FIELD Report No. 5

Mobilization of Savings in the West Bank & Gaza

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Acronyms

AED	Academy for Educational Development
AHLC	ADC-Hoc Liaison Committee
BoP	Balance of Payments
GDI	Gross Disposable Income
GDP	Gross Domestic Product
GNI	Gross National Income
GoI	Government of Israel
GS	Gross Savings
IMF	International Monetary Fund
IT	Information Technology
LTD	Loan to Deposit
MENA	Middle East and North Africa
MFIs	Microfinance Institutions
MPS	Marginal Propensity to Save
MSMEs	Micro, Small and Medium Enterprises
NIS	New Israeli Shekel
NPISH	Not for Profit Institutions Serving Households
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PMA	Palestinian Monetary Authority
PRDP	Palestinian Reform and Development Plan
SNA	System of National Accounts
UNRWA	United Nations Relief and Works Agency
USAID	United States Agency for International Development
VAT	Value Added Tax
WBG	West Bank and Gaza

Executive Summary

Economic development is driven by investment spending. And investment spending is determined by national saving. When investment is financed mostly by local savings, the fruits of development are enjoyed by the country's citizens. However, when national savings fall short of investment needs, countries resort to foreign borrowing in which case a certain percentage of future income will be transferred abroad in the form of interest and dividends. It is in this context that the present study is designed to identify the appropriate means of mobilizing national savings in the West Bank and Gaza.

National savings consists of household, corporate and government savings, with households owning the lion's share. Annual savings, which are determined through national income accounts, measure the amount of unspent disposable income. Its development over the years 1994 to 2006 reveals two distinct patterns: (1) from 1994 to 2000, the savings rate (as a percent of disposable income) fluctuated between +5 to +8 percent, averaging 6.1 percent; (2) from 2001 to 2006 in the wake of the second Intifada, it fell steadily each year through 2004 reaching negative rates in 2003 and 2004, averaging 2.1 percent. Only in 2005 did it return to its 1995 level. Available evidence indicates that, in comparison with other countries, the savings rate is also low. Even when the two years with negative savings are excluded from the analysis, the average in WBG of 5.9 percent is substantially lower than the world average of 19.8 percent, or the average observed in Sub-Sahara Africa at 12.4 percent over 1965-1994.

What determines the savings rate in WBG then and why is it so low? Using quantitative analysis to explain this phenomenon, the results ascribe the low rates to i) both the low level of disposable income and the slow rate of growth of real GDP, ii) the narrow expansion in the economy's productive base reflected in limited investment spending, iii) the decline in remittances and transfers to the private sector, iv) the high dependency ratio, especially as it relates to the number of young dependents (0-14 years) per independent person (15-64 years), and finally v) the limited accessibility to banking services, especially outside the larger cities of the West Bank and Gaza. These factors were tested quantitatively and their relationships with the savings rate were statistically significant. Other factors such as inflation, interest rate and financial depth were tested but were not strongly related to the savings rate. The findings identify the most effective ways of mobilizing national savings; namely through realizing higher economic growth rates, raising investment spending levels, lowering the dependency ratio and expanding banking accessibility into smaller cities and towns throughout the territories.

Is the economy hampered by a savings inadequacy problem? The answer is negative. Even with the low savings rates by international standards, the banking sector has a high liquidity problem due to its limited credit facilities. Two measures are used to test this hypothesis.

First, the average loan to deposit ratio since 1998 and until March 2008 is 38 percent. Over the last two years and in part in response to PMA's regulations, the ratio increased to approach the mandated 40 percent. The comparable ratios are 126 percent in the EU, 120.6 percent in Korea, 80 percent in Egypt and 68 percent in Jordan.

Second, deposits of the banking sector as a percent in GDP is compared in WBG with other countries and regions. World Bank data for 2006 show that the rates were 227 percent in the EU, 77 percent in Israel, 99 percent in Egypt, and 116 percent in Jordan. In the WBG it was only 9 percent. However, the official data published by PMA and PCSB show that it was 40 percent. Even at this rate, it is quite low by international standards.

The substantial disparity in both measures between WBG and international standards may be attributed to a) the heightened sense of uncertainty that transcends rational decisions, b) the lack of viable economic opportunities in the WBG and c) credit worthiness of potential borrowers and securitization for borrowed funds. Whereas the first factor lies beyond the limits of this analysis, the other two are issues that can be adequately confronted and resolved by national public policies.

In brief, savings are low and unstable and the banking industry is able to convert only a modest portion of its deposits into credits to the rest of the economy. The supply of loanable funds is more than sufficient to meet the banks' capacity to provide credit. Also, the banking sector's intermediation role has been relatively limited.

Moving forward and assuming the preservation of the status quo, can one set a target growth rate for the next five years? An attempt is made based on the consideration that rather than carrying out complex GDP projections, a GDP growth rate target is set on the condition that the economy will absorb all new entrants into the labor market each year from 2008 to 2013. Entrants to the labor market in 2006 were estimated at about 45,000. At a population growth rate of 3.5 percent, the flow of new entrants from 2008 to 2013 was derived; it increases steadily to 58,000 in 2013. Meantime, the declining overall average labor productivity is assumed to reverse its declining trend and start rising by a modest 1/2 percent a year. The resulting real growth rate target that will meet the pre-set condition turned out to be 7.3 percent (in real terms) in 2008, declining gradually thereafter to 6.61 percent in 2013. By then, total employment will have increased from 633,000 in 2005 to 1,022,000 in 2013. As part of the scenario, the anticipated increase in real GDP will engender additional savings estimated at $512 million in 2008 and $709 million in 2013.

Can this 2013 vision be realistically accomplished in light of the uncertainty of the private sector's ability or willingness to launch new investments in large productive economic and business activities under the current political environment? A ray of hope is seen in the results of a 2007 PCSB establishment survey, which shed some light on the significant role of micro and small enterprises in the economy. Micro enterprises defined as employing four or fewer workers hold no less than 57.3 percent of total employment in five of the largest economic sectors in the economy; namely manufacturing, construction, trade, transportation & storage & communications, and services. Micro and small enterprises (0-19 workers) contributed 79.4 percent of total employment, 58.2 percent of total production, 65 percent of intermediate consumption which creates further value added through backward linkages (supply chain) and 53.8 percent of the generated value added. This ray of hope lies in the capacity of this sector to effect development at a time when large establishments are not likely to take their place as is normally seen in other economies under "normal" economic and political conditions.

Based on the study's findings, the following recommendations for the government, banking sector and PMA are outlined as a package designed to mobilize national savings.

First: The Government Sector

1. Energize the private sector in view of the strong and statistically significant causal link between economic growth and savings and also because of the strong evidence gathered recently by the World Bank in 2008 indicating that the investment climate is relatively inhospitable,

2. Streamline and activate the pension fund program for government employees,

3. Mandate a pension program in the private sector as is the case in most other countries,

4. Work with the private sector to initiate a loan guarantee umbrella for micro enterprises whose loans are less than $10,000, and

5. Collaborate with the private sector to raise the level of awareness and interest in health, life and property insurance.

Second: The Banking Sector

1. Diversify the product mix beyond the traditional current, savings and time deposit accounts. There is room for innovations to offer tailored accounts for the youth, education, remittances of Palestinian Diaspora, a variety of balloon certificate of deposits, Islamic accounts, and so on. Further flexibility in minimum balances, withdrawals, and interest rates are required,

2. Branching into rural areas. Current population served by a bank branch is 21,900 in WBG, in contrast to 4000-10,000 in the MENA region and 1,500 in Germany. The geographical distribution is even worse in that 13,000 people in large cities are served per bank branch while 113,400 rural residents are served per branch. To reduce the overall rate to 10,000, the current number of branches should be increased from 180 to 390. It is recommended that the banking sector expand its number of branches in the direction of the rural areas, especially that evidence from other countries point to the fact that rural residents have characteristically shown a higher average savings rate than urban residents. An inexpensive and expedient way of realizing this target is to rely on expanding via Cash Offices rather than fully fledged branches,

3. Downscaling to address the pent up demand for credit by micro and small Enterprises, and

4. Transparency of banking practices, retail fees and truth in lending.

Third: The Palestinian Monetary Authority

1. Put into effect the current plan to introduce a Deposit Insurance Corporation,

2. In collaboration with commercial banks, raise the loan to deposit ratio gradually and consistently over time, downscale banks to address the needs of micro and small enterprises and build the credit provision capacities of the banking sector,

3. Envelop further expansion of bank branches into a campaign to increase the penetration of banks into rural areas by relying first on Cash Offices as a first step to broadening it to a Bank Office when conditions permit, and

4. Encourage the establishment of mutual funds through either the existing commercial banks by creating investment banking services or by allowing the private sector to launch mutual investment funds corporations. The latter has been the preferred way in many of the industrial countries.

Background

The objective of the study is to identify the means through which the volume of loanable funds from household and corporate savings is sufficient to enable the banking sector to meet the demand for credit from the private sector. Credit creation is viewed as the vehicle through which lending to micro, small and medium size enterprises (MSMEs) will bolster job creation in the economy. The issue at hand is essentially an issue of the adequacy of the supply of savings with respect to the demand for credit. It is also an issue of direct relevance to job creation in the short term through the expansion of the role of the private sector (especially MSMEs) in economic development.

To the extent that savings depend on income and income depends on the development process and because the development process is acutely impacted by the constant ups and downs in the Arab-Israeli conflict, political realties exert an indirect but significant influence on savings. Much is available in the literature on the military, social, political and macroeconomic conditions in WBG, especially since the second Intifada in September 2000 and the subsequent restrictions imposed by the Government of Israel (GoI) on the movement of people and commerce[1]. Instead of re-addressing these issues here, the reader is referred to a number of recent studies on these issues. Hence, our focus will be placed on national savings: their magnitudes, composition, evolution, comparison with other countries and regions, effectiveness of the intermediary role of the banking sector, remittances, adequacy of savings and suggestions to mobilize them. However, this study remains cognizant of the influence of external turmoil as a factor to be reckoned with throughout.

The depth and breadth of a study such as this depend on three factors: the availability, accuracy and consistency of data. Despite an extraordinary level of cooperation from government agencies and other sources of primary data, especially the Palestinian Monetary Authority (PMA) and the Palestinian Central Bureau of Statistics (PCBS), it was soon realized that there is much to be desired in all three areas. This is not unexpected in view of the fact that these sources are still in their early years of formation, data generation and cross checking by researchers. This is an area where much in terms of human and IT capacity building is still required. Because of potential observational errors, the reader is advised to interpret the results with care.

WBG does not conduct macroeconomic forecasting, nor has the Palestinian Authority (PA) developed indicative five-year economic development plans as is customarily practiced in MENA countries. The only growth projections available are those set in the Palestinian Reform and Development Plan (PRDP), which gives projected GDP till 2010. Nor has WBG developed modern tools of economic analysis on which basis macroeconomic policies are based or conceptualized. For instance, the most recent econometric model is outdated and hence is of little use since the economy's structural relationships are not reflected in the model's functional equations. WBG does not have an Input Output Matrix, nor does it have a Social Accounting

[1]See for example, IMF, May 2008,"*Macroeconomic and Fiscal Framework for the West Bank and Gaza: First Review of Progress*"; World Bank, May 2008,"*Implementing the Palestinian Reform and Development Agenda*"; World Bank, May 2007,"*Movement and Access Restrictions in the West Bank: Uncertainty and Inefficiency in the Palestinian Economy*"; and World Bank, March 2007,"*West Bank and Gaza Investment Climate Assessment*".

Matrix that can be used in economic projections. Little, if any, long term macroeconomic projections are known to specialized professionals at the relevant Ministries of National Economy and Planning or the PMA.

In the course of discussing rational economic behavior and standard tools of economic analysis in this study such as income generation, savings decisions, investment plans, bank deposits, loan to deposit ratio, bank branching, bank accessibility and the demand for credit, etc., it is important not to lose sight of the fact that this is not a "normal" developing economy; rather, it is a state with limited and uncertain autonomy over its public policies, borders and people. This is due not only to the visible physical checkpoint and roadblock impediments, for the GoI has also introduced a cobweb of administrative and military orders, rules and practices over the last five decades that have severely segmented communities, restricted movements and stifled growth in WBG. The World Bank estimates, for example, that 50 percent of the land of the West Bank is out of reach to Palestinians. It further states that marginal, incremental steps taken by GoI "lack permanence and certainty and can be easily withdrawn or replaced by other restrictions"[2]. When perceived risks are added to actual risks, the impact on the economy, consumer decisions and business and investment plans ought to be seen in this context. This is particularly acute in the case of banks, which are known for their overarching conservative and risk-averse posture toward business practices in general.

