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UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Tel: (+43-1) 26026-0 · www.unido.org · unido@unido.org

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STUDY FOR THE ESTABLISHMENT OF AN INDUSTRIAL DEVELOPMENT BANK IN THE OCCUPIED TERRITORIES OF PALESTINE

UC/PAL/85/090

Terminal Report*

Prepared by the
United Nations Industrial Development Organization

Based on the work of L. Harris (Team Leader),
H. Jabr and R. Shihadeh, UNIDO Experts

Backstopping Officer: Gabriel Rezek, Feasibility Studies Branch

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C O N T E N T S

CHAPTER 1

INTRODUCTION AND SUMMARY, AND RECOMMENDATIONS

CHAPTER 1

This report is a feasibility study on the establishment of an Industrial Development Bank to benefit the Arab economy of the Occupied Territories of Palestine.

The study's origins lie in the recommendations made in the United Nations Industrial Development Organisation (UNIDO) Report, Survey of the Manufacturing Industry in the West Bank and Gaza Strip (UNIDO/IO.584/29 1984). The study is concerned with the establishment of an Industrial Development Bank to further the recommendations made there concerning an industrial development programme and its financing. Hereafter, it is referred to as the UNIDO Survey of Manufacturing Industry.

In the present report we use the name 'Industrial Development Bank' for such an Industrial Development Bank. In addition, it should be noted that we use the name 'World Bank' to include all institutions of the World Bank Group.

The recommendations and conclusions of the Report are summarised as follows:

CHAPTER 2

1 The economic growth of the Occupied Territories has been greatly restricted by the conditions of the occupation, including the absence of banks carrying out financial intermediation to provide development capital.

2. Within these economies, the industrial sector is extremely weak. It consists principally of small workshops most of which are doing essentially

repair work or carrying out sub-processes for Israeli firms.

3. An industrial development strategy giving priority to the strengthening and growth of workshop industries, to agriculture-related industries and others can address the social and economic needs of the Occupied Territories. As one element, it will require infrastructure investment as well as investment in individual enterprises.

CHAPTER 3

1. The existing financial system in the Occupied Territories carries out almost no significant financial intermediation.

   Its main activities are transferring cash and deposits and foreign exchange dealing.

2. The underdeveloped character of financial intermediation means that the institutions do not mobilise local savings for local use. They supply virtually no long-term finance for industry and only a very small amount of short-term commercial finance.

3. The main institutions engaged in financial activity are the money-changers, Israeli commercial banks, and two Arab commercial banks. Their activities are not significantly financial intermediation. In addition, the Arab Insurance company and Jordan's Industrial Bank have some marginal role in financing. But in total the supply of long-term finance for industry is almost zero.

CHAPTER 4

1. The Industrial Development Bank should have an initial capital structure following the World Bank Model. That is, long-term subordinated debt should be in the ratio of 1.5:1 to share capital and the sum of the two should comprise the borrowing base against which other loans should be in the ratio of 3:1.

2. Share capital should be subscribed on a wholly paid-up basis by private named residents of the Occupied Territories.

3. Long-term subordinated loans should be sought.

4. Other loans are to be mobilised from private residents of the Occupied Territories (as wholesale funds) and from international development agencies.

5. Dividend payments are to be limited to 25 per cent of net profits.

6. Borrowing limits and the capital structure's other ratios are to be reviewed every five years.

CHAPTER 5

1. The Bank should actively seek to mobilize savings by attracting wholesale funds.

2. These funds should be on the basis of fixed-term liabilities, paying competitive, commercial interest rates.

3. The instrument for mobilizing these funds should be fixed term bonds issued by the Bank.

4. They should be non-negotiable, although negotiability may be adopted after the Bank has become well established.

5. Bond issues should be underwritten by Amman financial institutions.

6. Their interest rate should be set by the Bank on the basis of comparable rates in Amman. At a later stage, when the bonds become negotiable, a local market in them is to be encouraged and the yields established on that market will be the basis of the bank's rate.

CHAPTER 6

1. We recommend the establishment of two distinct

lending programmes: a small business programme and a project finance programme. The small business programme should account for the largest proportion of the Bank's lending, at least in its early years.

2. Interest rates on loans in both types of programme should be related to borrowing rates by the Bank setting an interest rate spread which yields a positive net profit.

3. Repayment periods in the small business programme should be short. It should be designed to offer borrowers a succession of small, short-term loans.

4. Conventional forms of collateral will not provide adequate security for loans in the small business programme. We recommend that the Bank should use as collateral a lien on the equipment that the loan finances.

