation, it could be effective for the donors and the implementing agencies to deal more vocally with those constraints. A case in point is the huge restrictions imposed by the siege in Gaza, which as argued by Pacheco (2010) could have been more fundamentally tackled by the donor community by using much less political restraint than it has been doing. Obviously this carries the risk of not being able to operate in the Palestinian territories altogether, but then Israel would be likely to face the consequences as the occupying power. As noted by Le More (2005) not only does aid relieve Israel of its responsibilities of services to the Palestinians under international law, but it also helps sustain its occupation, which would be much trickier and more onerous to maintain did the international community not foot the bill.

A corollary to this point is that aid should start helping to directly challenge the de facto inaccessibility for the Palestinians to area C (60% of the West Bank), which is of "fundamental

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thus risking to obtain the transfer of resources (from consumers to producers via an increase in tradable prices) as the only effect of this policy.

importance […] to economic activity and development" in Palestine (World Bank, 2010, p. 15). Increasing the level of development activities targeting area C (including the use of its resources) may help putting pressure on Israel for its clear breach of International Law, as area C falls squarely into the territory of a future Palestinian state. A large amount of activities blocked and/or destroyed by the Israeli military (as that is the current fate of any pro-Palestinian development in the area) would be less likely to go unnoticed as it currently happens to the very few activities in area C which are funded by donors and systematically erased.

Third, in order to inform the debate about the Israeli occupation more precisely, it would be important to get the evidence on the economic impact of the occupation right. While there is a consensus that the occupation is the single most important hindrance to the Palestinian development, a greater effort would be needed to analyse the development costs of the occupation, quantifying more precisely its overall costs to Palestinian welfare, the different costs of the various forms of the occupation, and identifying the most affected classes of people and economic activities.

Fourth, to the extent that the international community has a key role to play in terms of political pressure and mediation in the conflict, the constituencies behind this community need to be properly informed of the current economic unsustainability of the Palestinians' condition due to Israeli policies. This in turn would involve for example working with the civil society and the media in the Western countries as well as in Israel and Palestine, which expose and often challenge (legally and publicly) the developmental hindrances imposed by the current regime of occupation. A good example of this type of work is provided by various Israeli NGOs, such as B'tselem and Peace Now, Palestinian NGOs, such as International Solidarity Movement, as well as international NGOs, such as Amnesty International and Human Rights Watch.

One obvious reaction to these types of suggestions is that the donor community is supposed to be non-political (including the UN system), and these actions to some extent would involve taking, even though indirectly, a political stance. The clear response to this is that the attempt to de-politicise the developmental and humanitarian challenges facing the Palestinians has made the billions of dollars spent by the donor community in Palestine ineffective for the long-run sustainability of the Palestinian economy in the best case scenario. There cannot be such a thing as a humanitarian response to a problem which is inherently political. If the donor community wants to keep refraining from incorporating the political dimension into its assistance, then it would probably do better to abandon this undertaking altogether.

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Appendix
Trade competitiveness and aid in Palestine: symptoms of "Dutch-disease"?

The possible Dutch-disease effect of aid on the Palestinian tradable sector can be explained by thinking about the two general short-run effects of a sudden influx of foreign exchange (determined by aid inflows) in the economy: resource movement and resource spending effects. In order to illustrate those we divide the economy into two sectors: a tradable (*T*), a booming non-tradable sector (called *A*, like aid) and a non booming non-tradable sector (i.e. services *S*). To resemble more closely the case of Palestine, the *A* sector includes in this case also the government, which is funded essentially through aid money.

The *resource movement* effect is determined by the increase in the relative return to the booming *A* sector, following the increase in aid inflows, which draws resources from the other two sectors. The most realistic assumption in the short-run is that labour is the only factor of production mobile between sectors. This increased flow of resources towards *A* generates excess demand for labour by sector *T* and *S* up to the point when real wages are equalized across sectors at a higher level. The movement of resources would reduce the supply capacity of sectors *T* and *S*: while the excess demand in the former could be met through imports, the increased demand for services would be absorbed via a rise of the price of non-tradables relative to tradables, i.e. an appreciation of the real exchange rate (RER).[i] The magnitude of this effect clearly depends on the extent to which the resources used by the booming sector *A* are compatible with the other sectors in the economy. The aid sector is usually well connected to the rest of the economy, thus we would expect the resource movement effect to be strong in Palestine.

In order to describe the *spending effect*, it is convenient to assume for a moment that *A* does not demand labour from the other sectors and to concentrate on the way the increased income from the increased aid inflows is actually spent. Provided that both sectors *T* and *S* produce normal goods, then the demand for these sectors should increase following the boom in *A*. Given the relative prices of the economy, there would be excess demand for *S*, which would have to be met via an appreciation of the real exchange rate.[ii] This in turn would raise the return to *S* relative to *T* determining an expansion of *S* through resources drawn from *T*.