An additional uncertainty stems from the monetary situation where savings are made mostly in Jordanian Dinars in the West Bank, in USD in Gaza and the currency in circulation, the Israeli shekel. As intra-currency exchange rates fluctuate daily, the purchasing power and hence saving decisions are affected in an uncertain way. Furthermore, PMA is unable to rely on traditional monetary instruments such as the discount rate and open market operations to steer the economy towards one direction or another. The only tool available at its disposal is the reserve ratio. Fiscal policies are equally ineffective since a good portion of government revenues is externally controlled by the whims of the GoI (VAT and customs revenues) and by donors' contributions.

Finally, it should be recognized that this young state is still a work in progress, as far as policies and institutions are concerned, which would explain some of the observed shortcomings and the slew of draft public policies currently under consideration.

[2] World Bank, May 2007, Movement and Access ...."", Ibid, p. 2.

Conceptual Problems in Defining "Saving"

Saving is conventionally defined as postponed consumption or the act of cutting down on current consumption for future consumption. In national income accounting, it is estimated as the amount of unconsumed gross disposable income. In economic theory, saving is an increasing function of income. Simple as it may seem, however, gross savings as defined in national income accounting is not an accurate measure of national savings, either in itself or across countries. Briefly, the following are the major factors that distort the meaning of "saving":

- *Exclusion of Indirect taxes*: Gross Disposable income is net of direct income taxes. Indirect taxes (e.g. sales tax or VAT) should likewise be excluded since they affect the income from which savings are made. Indirect taxes also vary greatly from one country to another and by their exclusion, savings will not be comparable across countries. To wit, VAT in the EU varies between 15percent and 22percent, whereas it is only 6.5percent in the US, 7.8percent in Japan and 14.5percent in WBG.

- *Household consumption of public goods and services*[3]: The cost of public services, especially medical care and education, are collected from households in terms of direct income taxes in the EU whereas they are paid out of GDI in the US. Moreover, the size of the tax rate for the public service itself differs across countries. As a result, disposable income would increase by the exclusion of public services that are financed through direct taxation, and vice versa. Disposable income and, hence, savings rates will no longer be comparable once again.

- *Unrealized capital gains (losses)*: Unlike realized capital gains and losses, unrealized capital gains and losses are not incorporated in household incomes. Such gains directly affect wealth accumulation, which in turn affects saving. In 2000, households in Belgium, Netherlands and UK owned wealth that was three times their income compared to less than 3 times (Italy and France); and less than 2 times (Spain & Germany). Between 1995 and 2000, assets appreciated by 150percent in Belgian, Dutch and British households compared to 100percent in French and Spanish households, 50percent Italian and 25percent German households. Both the exclusion of unrealized capital gains and the inconsistency among countries distort the magnitude of national savings.

- *Retirement savings*: The System of National Accounts (SNA 93) recommends that household savings ratio must be calculated as the ratio of household savings (B.8 – SNA 93 code) divided by household disposable income (B.6) plus the adjustment for the change in net equity of households in pension funds[4]. The recommendation is optional

[3] Unless stated otherwise, the household sector includes Not for Profit Institutions Serving Households (NPISH).
[4] Harvey, Ross, June 2004,"*Comparison of household savings ratios: Euro area/US/Japan*", Statistics Brief, OECD. Households' savings ratios are adjusted to account for differences in a) consumption of public services, b) indirect taxes on production and imports (like VAT) and c) pension funds organization. Adjustments made for the factors reduced savings ratio in the Euro area by 1.6 percent, US by a significant 3.8 percent and Japan by 0.7 percent. See also Audenis, Cedric et al, August 2002, *Different Measures of the Saving Ratio and their Interpretation*, INSEE, France.

and some countries do not follow it (e.g. US). Forced savings should be incorporated in national savings.

- *Gross versus net saving*: Net value added is defined as gross value added minus capital depreciation. The same principle should apply to savings: by deducting capital depreciation of household durable goods (e.g., homes, automobiles, etc) from gross savings one can arrive at net savings versus the often used gross savings as a measure of national saving.

Owing to these differences, savings rates would either increase or decrease and in varying degrees across countries. The current discussions on the proper definition and measurement of savings signify the beginning of an attempt to streamline and eventually unify the definition of savings in national income accounting. The road ahead however will be arduous because it is fraught with both statistical and conceptual difficulties, more so in developing than in developed countries. With this caveat in mind, we now turn to examine national savings rates and their evolution since 1994 in WBG.

Saving Rates: Stylized Facts

Why Save?

Total national savings are composed of three components: (i) government savings, (ii) corporate savings and (iii) household and individual savings. The latter depends mostly on disposable income while corporate savings are equal to retained profits and government savings are the same as government budget surplus. Negative savings occur among all three: when consumption needs exceed disposable income in the case of households; when corporations realize losses and are forced to draw down their reserves or resort to debt financing; and when the government spending exceeds its revenue[5].

To the extent that our focus in this study is on mobilizing only household savings, it is useful to understand why people save. John M. Keynes in the 1930s delineated six main reasons:

1. Precaution against the unknown
2. Foresight in predicting known events such as a down payment or education expenses
3. Wealth augmentation due to interest earning and capital appreciation
4. Financial independence
5. Bequest of gifts and donation to others
6. Avarice or miserliness

These are universal motives; however, priorities do differ over time, from one country to another and from one group of households to another within the same country. For example, in a recent survey of US households' saving habits, saving for retirement was the top priority, especially among the older and well-to-do generation, followed by precautionary motives. The latter was especially strong among the young and relatively poorer households. Third priority was for purchases (foresight) such as new homes or home improvement or other consumer durable goods which was particularly strong among young and low income households, followed by education for all household classes and sub-groups[6].

In view of the extraordinary uncertainty that characterize the social, economic and political conditions since the first Intifada in 1987, but especially since the second and the election of Hamas in January 2006, one would infer that the most urgent rationale for saving in WBG must be the precautionary motive. Yet, this type of saving behavior (for a rainy day) is by definition a long term proposition which may seem less urgent in WBG because the long term is, at best, a foggy notion under the present circumstances. There are much more urgent and immediate needs that households must address through saving; namely the opportunity to augment personal incomes.

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[5] Because neither companies nor governments own their own assets which belong to households, all three are interrelated; savings of one sector will ultimately affect savings in the other. See Kerr, Roger, 1997, "An Economic Analysis of Compulsory Savings".

[6] US Congressional Research Services, June 2006, "Saving Incentives: What May Work, What May not," Library of Congress, Washington DC.

Foresight income augmentation serves more than one purpose: current consumption (i.e., daily survival), savings for future education and/or home improvements needs[7]. Additionally, saving to engage in business activity, however small or risky, under the prevailing conditions is driven by potential opportunities created by the Israeli restrictions on the movements of individuals and commerce. This can be seen from the dominant role played by the business services sectors in contrast to the commodities sectors such as agriculture and manufacturing. 2006 data show that the services sectors generated more than 2/3rd of GDP in current prices[8].

In brief, it would seem reasonable to hypothesize that households do save to meet expected, known future needs rather than to be ready for the unknown, as is the case in industrial societies.

The preceding discussion is contingent upon the assumption that savers are rational and do make sound economic decisions. In reality, this is not true for all. Credit cards have reduced the incentive to save, there is a lack of self control, there are limits to human intellectual capabilities and there is no perfect information on which basis individuals and households can make rational decisions. This aspect of human nature should be part of the search for reasons for saving.

Gross Disposable Income (GDI) represents the value of all goods and services produced in one calendar year, net of transfers to and from the rest of the world and net of direct taxes. It measures the amount of money available for either consumption or savings – nothing else[9]; should a household use part of its disposable income to buy a consumer durable commodity such as an automobile or a house, this will be reflected in private investment. Savings thus is a *flow* concept in that it is the amount shown in national income accounts as occurring each year. This is different from demand deposits in the banking sector, which is a ***stock*** concept reflecting the cumulative process of adding and drawing down on past savings. There is not, and should not necessarily be, a one-to-one relationship between the two concepts or between the annual change in demand deposits and realized savings over time, for a portion of household savings may be stored in the form of gold, hoarded at home, invested in stocks in the equity market and/or invested in pension funds, among others[10]. If none of these instruments is available, the changes in deposits will parallel annual savings.

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[7] Only 24 percent of 702 microenterprises expressed interest in pension funds compared to 52 percent loan insurance. IFC study, 2007, p. 43.

[8] PMA, 2007, "*Twelfth Annual Report, 2006*", Table (1/2).

[9] In national income accounts, net income received from non residents (returns to work and property) is added to GDP to reach Gross National Income. Next, net transfers from abroad are added to GNI to determine GDI. In WBG, GDI is higher than GDP due to the relatively large amounts of transfers and income from abroad.

[10] A simple Ordinary Least Square (OLS)regression of annual changes in deposits against annual savings over the period 1997-2006 resulted in Adjusted R2 (-0.13) and regression coefficients (-0.003) that are not significantly different from zero. Stronger results however were observed when private deposits were regressed against savings. The poor results are partly due to the factors mentioned earlier and partly to observational errors. Data on savings in current prices are from PCBS and demand deposits and private deposits from PMA.

Developments of Savings & Saving Rates

Evolution from 1994 to 2006

In 1994, the first year for which national income accounts are available, the savings rate is 5.4 percent of disposable income, or $195.8 million. Until 2001, gross savings fluctuated from a low of $168.7 million in 1997 to a high of $424.8 million in 2000. But it stayed within positive boundaries throughout the 8-year period. In part as a result of Intifada II, savings dropped steadily over the next three years to only $19.6 million in 2002, - $171.2 million in 2003 and to - $417.7 million in 2004. During the next two years, savings increased rather significantly to + $484.8 million in 2005 and are projected to increase to $601.8 million in 2006.

The evolution of the savings rate over the 13-year period 1994 to 2006 points to an unstable pattern as evidenced by the high standard deviation coefficients in the Table 1. See Figure 1. The savings rate fluctuated from + 5.4 percent in 1994 to – 8.1 percent in 2004 and to + 9.3 percent two years later. However, a closer look at this time series reveals two distinct patterns: the first from 1994 to 2000 when the ratio was relatively stable and the second during the post Intifada II from 2001 to 2006 when the ratio gyrated markedly and fell into negative territories in 2 out of 6 years, as shown below. Overall, the average savings rate during the early 1994-2000 period is three times higher (6.1 percent) than during the 2001-2006 period (2.1 percent).

Figure 1: Saving Rates, 1994 – 2006, in current prices

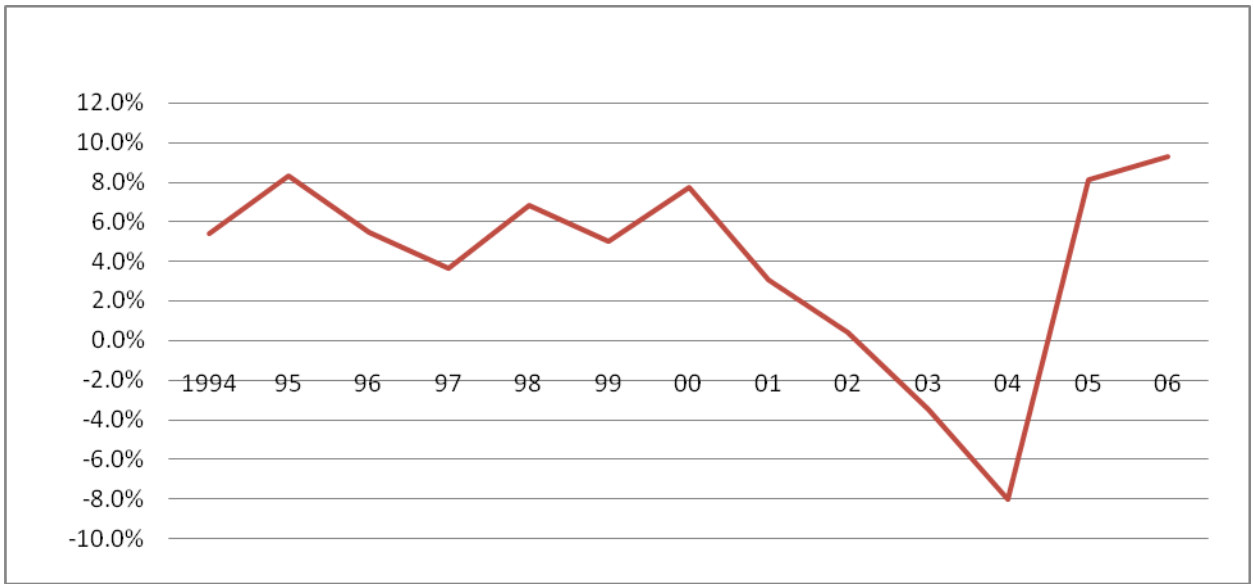


Table 1: Gross Saving/Gross Disposable Income Ratios in current prices in WBG, 1994-2006

Period	Average (%)	Range		St. Dev.
		Minimum	Maximum	
1994 to 2000	6.1	3.7 (1997)	8.3 (1995)	1.5%
2001 to 2006	2.1	-8.1 (2004)	9.3 (2006)	6.1%
1994 to 2006	4.1	-8.1 (2004)	9.3 (2006)	4.9%

Source: Computed from statistics provided by the Palestinian Central Bureau of Statistics, 2008.