5. The Bank should stimulate co-financing and managed funds in special packages.

6. Because even that form of collateral is inadequate the security of the Bank's lending should be founded on monitoring and advising the borrower on its operations. The structures for this are outlined in the next chapter.

CHAPTER 7

1. Business Development Associations should be organised. Enterprises should only be eligible to borrow if they belong to such a BDA. The BDA is a mutual organisation with the function of providing technical, financial and business advice to enterprises; appraising loan applications and monitored earnings.

2. The BDA, therefore, improves the quality of the bank's assets and reduces the risk of default.

3. Bank loan officers based in the field should initiate and participate in BDAs. They should assist in administering PTAs and in giving professional support to their advisory and monitoring functions.

4. The bank's headquarters should be in a major

commercial centre of the Occupied Territories, such as Ramallah.

5. The Board of Directors should include non-executive directors nominated by outside bodies. It should be served by the Managing Director. Under the Managing Director there should be four headquarters' departments headed, respectively, by the Secretary, Chief Loan Officer, Treasurer and Chief Accountant. Under the Chief Loan Officers will be loan officers based outside of headquarters.

6. Annual administrative costs should not normally exceed 2.5 per cent of liabilities minus retained earnings.

CHAPTER 8

1. On plausible assumptions an Industrial Development Bank will be both financially viable and contribute to industrial development.

2. The bank's financial viability and contribution are sensitive to economic and political developments.

3. Steps for establishing an Industrial Development Bank are proposed.

CHAPTER 9

1. The background legal environment is outlined.

2. The methods of incorporation are summarised.

3. Guidelines for a bank's Articles of Association are presented.

CHAPTER 2

INDUSTRY AND INDUSTRIAL STRATEGY IN THE OCCUPIED TERRITORIES

In this chapter we outline the character and problems of industry in the Occupied Territories and an industrial strategy for its development. The analysis is based upon the United Nations Industrial Development Organisation (UNIDO) Report, Survey of the Manufacturing Industry in the West Bank and Gaza Strip (UNIDO/IO.584/29 June 1984). That survey was conducted in 1983.

In Section 2.1 we outline the industrial position. Industry in the West Bank and Gaza is weak, organised principally on the basis of small workshops, and using antiquated and inefficient machinery and production methods. In interviews conducted in 1987 that finding of the 1983 survey was re-confirmed; the chairman of one Chamber of Industry and Commerce stated:

> "Machinery in most of the industrial establishments in the Occupied Territories is very old and fully depreciated, and it needs replacement and renewal to benefit from new technology. We are about to perish."

In Section 2.2 we outline an industrial development strategy.

2.1 Industry In The Occupied Territories

The main findings of the UNIDO Survey of Manufacturing Industry were these.

There are 4,006 industrial firms in the Occupied Territories of the West Bank and the Gaza Strip: 2,991 in the West Bank, 1,015 in the Gaza Strip.

13% of these firms are engaged in garage and minor repairs, smithing, and simple metal manufacture including furniture, 11% in quarrying, cement block and floor tile manufacturing, 13% carpentry and joinery, 20.5% sewing and garment manufacturing, 2% shoemaking, leather and plastic goods, 40.5% other miscellaneous products.

The majority of new firms are financed by owner capital. This is both symptom and cause of the small size of firms. Those operating at low levels of capacity have no stimulus to expand, while those few which may have such stimulus find the high rate of interest charged by Israeli banks, and the lack of alternative sources of funds, severe impediments. The continual devaluation of the Israeli currency is an added factor which creates severe uncertainty.

The small size of the industrial sector is illustrated by the fact that although of the 12,917 were found to be employed in the sector, 98% of the firms employ ten or less.

Of a current labour force of around 218,100, the numbers estimated to be employed in Israel are 74,000. This confirms previous studies where about one-third of the labour force has been estimated to be employed.

Although their wage levels are lower than their Israeli counterparts, the wages paid often are higher than possible earnings in the small owner organised manufacturing firms in the Occupied Territories . Under conditions of low capitalisation and below capacity operation of these firms, this has a further adverse effect on prospects for expansion.

Both the productive sectors and markets of the Occupied Territories have become subservient to the economy of Israel. By 1981, 90% of the Occupied Territories' imports came from Israel, and consisted predominantly of industrial products, while Israel absorbed 72% of their exports. The constant adverse conditions of industrial activity in the Occupied Territories compared with conditions in Israel have been weakening the production base to such an extent that few firms in the Occupied Territories can now compete even in their own markets, so that industrial activity is now being confined almost exclusively to the handicraft and repair types of activity, and those capable of being conducted at a low technological level.