Both of these effects have a clear outcome in terms of relative prices: the price of non-tradables relative to tradables should rise, determining a *RER appreciation*. More formally the RER can be defined as:

$$q = e\frac{P_{NT}}{P_T^*} \qquad \text{(A1)}$$

where *e* is the inverse of the nominal exchange rate (i.e. how many units of foreign currency are needed for one shekel) and P_T^* and P_{NT} are the prices of tradable (expressed in foreign currency) and non-tradable goods (in domestic currency) respectively. A rise in *q* represents a real appreciation of the currency and is determined by a rise of P_{NT}, of *e* or both relative to P_T^*. In the case of Palestine, the aid inflows should have no effect on *e* as this is essentially determined from what happens to the Israeli economy, therefore all of the effects should come about through the increase in P_{NT}/P_T (due to the excess demand for S described above). The appreciation of the RER penalises the tradable sector as its cost structure includes non tradable goods and services, whose price increases faster than the sale price of the goods produced, which depends on international conditions.

In order to measure the effects of increased aid on the RER, it is useful to consider the effects on the ratio of West Bank RER over Israeli RER.

We consider the West Bank alone rather than Palestine as a whole for a number of reasons. First, the majority of aid especially in the last years has been going to the West Bank, which is home to the Palestinian Authority, by far the largest beneficiary of aid to Palestine. Therefore any effect of aid would play out mostly in the West Bank. Second, Gaza's economy has been experiencing a total standstill due to siege imposed by Israel and by the widespread destruction of its productive capacity caused by the "Operation Cast Lead" in 2008/09. Therefore any evolution in the price of P_T^* and P_{NT} in Gaza in the last few years would not reflect normal market conditions. The ratio is defined as follows:

$$R_{WB,J} = \frac{e\dfrac{P_{NT}^{WB}}{(P_T^{WB})^*}}{e\dfrac{P_{NT}^{J}}{(P_T^{J})^*}} = \frac{e^2\dfrac{P_{NT}^{WB}}{P_T^{WB}}}{e^2\dfrac{P_{NT}^{J}}{P_T^{J}}} = \frac{P_{NT}^{WB}}{P_T^{WB}} \times \frac{P_T^J}{P_{NT}^J} \qquad \text{(A2)}$$

where the superscript WB is West Bank and J is Jerusalem. The terms *e* cancel out as it is the same for both areas, thus allowing us to concentrate only on the prices ratio as determinant of the relative competitiveness of the tradable sector. This measure essentially tells us whether the RER in West Bank has grown (q^{WB}) faster or more slowly than that in Jerusalem (q^J). The latter represents a useful comparator for the West Bank as it is its main trading partner (and thus it is a benchmark for the relative West Bank competitiveness) and faces similar international market conditions as those of q^{WB}. An important difference, which is essential for our identification of the effects of aid on the RER is that the importance of aid in Jerusalem is marginal relative to its importance in the West Bank.

Table A1: Weights for CPI index (2004 base)

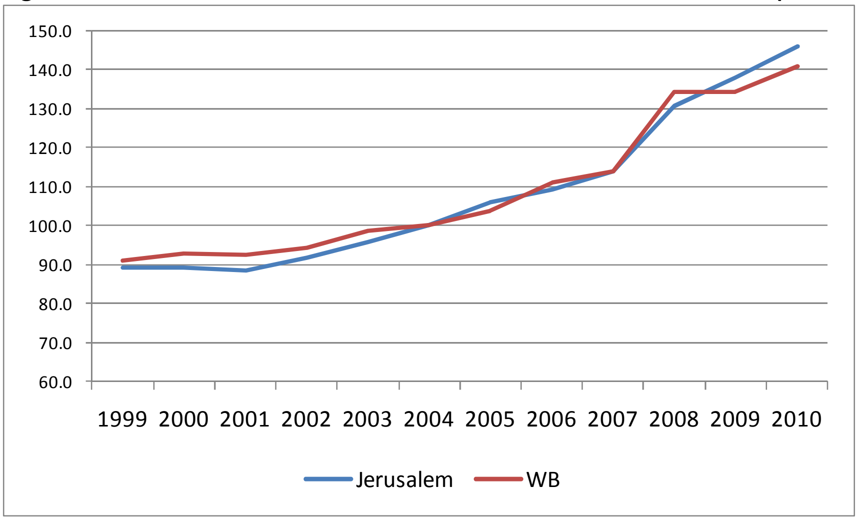
	West Bank	Jerusalem	Tradable vs. Non Tradable
Food and soft drinks	38,821	32,876	T
Alcoholic Beverages and tobacco	5,065	4,388	T
Textiles, clothing and footwear	6,960	6,623	T
Housing	10,718	11,943	NT
Furniture, household goods	6,294	6,353	T
Medical care	5,258	3,874	NT
Transportation	9,582	12,382	NT
Communications	3,866	4,274	NT
Recreational, cultural goods & services	3,910	4,578	NT
Education	3,189	3,636	NT
Restaurants and cafes	2,144	2,298	NT
Miscellaneous goods and services	4,193	6,775	NA
All items of consumer price index	**100,000**	**100,000**	