The trend from 1994 to 2006 is in line with the well documented direct relationship between savings rates and income growth; it also corroborates, in broad terms, the conventional wisdom that households tend to save more in bad times and less in good times unless of course economic conditions are severe enough to the point where savers must dip into previous savings to meet basic needs. To wit, positive savings were recorded during 2001 and 2002 but became increasingly negative during 2003 and 2004, indicating that negative growth rates were associated with negative savings.

Over the same period, a simple linear regression shows that the marginal propensity to save (change in savings/change in disposable income) is 0.18[11]. That is, 18 percent of every additional dollar earned is saved. The average propensity to save over the period 1994 to 2006 is 4.1 percent. Negative MPS coefficients during 2003 and 2004 imply that people consumed more than what they produced, which can only be accomplished by selling their assets (land, gold, etc.) or drawing down on their previous savings.

Saving Rate in an International Context

Keeping in mind the definitional problems mentioned above in the context of international comparisons, recent evidence shows that savings ratios vary significantly across countries and over time. A recent

Table 2: An International Comparison of Saving Ratios against WBG, 1965-1994

Region/Country	Number of countries	Average (%)	Median (%)	St. Dev.
World	85	19.8	18.8	7.6
Industrial countries	22	23.5	22.5	4.5
Developing countries	63	18.6	17.7	8.1
MENA	9	32.5	32.5	5.7
China	1	23.8	21.6	7.6
East Asia & Pacific*	9	27.2	27.9	5.7
Sub-Sahara Africa	20	12.4	11.5	6.1
WBG (1994-2006)	1	4.1	5.4	4.9

Source: Norman Loayaza, H. Lopez, K. Schmidt-Hebbel and L. Serven, November 1998, "Savings in the World: Stylized Facts."

research employing a massive new data set on savings generated at the World Bank covering 82 countries over 35 years measures savings ratios over four different time periods starting from 1965 till 1994 for 11 separate country groupings. Selected comparisons of this seminal research study on savings rates are summarized in Table 2. WBG is added as a comparator covering the period 1964 – 2006.

Even though there is no recognized rate at which savings rate is considered "normal" or "low", the savings rate in WBG is quite low relative to other countries and regions. It ranges between 1/8th to 1/3rd of their observed average and median rates. It is even lower than the savings rate noted in poor Sub-Sahara Africa. This is particularly poignant when one considers that the savings rate in WBG relates to the last decade (1994-2006) whereas the others relate to a much

[11] The relationship between GS and GDI over the period 1994 to 2006 is statistically significant at 0.19 percent.

earlier period with lower income levels. Besides being anemic, it is also highly unstable as evidenced by its high standard deviation coefficient relative to the comparators.

This does not mean that other regions or countries did not experience lower or negative rates. For the world at large, negative rates were reported across the three covered periods (65-73; 74-84; 85-94). The lowest rates recorded were in developing countries and Sub-Sahara Africa: – 0.41 during 1965-73. At the same time there were exceptionally high rates observed also: + 0.41 in China (1985-1994) and + 0.779 in developing countries (1965-73). Industrial countries maintained a steady *maximum* ratio over the entire period (1965-94) at about 0.41.

More recent information on savings ratios shows that most European countries save somewhere between 8-16 percent in 2002: 8.2 percent, Sweden; 10.1 percent, Spain; 10.4 percent, Germany; 10.7 percent, Netherlands, 12.2 percent, France; and 16 percent, Italy. In Japan, it fell from 11.1 percent in 1999 to 5.8 percent in 2002. The same trend is observed in the UK where it dropped from 12.4 percent during 1980-88 to 4.3 percent in 2003 and in the US where it declined steadily from a peak of 12.4 percent in 1965 to 0.81 in 2005.

Additionally, the Loayza et. al. study reached a number of conclusions that are pertinent to our examination of the development of the savings rate in WBG:

- World savings rates declined since the early 1970s with the industrial countries leading the trend, especially in relation to their public savings.
- Unstable savings patterns are associated with lower savings rates.
- Corporate and household savings rates in developing countries are larger than in industrial economies.
- Global investment rates have declined since the early 1970s.

While there is a strong relationship between savings and income, the relationship tapers off at higher per capita income levels.

In brief, the facts about the savings rate in WBG can be characterized by the following:

1) A high degree of instability is noted over the 1994-2006 period,
2) The observed degree of instability exceeds those seen in other countries and regions,
3) A distinct drop in the savings rate occurred from 1994-2000 to 2001-2006, and
4) The savings rate in WBG is, on average, at least 50 percent less than its counterparts in other countries or groups of countries.

Is there a Saving Gap?

Observers among focus groups, surveyed households and micro entrepreneurs assert that due to a host of variables, families save at homes in the form of cash. It is difficult to gauge the size of potential savings due mainly to the lack of detailed financial and economic databanks. Rather than ignoring the issue all together, researchers attempt to estimate the number of individuals or households that are either unbanked due to inaccessibility to a bank branch nearby or are reluctant to deal with banks in general. By doing so, some ball park figures can be generated on the magnitude of the savings gap. The results, however, are at best indicative guesstimates.

A field survey conducted a year ago on about 1200 micro enterprises reports that people save at home for three reasons: a) easy access to their savings, b) security (?) and c) the amounts involved are too "small" . It also found that only 22 percent have access to a savings bank account. About 1/3rd of the surveyed micro enterprises express the desire to have a savings account (28 percent in WB and 39 percent in G); and 24 percent of the interviewees in the West Bank and 19 percent in Gaza save outside the banking system: at home or in coops[12].

There are 1.9 million bank accounts in 2007. These include current accounts (36 percent of total deposits), savings accounts (22 percent) and time deposit accounts (42 percent). The average deposit balance is $2,350 per account[13].

According to the latest 2007 population census, there are 646,755 households in WBG[14]. It is likely that at least 2 members of each family, which consists of 5.8 individuals, will have a bank account. It follows that there should be 1.29 million depositors with a savings account. Currently, there are 1.83 million current and savings accounts in the system. Assume that, on average, each depositor has 2 accounts holding either different currencies and/or current and savings accounts. Out of the existing 1.83 million accounts, it is estimated that some 200,000 accounts belong to the 140,000 establishments (2007 Census), government and non-corporate entities. This leaves 1.63 million accounts that belong to households and individuals, which translates into 814,000 depositors. There are some 476,000 (1.29 million minus 814,000) unbanked depositors. Presently, the average balance is $1,435 between savings and current accounts. Assuming that each new account will have a balance of only $1,000, potential

[12] IFC, July 2007,"*Microfinance Market Survey in West Bank and Gaza*". p. 10.
[13] No information is available on urban versus rural accounts since no such classification exists at PMA nor are there data on the number of depositors in contrast to the number of accounts.
[14] The number of individuals in the age bracket 20-70 years is 1.65 million.

additional savings could amount to $476 million, which represent additional loanable funds into the system equal to 18.3 percent of all current and savings deposits in mid 2007.

In a recent Savings Market Survey conducted by UNRWA covering WBG in 2007, it is reported that 45 percent of surveyed individuals do not have bank accounts. Using this information and following a different approach to estimate potential accounts, it concludes that some 675,000 individuals are currently unbanked[15]. Another study used a third approach and reached the conclusion that there is a pent up demand of about 200,000 households for small savings accounts and money transfer services[16].

All three estimates agree that a) there are potential savings still untapped in WBG and b) that the amounts involved may be sizable. It is also evident that the primary reasons for the existence of the gap are a) the inaccessibility and b) the unavailability of "desired" and convenient banking services.

There is another phenomenon that supports the savings gap hypothesis. Commercial banks in WBG started recently to offer clients a lottery- based reward system in exchange for a) opening new savings accounts, b) raising the balance each month and c) accepting either no or insignificant interest rates that did not exceed 0.5 percent[17]. The rewards are attractive, ranging from daily ($5,000), monthly ($20,000) and yearly ($120,000) at the Bank of Palestine; JD 50,000 monthly at the Housing Bank for Trade and Finance; $100,000 monthly at the Arab Bank, and NIS 20,000 and a new Toyota Carolla car at the Islamic Bank of Palestine, among others. During interviews conducted with two of these banks, it was revealed that savings deposits increased by some $60 to $65 million each in response to the introduction of the reward system. Though it is not clear how much of the incremental savings are funds shifted from other accounts or from other banks, in both cases the bank managers claimed that about half is new money.

[15] UNRWA, September2007,"UNRWA Savings Study: West Bank and Gaza", p. 11, USAID and AED
[16] Kaled, Lauer and Reille, January 2006,"Meeting the Demand for Microfinance in the West Bank and Gaza"; reported in *ibid*, p. 11.
[17] Some banks maintained regular savings accounts besides the reward-based savings accounts while others converted all savings accounts to the lottery-based system as in the Arab Bank.

Determinants of Savings Decisions

Using Quantitative methods, an attempt is made to identify the factors that influence savings decisions in this section. Our motive is to find an answer to the question: Why is the savings rate so low in WBG compared to other countries or regions?

- Can it be attributed to the slow growth rates or low levels of GDP or GDI? Economic theory states that households tend to save more as income increases. Inversely, if income levels are less than the "subsistence" cost of living, no savings will occur and it is likely that negative savings will result.

- Does the pattern of income distribution affect the savings rate? It follows from the preceding proposition that if income distribution is skewed, those in the lower percentiles will save less than those at the top. Thus, it is not only income but income distribution as well that affect the savings rate.

- Are savings and investment positively correlated? *A priori*, increased savings will be channeled through the banking sector to the production sector, increasing employment and income and, hence, savings and investment will be positively related to each other.[18]

- Is the savings rate influenced by the dependency ratio? The larger the number of young (0-14 years) and old (>64 years) dependents that households must care for, the smaller their savings.

- Are corporate and household savings related? As corporate profits rise, share holders' dividends increase, thereby increasing the savings rate, holding other factors constant.

- Is there a negative relationship between the value of household housing and savings rate?

- Are consumer debt and savings rate negatively related?

- Are inter-country differences due to the inability of the population in WBG to save or due to unwillingness to save (i.e. hoarding of assets at home) or both?

Depending on data availability on the variables mentioned above, these contributing factors will be analyzed within the WBG context.

National Income

Using OLS regression analysis to determine if different measures of income do influence national savings, our findings corroborate the results obtained in other studies; namely that savings and income are positively correlated. The strongest associations were found between:

- Gross savings on Gross Disposable Income in current prices with R2= 0.45 and the F-ratio statistically significant at 0.03 level, and

[18] Norman Loayaza et. al., March 2000," What Drives ....," *Op cit*.

- Growth rates of real savings and real GDP with R2= 0.45; and F-ratio statistically significant at 0.02.

Other regressions showed the correct signs but with weaker relationships such as Current savings on current GDI; Real savings on real GDP and real growth rates of savings on real growth rates of GDI. We conclude therefore that the level of economic development and hence disposable income levels do affect national savings. Not only that, the rate of growth of real GDP exerts a significant influence on the rate of growth of national saving. This relationship is by far the strongest based on both economic theory and empirical evidence in WBG, which corroborates the principle that economic growth is the major determinant of national savings. It also attributes the low savings and savings rate to low GDP levels and low GDP growth rates. A sure way of increasing savings is through faster growth rates in real GDP or, alternatively, through realizing higher levels of disposable incomes.

