New Study by MAS Calls for Strategic Economic Policy Interventions to Activate the Productive Base and Promote Exports

The Palestine Economic Policy Institute (MAS) today published a new study entitled "Macroeconomic Structure, Financial Markets, and the Financing of Government Activity: Lessons for Palestine" The study was prepared as part of a research cooperation programme with the Palestine Monetary Authority (PMA), to assess feasible options for sustainable deficit financing in Palestine. The study was authored by a team of three researchers from Hamburg University-Germany and University of Sheffield, led by Professor Heiner Flassbeck, under the supervision of MAS and in cooperation with the PMA.

As the question of sustainability is inevitably tied to real economic conditions, recommendations emerge from an extensive analysis of Palestinian economic development, current institutional constraints, and the monetary system. The conclusions suggest that neither issuing government bonds in a foreign currency, nor introducing a Palestinian currency to engage in monetary financing are unviable options *as of now*, given the dire state of the economy and the restrictive institutional environment. Dr. Nabeel Kassis, the Director General of MAS, said "The study provides substantive empirical evidence for this reasoning. With regards to Palestinian economic development, it is noted that for the past 20 years, the Palestinian National Authority (PNA) has relied on foreign grants and donations to finance its expenditures". He added that the study highlighted that "more recently, this stream of income has substantially decreased, which led to the suspension of salary payments for civil servants as well as a general decline in government spending. Yet, sizeable and persistent trade deficits continue to push the government and, more excessively, the private sector into debt. Since there is no Palestinian currency, both the public and private sector rely on foreign reserves to finance investment and operations". Although the study confirms that the PNA managed, with the successful management of the Palestine Monetary Authority (PMA), to avert a full-blown currency crisis thus far, it is unlikely that current modes of deficit financing can be sustained indefinitely, as domestic stocks of foreign reserves rapidly deplete, and the accumulation of arrears and debt mounts at an alarming rate.

According to the study, this leaves the government with two options for deficit financing: either issuing debt securities on capital markets or introducing a Palestinian currency to finance expenditures via the central bank. Regarding the first option, the study argues that capital market financing without a fully-fledged central bank leads to high interest rate volatility and financial instability. As for monetary financing, in the current institutional and economic environment, the prerequisites for the introduction of a national currency are non-existent. If anything, its exchange rate would be highly volatile, whereas imported inflation could further destabilise economic development.

Therefore, the PNA should first intensify its efforts to obtain funds from external donors, and eventually widen the scope of international partnerships (e.g. with a focus on Asia). The use of these grants should be embedded in a broader development strategy, so that donors would be reassured that the funds are *directly* invested in infrastructure and productive activities (not consumption!). Secondly, any legal restrictions on government debt accumulation should be avoided. Such a stance poses an entirely arbitrary limit to government finance, whilst disregarding saving and investment positions of other sectors.

Therefore, the study recommends that the Palestinian authorities should focus on a different set of short-run and long-run objectives. As *any* issuance of bonds is contingent upon stabilising the external sector first, the PNA must deploy in the short-run strategic political and economic interventions to revitalise the productive base and increase exports. In the long-run, the introduction of a Palestinian currency is indispensable for sovereign and sustainable economic development. It cannot be overstated, however, that any attempt to issue debt securities without having rectified current imbalances would lead to highly volatile interest or exchange rates. Finally, the study concludes with other suggestions and recommendations for the PMA and other PNA apparatuses, that can be achieved despite the institutional and economic conditions.

The study (in English only) may be accessed at:

http://www.mas.ps/files/server/2019/Financing%20of%20Government%20ActivityPMACLEAN.pdf