Source: PCBS

I use two sources of data for the analysis. Data for prices to compute eqn. (A2) come from consumer price data collected by the PCBS, which divides all the items into different categories described in Table A1 along with their weight in total expenditures in West Bank and Jerusalem. I classify them into tradable (T) and non tradable (NT) and construct consistent price series for T and NT in West Bank and Jerusalem on the basis of these weights for the years 2004-2010. I do the same exercise for 1999-2003 as well using the 1996 weights and then make the two series consistent via the common 2004 data. Once the four consistent series are computed for 1999-2010, it is straightforward to compute the ratio in (A2), whose graph is represented in figure 4.

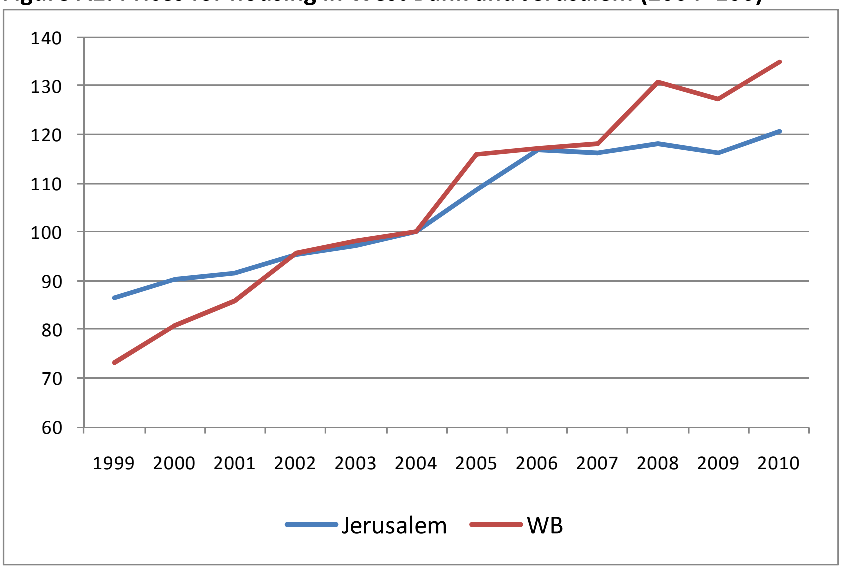
The increase in the long-term ratio in due in good part to the faster growth in NT prices in West Bank relative to Jerusalem while tradable prices moved more closely to each other. This is evident when considering the major component of T and NT, i.e. food and soft drinks and housing respectively. In Figure A1 food prices appear to evolve in a very similar way between Jerusalem and West Bank, consistently with the view that prices of these items are fixed internationally and do not depend much on local conditions.

Figure A1: Prices for food and soft drinks in West Bank and Jerusalem (2004=100)



Source: PCBS

Figure A2: Prices for housing in West Bank and Jerusalem (2004=100)



Source: PCBS

On the other hand prices for housing tend to follow two different patterns, with those in West Bank growing significantly more rapidly than in Jerusalem (figure A2). This would be consistent with a spending effect from the surge in aid inflows which operates in Palestine but much less in Jerusalem. In order to examine whether that is the case let us check to correlation between aid and this ratio.

Aid data come from two sources: World Bank/OECD and Ministry of Planning. The data have been put together by DeVoir and Tartir up to 2008 (2009) and are presented in Table A2. There are some differences between sources but overall the pattern of increasing inflows is evident over this decade both for disbursements and commitments. I use the former data as it is only the aid which is disbursed to have an effect on the economy. The results of the aid-RER analysis are robust to using data from any of the two sources. For convenience I present results using World Bank/OECD data in the main text of the paper.