A key factor that explains the low level of savings is the low household income level compared to the cost of living in WBG. To wit, the preliminary figure for GDI in 2006 at current prices, according to PCSB, is $6,485.5 million. Meanwhile, the results of the 2007 population census reveal that the population in 2006 is estimated at 3,641,477[19]. With a family size of 5.85, the number of households should be about 622,475 in 2006. A PCSB 2006 Household Expenditure Survey indicates that average consumption expenditure per household is $832 per month or $about $10,000 annually. In the meantime, income per family, derived as (GDP/population) x family size, is $10,418. It follows that, on average, a typical family has an annual disposable income of $10,000 and a cost of living of about $10,418, which explains why families in general find it difficult to make ends meet, let alone save[20].

Investment

Though the direction of the relationship is not always clear, increased savings will be translated through the banking sector into investments, which represent the driving force behind economic growth as they expand the economy's productive base. This presupposes the availability of viable business opportunities in the country and the presence of an active banking and private business sectors. Empirical evidence in WBG indicates that there is a cause and effect relationship between these two variables in line with economic theory. The result however was not strong, most likely because the period under study is too short and/or due to data shortcomings. This notwithstanding, there was a relatively strong and statistically significant causal link between investments in building and gross savings, which lends support to the view that a high percentage of household savings (especially remittances) are motivated by home improvement, land purchase or the building of new homes.

[19] PCSB estimates population annually; 2006 estimate was 3,888,292 inhabitants in WBG. However, since the October 2007 results show that the population in 2007 was 3, 761,646, population estimates for previous years census will have to be re-estimated.

[20] Household consumption in 2005 is 100.1 percent and total consumption is 122.4 percent of GDP at current prices. Total consumption as a percent in GDI is 91.9 percent.

Remittances

The IMF Committee on Balance of Payments Definitions states "Remittances are an important source of income for households, in particular in developing countries …. Remittances have been identified as the third pillar of development as their volume is second to foreign direct investment and higher than overseas development assistance. Analytical studies have shown that remittances contribute to poverty reduction in home countries. These are some of the reasons why remittances have been receiving increasingly the attention of politicians and analysts. The G7 recently called for improved information of remittances, which still remain weak as compared to other balance of payments components". BOP presentation in WBG does not specifically show remittances. By following the IMF definition and in light of data constraints, remittances here are defined as the sum of "Compensation of Employees" plus "Current transfers to the private sector" which consists of households and not for profit institutions serving households. Below, we show the amounts of remittances. A breakdown of net transfers between households and NGO was not possible; hence, we cannot examine the relation between private savings and private remittances. The major trends of the inflow of funds from outside WBG can be briefly summarized in the following. See Figure 2.

- Travel, as part of export services, was affected considerably by the events of 2001-02. Its revenue fell from $148.7 million in 1999 to only $9.4 million in 2002.

- Palestinians' income from working in Israel fell from a high of $686.8 million in 1999 to $106.1 million in 2002 and $264.4 million in 2006. Preliminary estimates for 2007 point to a probable leveling at $250 million.

- Palestinian residents' income from working elsewhere has been rising steadily from $20 million in 1998 to $100 million in 2006 but remains modest.

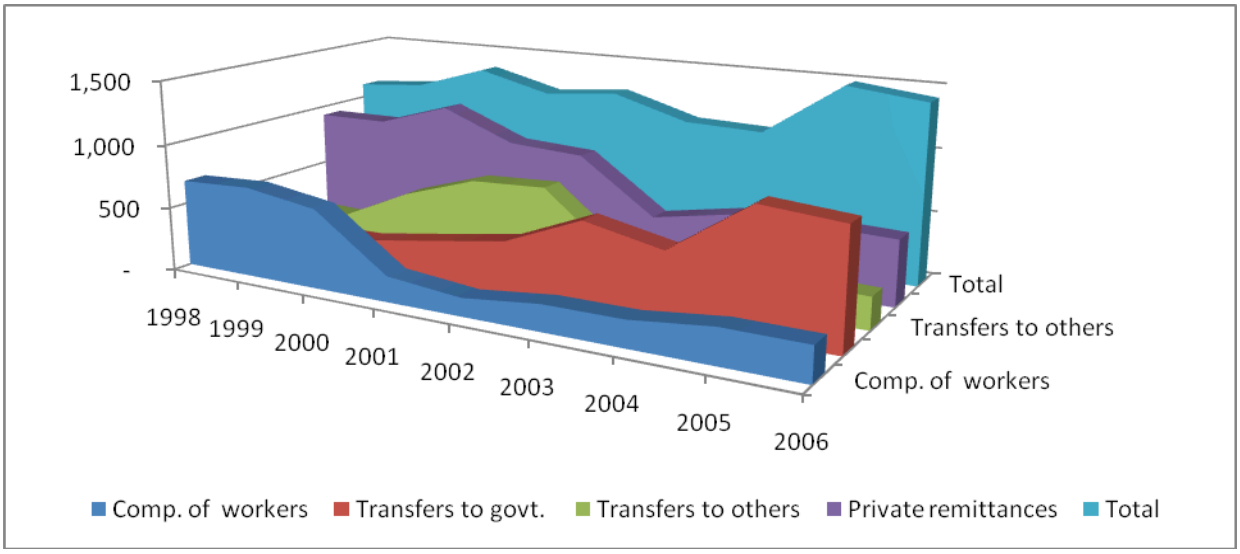
- Investment income fluctuates from a low of $51 million (2003) to a high of $130 million (2006), but remains modest

- Transfers directly affect the volume of savings to either the public or the private sector. In the case of the government sector, donors' contributions increased from $190 million in 1998 to about $900 million in 2005 and 2006 to pay for government wages and salaries and to finance government procurement, especially fuel.

- Donors' transfers to households and NGOs increased year after year from 1995 to 1998 between $233.8 million and $351.3 million. From 1999 to 2002, it reached new heights of $600 to $700 million. Since 2003 and until 2006, it returned to pre-1999 levels.

- Total remittances to non-government entities (the fourth block in Figure 2), peaked in 2000 and declined since except for a modest increase in 2005 and 2006.

Figure 2: Net Transfers and Income Flows with the Outside World, 1998-2006



The modest increase in income of resident Palestinians working outside Israel could not reverse its overall declining trend as a result of the drop in income earned from working in Israel. As shown in Figure 2, transfers to households and NGOs peaked in 2001-02 during the difficult time in the post Intifada II period, rising from $488 million in 2000 to $675 million and $700 million in the following two years. But, this too started declining thereafter. Overall, remittances to the private sector (net income + transfers) have fallen gradually while government support has been rising, thus lifting the aggregate amount of transfers and remittances to WBG. Donors' contribution to the government is the only exception in that it shows a major increase in recent years.

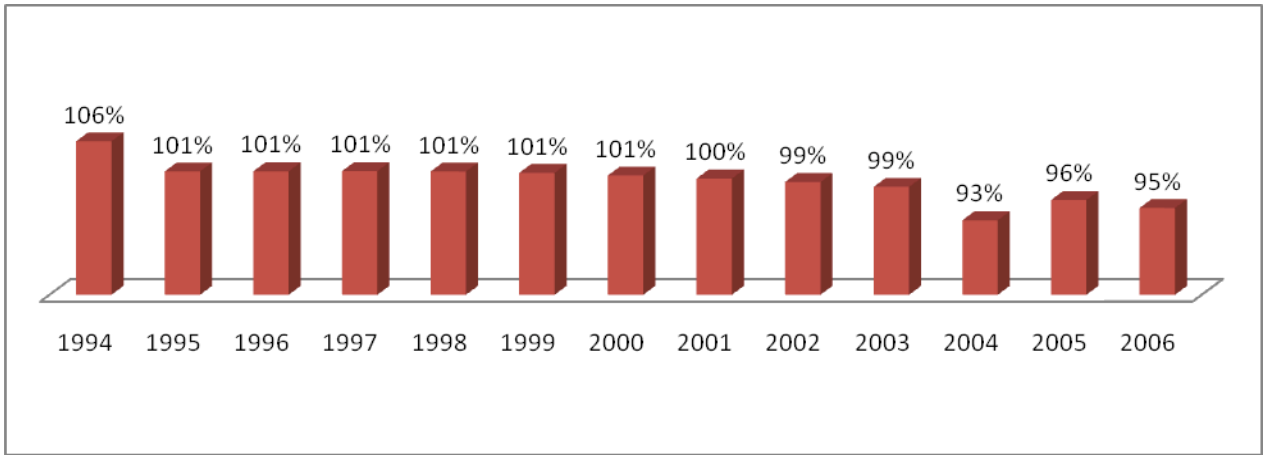
Quantitative analysis has failed to show a statistically significant relationship between remittances (or remittances per capita) and gross savings or demand deposits. What is undisputable however is that net transfers and income inflows, whether intended to reach households directly or indirectly through transfers to the PA (to pay salaries of government employees) or to NGOs (to support families below subsistence level or provide credit to MSMEs), eventually increase disposable income collectively.

Life Cycle Effect

Dependents are defined as individuals falling in the age category of 0-14 years and those older than 64 years. The dependency ratio is measured as the number of dependents as a percent of the number of independents population (15-64 years). The dependency ratio is relatively high in WBG compared to other countries. The average family size according to the most recent October 2007 population census is 5.8, down from 6 in 2005. In Western countries, the comparable number is about 2.2. The dependency ratio in the US at the turn of the 20th century was 79.9 percent; it declined steadily with the decrease in family size to 63.33. In contrast, it stood at

100.6 in WBG in 2000. This implies that for every 100 independents in the US, they care for 63.33 individuals while in WBG they care for 100.6 individuals.

Figure 3: The Declining Trend of the Dependency Ratio from 1994 to 2006



It is often argued that households with a large number of dependents tend to save less than those with fewer dependents and vice versa[21]. Most studies show a negative correlation between the savings rate and the dependency ratio. In WBG, the correlation gives the correct sign, meaning that there is a negative relationship between the two variables but with a level of statistical significance at 0.17- with a low correlation coefficient of R2= 0.17. The same is true when the dependency ratio of only the young males and females was regressed against the savings rate. The higher the number of young dependents the lower is the savings rate. No such association is observed between savings rate and "old" dependency ratio.

In sum, available evidence corroborates the proposition that in the WBG, savings rates are low because of the high dependency ratios.

Accessibility to Banking Services

There were 12 commercial/retail banks in WBG in 1967 operating 39 branches. All were closed in the wake of the 1967 war until 1987 when the Intifada I made it impossible for the Israeli banks to continue operation in place of the pre-war Arab and Palestinian banks. Two Arab banks restarted prior to this date: the Bank of Palestine in Gaza in 1981 and the Cairo Amman bank in Nablus in 1986. Throughout this period and due to the absence of legitimate banking services, currency exchangers took over some of the banks' retail functions, especially transferring funds from and to overseas, providing short term credits, accepting deposits and cashing checks drawn on foreign banks. In October 1995, there were 195 such currency exchangers in operation[22], let alone the thousands of currency exchangers who roamed the streets in WBG. In 1995, legal banking services were restored; 13 banks operating 57 branches were in place. Since then, the number of bank branches has been rising steadily. As of June 2008, there were 180 bank branches and offices, as shown in Table 3.

[21] Dependency ratios actually underestimate the burden placed on independents because, among the independents, there are the disabled, invalids, mentally ill, unemployed, retirees, etc,

[22] PMA, *First Annual Report, 1995*.

Table 3: Distribution of Bank Branches by Type, June 2008

	West Bank	Gaza	Total
Branches	97	32	129
Banking Offices	22	8	30
Cash Offices	15	6	21
Total	134	46	180

Source: Correspondence with PMA.