The whole picture is one of small workshops, providing for local markets, and in general spread throughout the country. Much of what is classified as "industry" is more akin to the small-scale activities associated with agriculture and the small towns and villages characteristic of agricultural communities rather than to an industrial sector in which many specialised firms cater for a whole economy. Only one or two exceptions are evident from the aggregate figures. "Cigarette manufacture" in East Jerusalem, one or two larger units in "paper and printing" in Bireh and Ramallah, and in "soap and detergents" and "chemicals" generally. None of these plants can be said to be of a stature sufficient to form a basis for development of the type and form necessary for a modern economy. By contrast, a large number of examples of the smallness of units exist. In the "food and drinks" activities these are almost without exception units such as bakeries and similar establishments catering for a local population. A possible exception is in "soft drinks" in the Gaza Strip, where one or two larger units increase the average size somewhat. But, it is in textiles, wood and furniture, and shoes that the large number of small units show so vividly. The "shoes" category rely almost exclusively on small outwork activities rather than any large scale manufacture, and the "furniture" similarly rely on demand from local markets. But the "textile and knitting" group contains many units taking in out- work from Israeli factories and finishing them for return and marketing by Israeli factory owners and agents. This is a classic example of the use of a fragmented industry by entrepreneurs; (a) to keep down labour costs, as only piecework payments are made and the wage/output ratio is guaranteed; (b) to minimise capital outlay, as much of the cost falls on the worker; (c) to escape labour and other regulations, notably on safety and working conditions, as the responsibility is transferred to the worker or small-scale employer; it is not the responsibility of the Israeli agent or contractor.

Data for 1985 shows 16,000 employed in industry in the West Bank and Gaza. Another 11,000 are employed in construction. These figures compare with 24,400 in agriculture and 48,200 in other sectors (incl. commerce). They confirm the weakness of industrial employment in a society where agriculture and trade predominate. As was found in the 1983 survey, employment in industry in the Occupied Territories' is overshadowed by employment of Palestinian Arabs in Israel. Compared with the 16,000 employed in local industry, 18,000 Arabs from the West Bank and Gaza were employed in Israeli industry in 1985 (and 47,600 were employed in the Israeli construction sector).

These characteristics of the industrial sector have to be seen in the context of the structure of the Occupied Territories' economies as a whole.

An overview is provided by the United Nations

Conference on Trade and Development Report, <u>The Palestinian Financial Sector Under Israeli Occupation</u> (UNCTAD/ST/SEU/3; 1987). The main points are summarised in the following paragraphs.

The 20 years of occupation have resulted in significant structural changes in the economy of the territories. As noted earlier, the traditional sector has gradually given way to areas within the efficient modern sector, which generally enjoys higher rates of productivity. The agricultural sector has lost its predominant role in terms of its contribution to total output and employment, largely in favour of services which have gradually emerged as areas closely linked to the Israeli economy. The industrial sector has virtually stagnated under occupation, despite its subcontracting arrangements with Israeli enterprises. In fact, the composition and pattern of output of the commodity-producing sectors themselves have slowly undergone changes largely geared to meeting the requirements of the Israeli market. Developments in these and other sectors indicate an increasing alignment of the economic performance of the territories with the economic interests of Israel rather than the creation of structures for an independent and self-sustaining economy.

After a period of relative growth, the domestic contribution to gross national product (GNP) fell steadily during the period 1978-1984 (see Table 2.2 page 21). Developments during this period reflect a pattern of structural change which brought about a rapid decline in the relative share of the traditional sector - an approach witnessed in many developing economies during their initial period of economic transformation. The share of agriculture in gross domestic product (GDP) fell by more than 12 per cent in real terms over the period 1978-1984.

However, the structural changes have not brought about increased capacity within the modern commodity-producing sectors for the establishment of a more durable base for the sustained growth and development of the economy. The share of the industrial sector in domestic output stagnated over a period of 7 years. In fact, for much of the period this share too declined from its low level of 9 per cent to a mere 7 per cent of domestic output, only to rise again in 1984 to the initial level of 9 per cent registered in 1978. It has hardly shown any increase since 1972. Despite modest increases in the services sector, the overall share of domestic output in gross national product declined to a low level of less than 65 per cent in 1984.

The GDP of the West Bank rose by only 1 per cent in 1984 and 1985. The gradual deterioration of the economy during the period reflects the absence of sound planning or programming with appropriate policy measures based on a coherent economic policy for the development of the territories. On the contrary, indigenous efforts and proposals aimed at enhancing economic activities and contributing to development have been stifled on security, political and economic grounds as and when such efforts and proposals were considered to undermine Israel's security and create economically based Palestinian power centres and were potentially competitive with Israeli production.