Table A2: External aid disbursements and commitments to WB&GS (mln US$)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008*
World Bank/OECD										
Aid disburs.	516	637	869	1616	972	1115	1116	1450	1876	3250
Aid comm.	626	681	563	644	754	616	954	987	1470	3700
Ministry of Plann.										
Aid disburs.	482	549	929	1026	927	737	1119	1288	1605	2773
Aid comm.	692	973	1228	1527	1404	776	1235	2102	1222	3728

*Source: DeVoir and Tartir (2009); *Estimated figures.*

The results of the analysis are preliminary and should be taken with the due notes of caution for an analysis which only has 10 observations and which does not employ techniques to properly account for the time series nature of the data. However this analysis provides suggestive evidence of a deleterious effect of aid on the relative RER $R_{WB,J}$ in line with the Dutch-disease framework presented above.

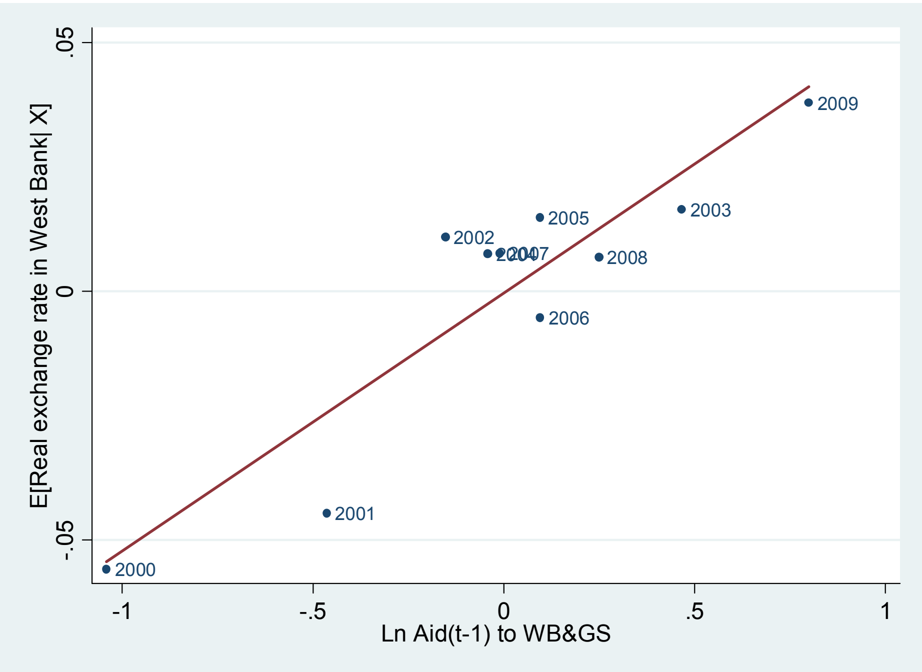
Table A3 presents the results of regressing the ratio $R_{WB,J}$ on the lagged value (in log) of aid disbursements and a dummy for the second Intifada years (2001-06). For every 100% increase in aid, the RER ratio increases by 0.09 in the following year (column 1). This effect is highly significant and is robust to the use of aid data from the Ministry of Planning (col. 2), to the inclusion of a control for the post-2004 years which should capture the effects of the separation wall (col. 3) and to the inclusion of a time trend (which reduces somewhat the coefficient) - column (4). In particular by removing a linear time trend from the variables, the latter specification specifies the empirical relationship between them using detrended variables, thus partly addressing the problems that the non stationarity of the variables would generate in the estimation. Finally, in column (5) I also use the actual RER in the West Bank and regress it on lagged aid, Intifada and the RER in Jerusalem, obtaining a similar positive and significant effect of the aid variable. This conditional relationship between RER and aid is represented graphically in figure A3.

Table A3: RER ratio and aid, 2000-2009

	(1) ratio	(2) Ratio	(3) ratio	(4) Ratio	(5) q_{WB}
Ln Aid_{t-1} (World Bank)	0.092***		0.085***	0.066**	0.052***
	(0.013)		(0.015)	(0.022)	(0.006)
2nd Intifada (2001-06)	0.077***	0.083***	0.080***	0.081***	0.039***
	(0.014)	(0.015)	(0.013)	(0.013)	(0.008)
Ln Aid_{t-1} (MoP)		0.097***			
		(0.015)			
Wall (post-2004)			0.013		
			(0.018)		
Time trend				0.006	
				(0.005)	
q_J					1.308***
					(0.208)
Observations	10	10	10	10	10
R-squared	0.828	0.798	0.837	0.847	0.935

*Robust standard errors (Huber-White method) in parentheses; * significant at 10%; ** significant at 5%; *** significant at 1%.*

Figure A3: RER and Aid conditional on controls



Source: Table A3

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[i] This would not be the case if there was spare supply capacity of services which may be employed to meet the increased demand. This however does not seem to be the case of the Palestinian economy.

[ii] Again, with fully employed resources, the higher demand for *T* could be met through imports without changing the nominal price.