Banks play a significant role in mobilizing savings. To this end, accessibility to banking facilities is a *sine qua non* for increasing savings. To test this hypothesis in the WBG context, we ran a correlation analysis between deposits and the number of operating branches in WBG. The results, not surprisingly, showed a positive and statistically significant association between the two variables[23]. This implies that spreading branches throughout the territories tends to encourage savers, especially households, to convert their savings into bank deposit and to raise their volume of savings as well. Evidence abounds of the importance of this factor. First, saving inertia often explains the rate of increase in the size of savings over time as individuals tend to save more when their savings rise. One begets the other. Second, the ease of banking in general (depositing and withdrawals) overcomes the reluctance to part with one's wealth to a bank. Third, the geographical proximity of a bank encourages individuals to deal with banks, including the opening of a savings account, rather than saving in unproductive venues such as buying land or gold.

Available information in WBG indicates that there is a low level of bank accessibility. The overall average number of inhabitants per bank branch in June 2008 is 20,900 (3.77 million/180), ranging from a low of 7,797 in Jericho to a high of 68,781 in Silfeet in 2006[24]. Comparable figures range between 4,000-10,000 in Kuwait, Jordan, Lebanon, UAE, Oman and Qatar; and in most industrial countries, the numbers run from 1,500 in Germany to 7,000 in Japan. We conclude therefore that the total number of bank branches in Palestine is low. Moreover, in order to reach 10,000 persons per bank branch in 2008, the current number of branches must be more than doubled to 390. To put it differently, out of every 10 individuals, at the present time only four to five individuals have access to a nearby bank branch or cash office. Given the association between bank branches and the increase in deposits that was noted above, one would expect savings to increase with the increase in bank accessibility.

Besides the total number of branches, the distribution of branches between urban and rural areas is also important. Concerning the geographical distribution, the situation is worse. Of the 12 governorates, there are three without any bank branches in their rural districts. Additionally, the overall average number of inhabitants per bank was 13,184 in urban centers in contrast to 113,400 in rural area. The disparity is unusual in that evidence in other industrial countries shows that typically there are more banks per capita in rural than in urban areas. In Palestine,

[23] The results: Deposits = 45.54 + 0.024 Bank branch; R2= 0.93 and F Ratio = 82.51, significant at .01 level.
[24] PMA, 2006, an internal memo titled "*A study on Bank Branching in Palestine*".

bank per capita in rural Jenin is 242,392 and 375,609 in Gaza[25]. Therefore, further expansion in bank accessibility is necessary to mobilize savings on the condition that the expansion ought to take place in rural areas rather than urban centers which are overbanked in comparison.

Empirical studies conducted in other countries indicate that savings in rural areas are larger than in urban centers. In a study consisting of 150 countries over the period 1965-1994, the precautionary motive in rural areas readily explains this phenomenon because farmers have no means of diversifying away from the uncertainty of their income. As a result, they tend to save a larger proportion of their income compared to urban center residents[26]. In fact, the study finds a negative correlation between urbanization and savings rates. In China, it is reported that "rural household savings rates are substantially higher than urban savings rates" over the period 1978-1995[27]. This was particularly evident in yesteryears when the post office, located in every village and every distant hamlet, acted as a depository of savings for individuals and households using the reliable passbook that showed their assets at any point in time.

Should it be true that households and individuals in rural WBG behave similarly, it would appear that commercial banks are missing the boat in that they are all highly concentrated in cities with limited abilities to save.

PMA Circular (205/December 2007) addresses the issue of bank branching[28]. It states that banks can expand via opening a Bank Branch, a Banking Office, a Cash Office and/or a Bank Representative Office. Their respective spheres of authorized activities are outlined in the circular as follows:

1. ***A Bank Branch*** is authorized to carry out all regular banking services. Currently, there are 129 such branches or about 72 percent of all bank branches and offices.

2. ***A Banking Office*** is authorized to carry out about half the services a branch would typically offer; including opening accounts, receiving deposits, exchanging currencies and acting as a liaison with the main office on matters related to loans & credit cards applications, among others. It is not authorized to provide loans, issue credit cards & all types of checks, offer letters of credit, finance leasing arrangements, trade in investment instruments, offer investment portfolios or offer Islamic banking services. This category is composed of 30 units or 17 percent of the total.

3. ***A Cash Office*** is authorized to implement only three functions: i) deposit and withdrawals; ii) currency exchange and iii) collecting official fees on behalf of the government and public organizations. There are 21 cash offices, most of which operate in the West Bank.

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[25] *Ibid.*
[26] Loayza, Norman and Klaus Schmidt-Hebbel and Luis Servin, March 2000,"What Drives Private Saving around the World," World bank Working paper No. 2309. p.13.
[27] Kraay, Art, August 1998,"*Household Saving in China,*" p.15, prepared for the World Bank project entitled "*Saving Across the World: Puzzles and Policies".* Rural savings averaged 15.9 percent of household income while urban savings rate averaged 5.2 percent.
[28] PMA is aware of the need to branch out into smaller cities and is persuading banks to move in this direction.

4. ***A Bank Representative Office*** conducts market surveys & searches for investment opportunities but it does NOT carry out any banking functions.

The mobilization of savings can be realized speedily, effectively and inexpensively through an expansion via Banking Offices and even cash offices (in contrast to fully fledged bank branches) in rural areas. Cash Offices represent only 11.7 percent of the total. In terms of luring money hoarded in homes or money that would be converted into gold, Cash Offices represent a most effective avenue due to their semi-informal character, especially when bank employees are hired from the same areas where familiarity with the local community will further reduce cultural barriers to banking and encourage savings. Based on its experience in the Philippines, the Asian Coalition for Housing Rights puts it succinctly as follows:

> Monthly savings systems tend to work best for those better off community members with more regular jobs, while they often exclude the poorest. For those living day-to-day on the edge of subsistence, putting very small amounts of money into savings each day is much easier than trying to put in large amounts all at once. This makes daily savings a system that works for the poorest.

In brief, further savings can be mobilized through the expansion of the banking system into smaller cities, as it did when it increased its branches in larger cities since 1994.

Adequacy of National Savings

Loan to Deposit Ratio

Reduced to its core, the banking business consists of banks that accept deposits from savers and rewards them through interest payment and lends others a certain percentage of the deposits at a higher interest rate, thereby realizing a profit margin. Banks however must stand ready at all times to repay the deposits on demand. This ability is often described as the banks' "liquidity". Liquidity is measured in a variety of ways, one of which is the loan to deposit (LTD) ratio. Traditionally, when banks relied primarily on deposits to provide credit, liquidity was equated with a relatively low LTD ratio. Since banks at the present time can augment deposits through a variety of other financial instruments such as the use of insured funding and bank to bank loans[29], there are some that argue that the ratio is no longer the acid test of banks' liquidity.

The same ratio has often been used by US regulators to gauge the extent to which branch banks are serving the interests of their local communities rather than acting primarily as a source of deposits for their out-of-state main banks. LTD ratios depend on a host of factors, most importantly among them are i) the availability of sound business opportunities, ii) loan securitization and iii) the credit worthiness of the borrower. If these conditions are met and if banks are primarily dependent on deposits as sources for credit, LTDs are likely to hover around 70 percent. When additional funding sources are available, LTDs can exceed 100 percent.

In a recent survey of the banking system in the US in all 50 states (June 2007), LTDs exceeded 100 percent in 10 states; ranged between 91 percent-99 percent in 18states; 70 percent-90 percent in 19 states and < 70 percent in 3 states. The highest rate was in North Dakota at 170 percent. Within the 9th district (Minnesota) of the US Federal Reserve System, the average LTD rate in 1998 was 72 percent among small banks and 150 percent among large banks. At the EU in 2003, the overall average was 120.6 percent. In semi-industrial countries such as Korea, the ratio was 105 percent in 2005. Similar ratios are observed in other developing countries. In neighboring countries, the LTD ratios are 80 percent, 96.3 percent and 68 percent in Egypt (2006), UAE (2006) and Jordan (2007), respectively.

In order to render the inter-country comparison accurately, however, it is important to point out that the way in which people saved has changed dramatically over time where banks in the US, for an example, have long faced strong competition from mutual funds and the rise of the equity market as viable savings venues. As a result, available data show that in the US over the period 1980 to 1996:

1. Bank deposits fell from 36 percent to 15 percent of all household savings,

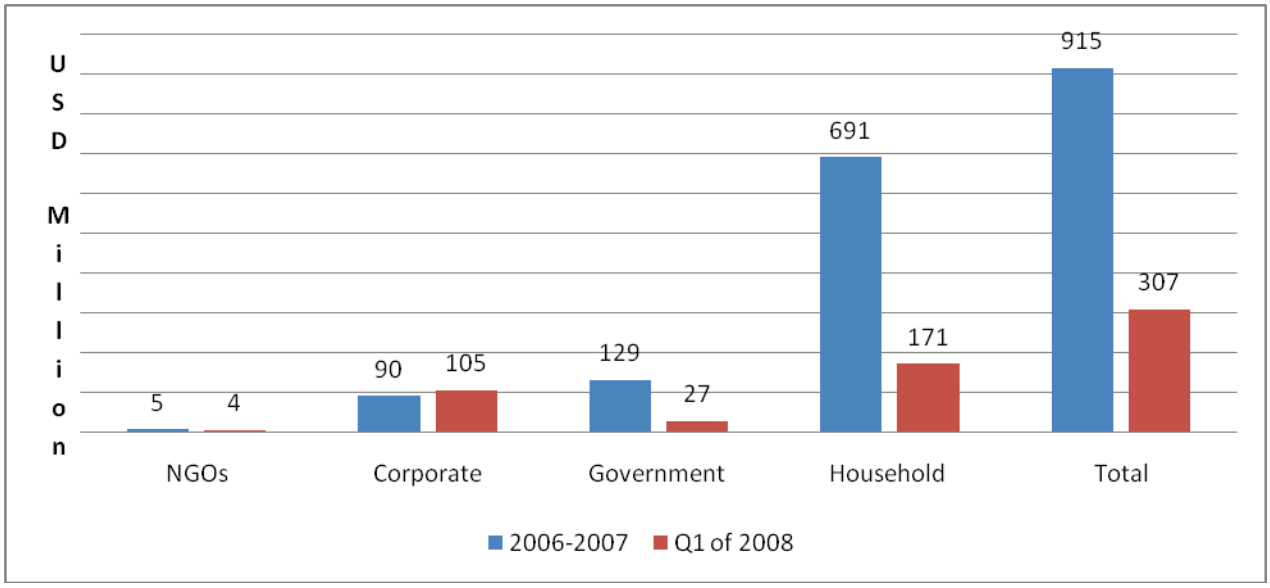
2. The share of stocks, bonds and money market mutual funds increased from 32 percent to 45 percent, and

[29] The two additional funding sources in WBG banks are bilateral interbank loans (8 percent of available funds in 2006) and equity assets (10.3 percent of available funds in 2006). The latter increased appreciably as a result of PMA's ban on the transfer of profits outside Palestine. See PMA, *ibid*.

3. The share of trusts, insurance policies and pension funds increased from 32 percent to 40 percent.

In contrast, the banking system in WBG is not currently facing similar competition. It is reaping the (indirect) benefits of the weak competition arising from a nascent equity market, the unavailability of government bonds and treasury bills, inaccessibility to investment and mutual fund companies that would normally offer a wide variety of financial instruments including savings accounts (money market funds) and the absence of mandatory pension plans for the private sector, all to no fault of their own. Nevertheless, banks in WBG are basically the sole depositories of financial assets, unless residents choose to invest overseas, which represents another fraction of the savings gap. That the household sector is the dominant entity that shapes the magnitude of demand deposits in the banking sector can be seen from Figure 4 below. During 2007, households contributed more than ¾ of the increase in total deposits into the system and more than ½ of the increase during Q1 of 2008. This attests to the high propensity to save among households and to the absence of competition from other savings assets such as government bonds, pension funds, insurance policies, trusts or a transparent equity market.

Figure 4: Shares of Different Saving Agents in the Change in Total Deposits in the Banking Sector

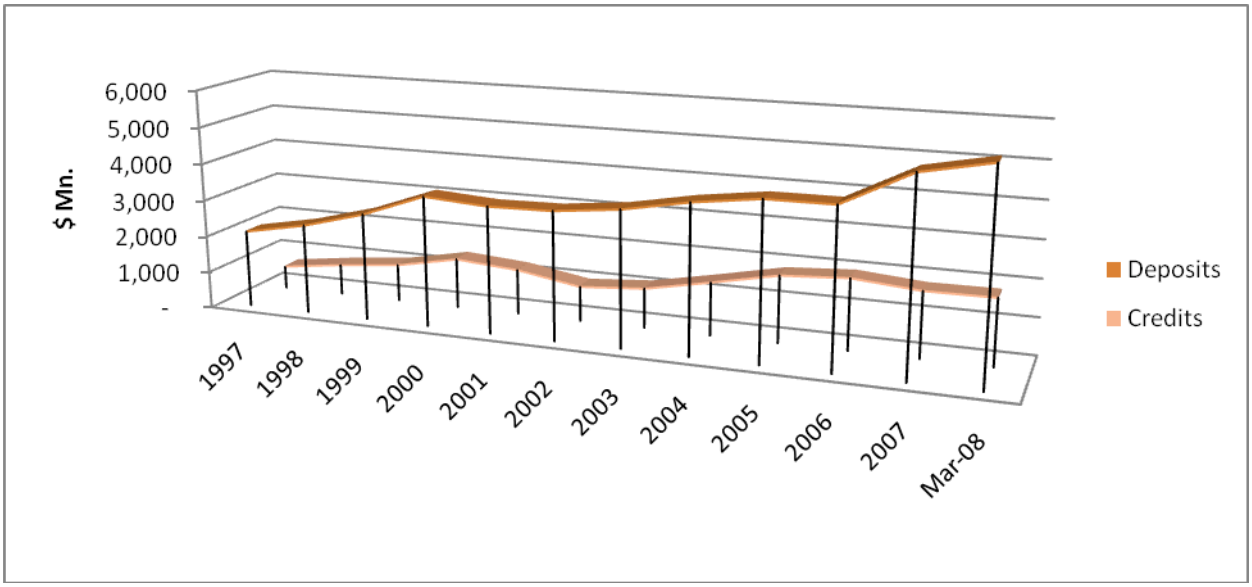


Note also that the share of deposits in the three Islamic banks operating in WBG has increased steadily from 7.7 percent at the end of 2006; 8.1 percent in mid 2007; 8.4 percent at the end of 2007 and 9.4 percent as of 3/31/2008.

Looking at the LTD ratio in WBG, we begin by examining the overall trends of both deposits and credits. As shown in Figure 4, the overall trends of both aggregates are rising from 1997 to 2008 with minimal gyrations. This indicates that banks in WBG have been quite successful in attracting savings from both businesses and households. In light of the perceived Israeli threat of carrying out whatever they decide to do, trusting one's savings to the banking sector is

undoubtedly a challenge, which was addressed effectively by the banking industry[30]. This is an important factor as we look for greater efforts by the banks to reach out to rural areas.

Figure 5: The Relationship between Deposits and Credit Facilities in WBG, 1997-2008



As of 3/31/2008, the household sector has accumulated $4.38 billion in deposits, most of which is from the West Bank (82 percent). Over the first three months of 2008 alone, individuals' savings increased by about $170 million. One of the strong motivations of the increase in savings can be ascribed partially to the introduction of the new attractive lottery-based reward system in exchange for increasing balances in savings accounts. From 1997 to 3/2008, deposits have invariably exceeded loans. Not only that but the divergence between credits and deposits widened in recent years, especially during the last 15 months, as can be seen in Figure 5.

Table 4: Composition of Bank Deposits, mid-1997 to March 2008

	Value ($ Mn)	No. of Accounts	Avg. Balance (USD)	% Distribution
Current Accounts	1,619,585,433	1,168,713	1,385.79	36.0%
Savings Accounts	980,060,700	659,790	1,485.41	21.8%
Time Deposits	1,895,127,539	81,178	23,345.33	42.2%
	4,494,773,672	1,909,681	2,353.68	100.0%

Source: Correspondence with PMA.

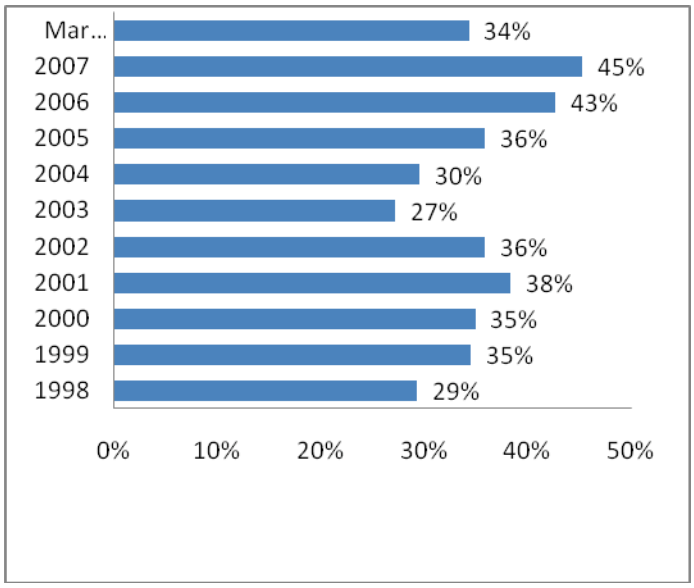
Returning to the LTD ratio in WBG, it is comparatively low by regional and international standards. Since 1998, the ratio fluctuated between 27 percent in 2003 and 45 percent in 2007. From the 11 observations shown in the figure to the left, the rate rose above 40 percent only twice. PMA has mandated a minimum of 40 percent, which was met only in 2007. This implies one or all of the following four causes: 1) that viable business opportunities are scarce and hence the demand for credit is relatively low, 2) that credit worthiness of potential borrowers is

[30] Incidents of an Israeli confiscation of certain clients' bank savings have taken place.

tenuous, especially as a result of the financial difficulties faced by PA and its inability to meet wage obligations to its employees as well as a result of the Israeli closures and restrictions on movements of business and workers, 3) the securitization of loans has become weaker as cosigners' guaranteed government salaries were no longer reliable and/or 4) investment by definition is a long term proposition and investors are reluctant to commit their assets under such heightened levels of uncertainty in Palestine.

Given the revealed demand for credit in the West Bank and Gaza, the prevailing socio-economic setting since the establishment of the Palestinian Authority, the amount of available funds in the banking sector, the steady increase in savers' deposits from both the corporate and household sectors, there is no doubt that there is no inadequacy problem in the financing system, neither now nor at any time since 1998, when data were first published.

Figure 6 Credit-Deposit



Domestic Credit to GDP Ratio

The degree to which the banking sector provides credit can also be measured and compared with other countries and regions through the domestic credit by the banking sector as a percentage of GDP. The higher the percentage the more active banks are and the more developed the economy is since credit is a proxy for investment spending. A comparison of the situation in WBG with neighboring countries and the OECD countries is provided in the table below.

Table 5: International Comparison of Credit Facilitation by the Banking Sector, 1994-2006

	1994	1996	1998	2000	2002	2004	2006
Domestic Credit by the Banking Sector as a Percentage (%) in GDP							
OECD	173	177	198	201	222	223	227
MENA	55	60	67	64	65	56	50
Israel	84	78	77	79	89	79	77
Egypt	81	82	91	96	108	112	99
Jordan	89	85	86	84	83	91	116
WBG	NA	NA	5	7	6	7	9
WBG*	NA	NA	21	32	28	34	40
Domestic Credit to the Private Sector as a Percentage (%) in GDP							
OECD	126	129	109	152	146	152	164
MENA	31	30	36	38	40	39	41

Israel	69	66	74	79	93	88	90
Egypt	32	41	53	59	62	60	55
Jordan	71	76	75	78	73	75	98
WBG	NA	NA	5	6	6	7	8
WBG*	NA	NA	19	22	24	24	30

***Note**: Domestic credit provided by the banking sector includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities and deposit money banks, as well as other banking institutions where data are available (including institutions that do not accept transferable deposits but do incur such liabilities as time and savings deposits). Examples of other banking institutions are savings and mortgage loan institutions and building and loan associations.*
** Computed from PMA, Twelfth Annual Report and PCBS GDP data, all in current prices.*

***Source**: The World Bank's World Development Indicators; International Monetary Fund, International Financial Statistics and data files, and OECD GDP estimates.*

The results reaffirm the weak role played by the banking sector in the provision of credit in WBG. In the table, the World Bank's results for WBG are reported as published but since they do not match data from PMA and PCSB, we include the results from these sources as well. Note that even though PMA & PCSB data are significantly higher, the conclusion is the same: WBG banks are providing credit in far less amounts relative to GDP, compared to other countries.

There are some interesting trends that emerge from the data shown in the table, which are briefly outlined as follows:

1. Total credit and credit to the private sector as percent in GDP are rising all across and over time.

2. The rates vary greatly and seem to oscillate modestly.

3. The overall average credit to GDP ratio in the developed countries of the world (OECD) is far above rates observed elsewhere (227 percent in 2006), which reflects the advanced levels of information available on business opportunities, credit worthiness, credit bureaus and the relatively high level of transparencies that characterize the institution involved in this process.

4. Unlike the rest of the MENA countries, Israel, Jordan and Egypt maintain high credit levels. Israel's rates have declined, however

5. A greater amount of credit goes to the private sector rather than the government sector in almost all countries and regions, and

6. Credit provision to private, public sector or both in WBG is far below the levels realized in neighboring countries, let alone advanced economies.

Recommendations

The economic development process in the WBG would be best implemented by mobilizing national savings and converting them into productive, job creating business opportunities. There are two sides to this process. First, there is the mobilization of national savings to increase the supply of loanable funds. The second is to efficiently provide credit to productive entities, thereby meeting the demand for loanable funds. Since our focus is on savings mobilization, the host of recommendations given below will address the supply side.

The ideas and suggestions presented here are just that. To go beyond this phase to the process of implementing any of them would require some further research to reach the level of detail necessary to make it operational, develop the laws and regulations needed and draw up a monitoring & evaluation mechanism to review its effectiveness and ensure its success.

The recommendation should also be considered as a package, each component reinforcing the other. By selecting one or the other, the benefits of synergy will be lost and the net effect would be less that it would have been if all components were tackled together, especially that they all aim to reach the same exact conclusion; namely to mobilize national savings. A suitable time horizon for the implementation of the package is 3-4 years, provided that the present political situation does not deteriorate markedly.

The Government Sector

The role of the government, besides its well-known traditional functions, will be either to initiate programs that are within its sphere of influence and/or work with other entities to bring attention and awareness to issues of national interest. The following recommendations will deal with both.

1. ***Energizing the private sector:*** The economy in WBG has recently slipped into a higher than necessary level of dependency on the public sector; the World Bank reports that the government has become the largest employer in 2006. Meantime, the World Bank's "Doing Business" indicators for 2008 rank WBG 118 out of 178 countries. As mentioned earlier, both the level of disposable income and the growth rate of real GDP are closely and strongly associated with the savings rate in WBG. Therefore, the mobilization of national savings is strongly influenced by economic development, which has been constrained by the prevailing investment obstacles. To effect the desired mobilization of savings, the private sector must be energized by deregulating and liberalizing the investment climate in WBG.

2. ***Streamline the pension fund program of government employees***: The pension system in WBG is broken despite the number of laws and regulations promulgated and institutions established over the last 10 years. Two drastically different systems were followed in Gaza (Egyptian system) and the West Bank (Jordanian system). Then in 2005, the two systems were combined into one with too many "special" provisions and multiple authorities such as the national Palestinian Retirement Organization, established in 2007, and the old Retirement Directorate at the Ministry of

Finance. Currently, turf disputes, ambiguity of rules, delayed processing of retirement applications and the lack of transparency are only but a few of the problems that plague the system. Streamlining the entire retirement system is not only in the interest of pensioners who own it but also to the economy in light of the significant contributions made by pension funds elsewhere as one, if not the only one, of the major sources of investment spending in the economy. When commercial and retail banks provide credit to MSMEs, pension funds complement them by focusing on mega projects with long term horizons.

3. ***Mandate pension programs for the private sector:*** Only government employees have a mandatory pension fund scheme in WBG. The 2005 pension law made it optional for the private sector to institute retirement programs for their employees. While this reduces the cost of labor, it deprives them from the financial security they need at retirement and, hence, weakens the loyalty they have towards their employers. This mandatory system is prevalent in almost all countries and, given the dominant size of the private sector compared to the public sector, it adds sizable amounts of loanable funds to pension funds authorities. By mandating pension schemes in the private sector, the supply of loanable funds would increase substantially.

4. ***Initiate with the private sector an insurance umbrella against non-payment of small loans made to MSMEs***. The Palestinian Investment Fund signed in July 2007 a Loan Guarantee Program for SMEs with the US Overseas Private Investment Corporation (OPIC) and the Aspin Institute, where SMEs would receive loans from $10K to $500K over a period up to 10 years. PIF will partner with commercial banks in WBG, which will manage the loans. What this excellent program does not do is to provide the same investment guarantee program for micro entities with loans of less than $10,000. In Annex II, it is reported that micro enterprises (1-4 workers) contributed during 2006 more than half of the total employment (57 percent) in 5 of the largest sectors of the economy. Hence, besides SMEs, micro enterprises also play a major role in Job creation. They, too, lack an insurance umbrella against unexpected events resulting in non-payments. Faced with a similar situation in the 1990s, Egypt's Social Development Fund launched a private firm that offered micro loan guarantee against nonpayment in exchange for a 1 percent premium paid on loans. A similar insurance umbrella would positively affect loan provisions to micro enterprises and encourage commercial banks to downscale their operations to handle MSMEs.

5. ***Promote life and property insurance awareness in cooperation with the private sector***: According to the 2007 IFC study on Microfinancing in WBG, there appears to be a strong demand for financial products other than loans and savings accounts. No less than 53 percent of respondents indicated a need for insurance products. More specifically, it was reported that 53 percent expressed interest in health insurance; 25 percent for property insurance; 22 percent for pension funds and 19 percent for loan insurance[31]. As with pension funds, insurance companies are an

[31] *Op. Cit*, p. 68.

important potential source of loanable funds. As a result, it is recommended that the government work with the private sector to raise the level of national awareness to the demand for and the supply of such financial services, including the establishment of new private firms if necessary.

The Banking Sector

The banking sector in WBG is highly competitive, privately owned and run and, in many ways, rather modern in its practices. Some offer online banking, phone banking and ATMs. They have also been active in mobilizing national savings using a lottery-based reward system, which, as mentioned earlier, has been effective thus far. These notwithstanding, the banking industry can still do much more. There are three areas that we will focus on.

1. ***Diversify current financial products***: With one exception, all banks offer only the three traditional accounts: "current" at no interest, "saving" with low interest and "Time" deposits accounts for longer periods at higher interest rates than savings accounts. Many now offer the "lottery reward" accounts at no interest or at insignificant rates. It is likely that a somewhat similar response can be realized by offering new products, some of which are suggested below:

    - Multiple balloon accounts where savers can double their deposits over a specific period of time (5 to 8 years) with the possibility of taking out advances against their deposits,
    - A youth account where parents can deposit small amounts over a long period of time,
    - An educational account, where certain monthly or quarterly deposits are pre-set to yield certain end-of-period payments to cover educational fees and tuition,
    - A Diaspora Remittance account that enables overseas depositors to manage their funds in the way they see fit. As an example, Banco Solidario in Ecuador issues a "smart card" that allows depositors to accumulate savings to buy a home,
    - A Micro Enterprise account that is liquid with no or minimal balances (or a minimum of 200 NIS) and with interest,
    - A Retirement account which is illiquid with varying time periods at high interest rates. Even if the private sector deposit pension scheme becomes mandatory as suggested above, it is highly likely that it will exclude micro projects with four or less workers. In this case, this type of account will still be in demand,
    - A "family and friends" or "group" account, which is quite prevalent in WBG already,
    - An Islamic account at no interest where a conventional bank would either provide this type of account or act as an intermediary with Islamic banks.

A product mix should provide enough options to meet demand but not too varied to cause confusion among un-sophisticated small clients. It should also be varied enough to appeal to the divergent needs of potential savers. Moreover, it must bring about an acceptable balance

between high and low cost accounts. But above all, banks must utilize the accumulated deposits to earn acceptable returns in terms of fees and interest payments on their loans.

For each of the accounts mentioned above, banks will have to delineate the main features that will attract savers. These are as follows:

- Volume where certain minimum amounts may be required
- Access to own funds with and without penalty
- Interest rate and interest payments
- Flexibility in terms of swapping funds among accounts, taking a loan against own time deposits, withdrawals, etc.

2. ***Bank Branching***: Based on the analysis provided earlier on the geographical distribution of bank branches, it was concluded that rural areas are severely under-banked, which represent a major lost opportunity for banks since, based on experiences in other countries, rural households tend to save more than urban households. Expanding in remote areas and smaller cities will mobilize more savings. This is a doable proposition if banks chose to expand via the use of Cash Offices, which will require little additional capital costs. These units will act basically as depositories for savings in as much as Microsaving Units have been introduced into other developing countries and replaced the old post office function as savings centers.

3. ***Provide credit to micro and small enterprises****:* There is abundant evidence shown in recent surveys of microenterprises conducted by IFC and UNRWA that there is a pent up demand for credit; moreover conventional commercial banks are not up to par in dealing with micro projects in terms of accessibility and flexibility. The IFC study provides glimpses into the pent up demand for credit, which is briefly characterized by the following based on a sample of 1202 microenterprises:

    - There are some 190,000 potential clients in WBG,
    - Estimated demand for credit is $280 million,
    - 90 percent of respondents have no access to credit
    - 57 percent would apply for credit subject to the charged interest rate and the size of the monthly payment,
    - 16.4 percent applied for credit; of which 2/3rd were accepted and 1/3rd rejected,
    - Estimated market penetration of the demand for credit is 10 percent,
    - Most frequently mentioned loan size is $2,500 for 2 years,
    - 98 percent can submit to monthly payments,
    - 49 percent need credit o finance working capital,

- 49 percent need credit to acquire fixed assets,
- 79 percent would apply for a loan to expand business,
- 45 percent need credit to start up a new business activity,
- Only 7 percent in the West Bank and 5 percent in Gaza have access to a bank savings account; the rest either save at home (majority) or do not save,
- 95 percent in the West Bank and 53 percent in Gaza are interested in buying health insurance,
- 55 percent would like to have the choice between conventional and Islamic banking while 61 percent prefer Islamic banking. UNRWA management asserted that these figures are inaccurate based on their extensive experience in the field; thus, the evidence is inconclusive,
- Only 14 percent in the West Bank but 35 percent in Gaza are interested in money transfer services

The demand for credit in general is a subject that requires further research in order to update and broaden the analysis to provide the background on which basis banking decisions can be made.

A focus group discussion yielded the following types of accounts that are in demand by respondents (IFC, 2006):

Basic savings accounts:

- Minimum account balance of no more than 200 NIS[32]
- No restrictions on withdrawals
- No maintenance fees
- Attractive interest rates

Term Deposits

- Certificate of deposits with varying maturities: 3,6,9, and 12 months
- Funded by residents or friends and families overseas
- Flexible restrictions as per the instructions of the depositors

4. ***Transparency and truth in lending***: The true cost of lending, short and medium term interest rates on savings and time deposits and the numerous fees banks collect on retail

[32] The current minimum balance required in most banks in savings accounts ranges between $200 to JD 200 ($280 or about 1000 NIS).

services ought to be announced in the open so that clients can make rational decisions based on facts. A transparent banking industry is associated normally with healthy and competitive environments. As an example, the heavy advertising for lottery-based reward system in the local media should be accompanied by a statement revealing the interest rates depositors will earn on these accounts (which range from 0 percent to ½ percent) along with a statement on the probability of winning. Other conditions such as the necessary monthly increase in lottery-linked savings account balances are not always transparent to clients.

The Palestinian Monetary Authority

1. ***Bank Branching***: PMA is recommended to expand bank branches to 390 in the next 3-5 years, as articulated above,

2. ***Direct expansion into rural areas***: Priority should be given to licenses in new areas not covered by banking services at the present time. The use of Cash Offices as a prelude to expanding them into Banking Offices when condition permit should be encouraged.

3. ***Establish a deposit insurance corporation***: The PMA is currently considering the launching of a deposit insurance firm. It is not clear at which phase this project is at the present time, but it must be pursued as part of the recommended package of recommendations. In fact, it should receive priority among other policies, and

4. ***PMA to work with commercial banks to build their capacities in the area of credit provisions***. Currently, MFIs provide micro loans at 2 percent interest monthly. Interest payments in either absolute values or on an annualized basis are substantial and the banking sector, once it becomes involved in microfinancing, will provide a competitive edge to MFIs for such a promising sub-sector. A key reason for the conventional banks' arm's length posture toward microenterprises stems from the lack of familiarity with micro entrepreneurs. MFIs have an advantage over commercial banks in this area. However, such experience can be gained with training and capacity building. Currently, there are two large commercial banks that are in the process of launching microfinancing sub-units within the banks' operations. With well-directed support in building appropriate systems, qualified manpower, MIS, client development and customer relations, mixed with the expansion via Cash Office, commercial banks can energize their intermediation role effectively.

5. ***Encourage the establishment of Mutual Funds either through the banking sector or through private investment corporations***: A mutual fund industry would encourage savings and infuse an element of competitiveness with existing commercial banks. In many of the industrial countries, the preferred method is to allow the private sector to establish specialized Mutual Investment Funds Corporation rather than allow banks to carry out this role exclusively.

Annex I: Target Growth Rates and Saving Rates

The significance of mobilizing local savings becomes apparent from the proceeding analysis because it is through investment spending that economic growth can be realized. And investments financed through national savings instead of relying on borrowing from abroad will mean that smaller and smaller percentages of future GDP will be claimed by foreigners in the form of interest and dividends.

According to the official PA statistics, real GDP grew at 6 percent in 2005, fell drastically to -8 percent in 2006 and is projected to rise to zero growth in 2007. The Palestinian Reform and Development Plan (PRDP) projected a medium term growth of 3.8, 5.0 and 6.0 percent in 2008, 2009 and 2010, respectively. The noticeable fluctuation in the growth rate within a short period of time is an unusual phenomenon, reflecting the geopolitical turmoil in the territories. The expectation of steady rates in 2009 and 2010 presumes the absence of new major disturbances that would impact macroeconomics aggregates of WBG. Based on a recent PCBS preliminary estimate that the WBG economy is perhaps more resilient than was initially anticipated in that a) real GDP in 2005 increased by 6.72 percent compared to the expected 6 percent, and b) it fell in 2006 by 3.2 percent compared to the expected 8 percent. In nominal terms, GDP grew at 6.62 percent in 2006.

In the absence of macroeconomic modeling, economic growth projections are difficult to estimate. Rather than *projecting* what the economy would be like at some point in the future under specific scenarios, we will attempt to set economic growth *targets*. The principal determinant of the growth target is defined as the economy's ability to absorb new entrants into the labor market. The number of new entrants measures the annual increase in the local labor supply available within the Palestinian territories, i.e. excluding employment of Palestinians in Israel. PCBS data show that the labor supply increased from 569,000 in 2005 to 603,000 in 2006, or by 34,000, which represents 5.1 percent of the 2005 labor force. Assuming that the average annual growth rate in the labor force over 2002-2006 (5 percent) will not change during the next five years, projected increases in the labor force are shown in Table A-1.

Table 6: Labor Force Projections, New Entrants & Targeted Labor Absorption Levels (000)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Labor force	827	872	916	961	1,009	1,060	1,113	1,169	1,227
Entrants		45	44	46	48	50	53	56	58
Employed		34	44	46	48	50	53	56	58
Employment	633	667	710	756	804	855	908	964	1,022

Note: The projection horizon begins with 2007 due to the lack of published data beyond 2006.
Adapted from PCBS, 2008, Labour Force Survey, 2006.

During 2006, only 34,000 out of 45,000 who entered the labor market found employment, which explains the rise in the number of unemployed individuals in 2006. From 2007 on, however, the targeted economic growth rates are determined on the basis that they will create enough jobs to absorb all new entrants. This will have the effect of maintaining the current level

of unemployment at about 200,000 throughout the projection period. Consequently, as the size of the labor force increases over time, the unemployment rate will decline from 23.5 percent in 2005 to 16.7 percent in 2013. The number of newly unemployed individuals will be the same as the number of new entrants starting from 2007 because all new entrants will be absorbed into the economy. But, what growth rates are required to achieve this objective?

Average real value added per employee at the economy level is estimated for each year from 1995 to 2006. Due to statistical aberrations over the period 1995 to 2006, however, projected growth is based on the most recent 2006 data. Three assumptions are made a) average labor productivity will increase by ½ percentage point each year, b) current level of Palestinians working in Israel will stay the same and c) price inflation is neutral. Knowing labor productivity and the number of new entrants, targeted real GDP estimates are derived for the period 2008 to 2013. The results showing real GDP levels and growth rates are shown in Table A-2.

Table 7: Derived Real GDP Growth Targets, 2008 to 2013

Real GDP ($ Mn)	5124.7	5490.9	5874.9	6276.9	6705.2	7159.9	7633.3
Labor productivity ($)	7960	8000	8040	8080	8121	8161	8202
Real GDP growth rate (%)	7.30	7.15	6.99	6.84	6.82	6.78	6.61

Source: Own computation.

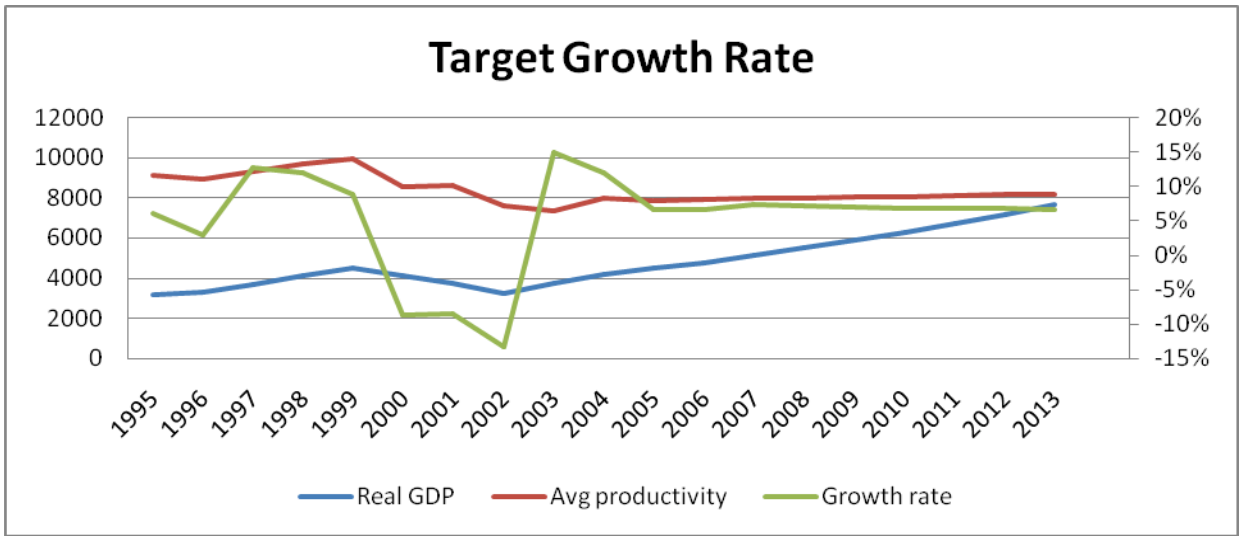
In order to develop an economy that is able to create enough jobs to employ at least all new entrants in the labor market for the next five years, real GDP growth rates will have to reach more than 7 percent in the near future, while declining ever so marginally thereafter. Based on PCBS published data, real GDP grew by 6.6 percent in 2005 while GDP in current prices is provisionally estimated at 6.7 percent. See Figure F-1.

Realistically, it will be difficult to experience a 7.3 percent real growth in GDP in 2008; the downside risks stem from the fragile political situation, world price pressures resulting from food, energy and other commodities and foreign exchange instability.

Nevertheless, this analysis can be used as a guide to estimating the potential job opportunities lost as a result of not being able to achieve the targeted growth. In fact, GDP elasticity coefficient with respect to labor over the period 1995 to 2006 is 1.1, which is relatively high compared to developed countries where it is usually around 0.5[33]. The elasticity coefficient measures the percentage change in employment per 1 percent change in real GDP. The disparity is readily explained by the degree to which the Palestinian economy is labor dependent as evidenced from the importance of the typically labor intensive sectors such as agriculture, trade, household services and the widespread proliferation of micro and small enterprises. The elasticity coefficient indicates that if GDP fell 1 percent off its target, this will result in a 1.1 percent reduction in the projected employment figures.

[33] Employment elasticity varies over different time periods. During the early period from 1995 to 1999, it was 0.64; from 2000 to 2006 it increase markedly to 1.99 but returned to 1.1 when the 2000-2002 period was eliminated to avoid the major economic turmoil that witnessed a decrease in value added unmatched by a decrease in employment.

Figure 7: Target Real GDP, Average Productivity of the Economy and Growth Rates, 2008-2013



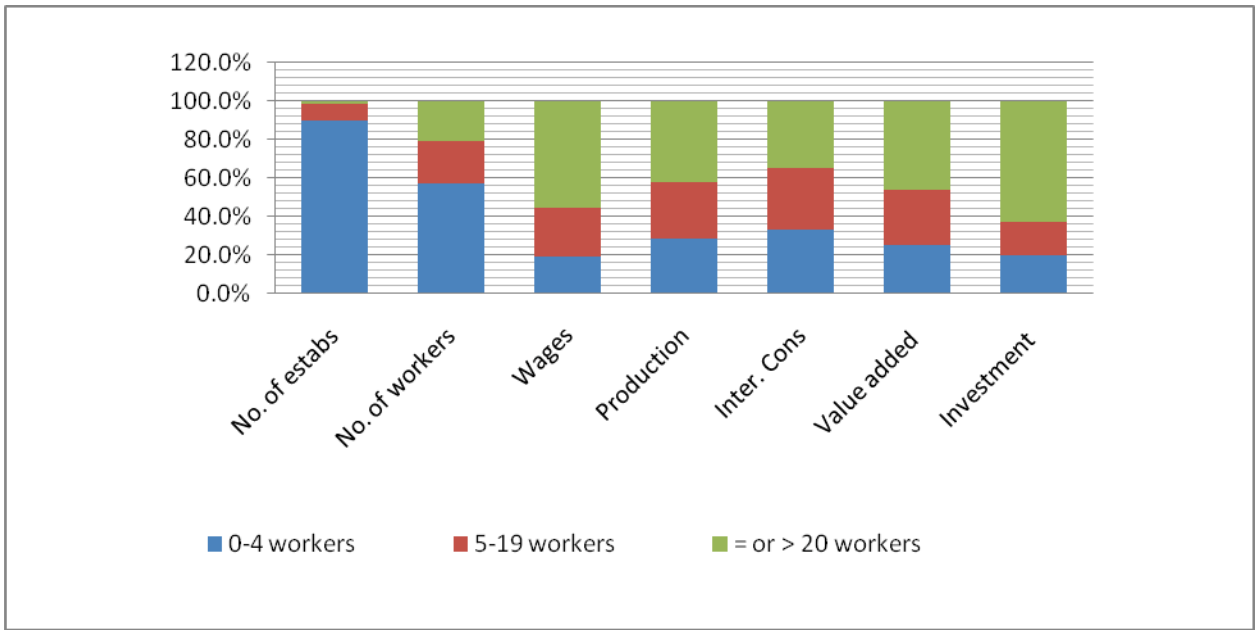
If the economy grows as projected, gross savings will increase only marginally. An analysis of the Gross Disposable Income and Gross Savings data shows that the marginal propensity to save, which is estimated using OLS regression analysis over the period 1994 to 2006, is 0.18. Gross savings were $484.8 million in 2005 and $601.9 million in 2006, which represent 8.1 and 9.3 percent of GDI, while the overall average for the entire period from 1994 to 2006 is 4.1 percent. If only 18 percent are saved from incremental disposable income while maintaining the overall 4.1 percent, gross savings will increase slowly. However, should some of the recommendations mentioned in this study be put in place, it is possible to see a rise in the average savings ratio, which is not farfetched when one considers the high ratios realized over the last two years[34]. Assuming therefore that the average propensity to save will stay at the 2005/06 average rate of 8.7 percent, total savings are projected to increase by an amount of about $512 million in 2008 to $709 million in 2013.

[34] This is supported by the significant increase in demand deposits in the banking system from $4.058 billion on 12/31/2006 to $5. 424 billion on 3/31/2008. Individuals' savings over the same time rose from $3.516 billion to $4.378 billion.

Annex II: Are MSMEs in WBG a Viable Job Creation Venue?

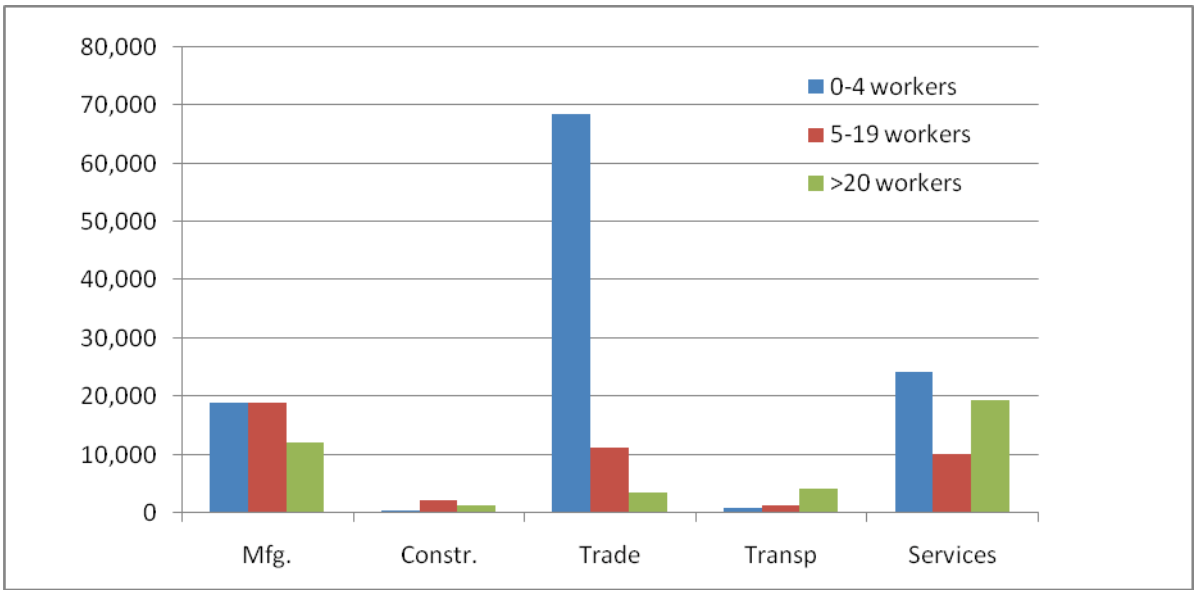
Conventional wisdom contends that MSMEs are effective in generating job opportunities. In the US, it is often quoted that small enterprises hold 70 percent of all jobs in the economy. How true is this supposition in WBG, especially that MSMEs are defined in a widely different way. A 2006 establishment survey covering five major economic sectors indicates the extent to which micro enterprises contribute to employment and economic growth (value added). Micro enterprises defined as entities with 4 workers or fewer contribute more than half of the total number of jobs (57.3 percent) and 1/4th of the total value added.

Figure 8: Distribution of Relative Shares of MSMEs in Jobs, Value Added and Investment, 2006



When micro enterprises are added to small enterprises (5-19 workers), their combined contribution to the economy increases significantly to 79.4 percent of total jobs; 58.2 percent of total production; 65 percent of intermediate consumption that creates further value added through backward linkages (supply chain) and 53.8 percent of the generated value added. These statistics point out unambiguously to the considerable role played by MSMEs in the national economy, which lends credence to the need to support their growth through additional financial resources. Turning to the sectors in which MSMEs are relatively more active, Figure F-3 depicts the number of jobs in the five sectors classified by sector and size of establishment.

Figure 9: Number of Jobs Classified by economic Activity & Size of Enterprise, 2006



Due to the Israeli restrictions on the flow of goods and people, MSMEs flourished in business activities that do not require large economies of scale. Activities that do not require much in the way of plant and equipment (i.e. capital assets) and can produce import substitutes also thrived, as well as activities that are strictly service-oriented. This can be seen from the dominance of micro enterprises in retail and wholesale trade. The same is true for the services sector, albeit in smaller numbers. What is surprising is the size of MSMEs in the manufacturing sector, which is clearly labor intensive. This sector contributes 65 percent of total intermediate consumption, indicating its strong interrelationships with other sectors of the economy. It also captures 1/4th of the total jobs created. That MSMEs can flourish in the manufacturing sector is a signal that this is a promising economic activity, worthy of support by MFIs.