Around 36 per cent of national disposable income in 1984 was generated outside the territories, mostly in the form of remittances of factor income consisting mainly of wages of Palestinian workers in Israel and the rest of the world, and partly as transfers from various private and official sources. The net effect of these has been a sizeable increase in private income and consumption, as well as in transfers (as taxes, social security payments and others) to Israel. Similarly, private consumption expenditures have increased by an average annual rate of 3 per cent. Since 1978, private consumption has exceeded GDP, with margins varying from 3 to 18 per cent during the period, with an adverse effect on prices and the balance of trade.

It is the flow of external resources (i.e. factor income and transfers) that has made the high level of consumption possible and, at the same time, provided for a certain level of savings. However, lack of appropriate financial institutions and investment opportunities has prevented the mobilization of residual income and its allocation into productive areas. Hoarding, conspicuous consumption and placing of savings in safer and reliable currencies and accounts abroad have provided the main outlet for the use of such income in the territories. This is a feature that the economy of the territories cannot afford to sustain, given the 20 years of neglect and the unstable economic situation. Every effort is needed to encourage the mobilization of these resources and facilitate their allocation to productive areas with a view to creating the basis for sustained economic growth and development.

The growing domestic resource gap in the economy of the territories has increasingly been met from external flows. As indicated above, total disposable private income from all sources has increased at a rate much higher than the rise in gross national product. This rising trend does not seem to have been equally reflected in the level of personal savings. Private savings have amounted to around one-fifth of gross disposable income for much of the period. This is partly due to higher propensities to consume, a deterioration in the balance of trade, lack of financial markets, anomalies in the structure of interest rates, and increasing inflationary pressure coupled with frequent depreciation of the Israeli currency. While domestic savings depict a negative trend, national savings amounted to an annual average of 28.3 per cent of GDP during the period 1980-1984. Although this is entirely attributed to net factor income and net current transfers from abroad, it is significant, bearing in mind that the territories have no institutional means of mobilizing and/or augmenting the meagre resources of individuals. This is a reasonable performance when seen against the figure of 23.3 per cent of GDP for total savings in all developing countries and 21.9 per cent for middle-income countries. It is also higher than that of the industrial market economies.

To a large extent, the level of total savings has been influenced by the strong impact of external forces and the structural changes in the economy of the territories. More importantly, it can be attributed to the initiative of the private sector and to its saving effort under very difficult circumstances. It should be noted, however, that the stagnating level of domestic sources of income would not have made such a level of consumption and savings possible were it not for the inflow of resources from abroad.

In principle, the investment requirements of the economy should be met from the savings of three sectors, i.e. government, business, and household. The first source is virtually non-existent in the territories. The economy has therefore been deprived of a source of finance which is usually called upon to render the basic public services to citizens and to undertake capital expenditures aimed at providing the economic and social infrastructures necessary for the successful launching of productive projects in agriculture, industry, construction and elsewhere. Similarly, the corporate source of savings is negligible due to the undeveloped state of this category of business institutions in the territories. It is largely the third source of domestic savings on which the economy of the territories has relied upon during the 20 years of occupation.

As for investments, the household sector has also played an important role, despite various obstacles brought about by occupation, especially the non-existence of a financial structure with an adequate banking system to encourage and guide savings and investments in the economy. However, total private investments have lagged behind private savings throughout the period under review, reflecting poor financial intermediation, as well as a high degree of political and economic uncertainty and risks. Despite these unfavorable factors, the private sector's share in total gross domestic capital formation has reached over 80 per cent.

Total gross domestic capital formation amounted to an annual average of 31.3 per cent of GDP over the period 1980-1983. Although this is totally attributed to external flows, it compares favourably to the figure of 23.8 per cent for all developing countries and the figure of 21.1 per cent for industrial market economies. The share of the private sector in total gross capital formation amounted to an annual average of 85 per cent during the period 1978-1984.The balance comprises the Israeli Government's small share, which is generally intended for infrastructural work mostly related to Israeli settlements in the territories.

As a result, physical and human infrastructure and government services for the inhabitants of the territories have remained very limited over the occupation period. Similarly, municipal services have been constrained due to the mounting budgetary difficulties. External assistance is increasingly being sought to provide some of the public services needed in such vital areas as health, water, education, electricity, road and others. There has been no government involvement in the productive sectors. In fact, official policy, or lack of it, has consistently acted against productive projects, even if these have involved local resources and entrepreneurs. Heavy investment is badly needed to provide an adequate infrastructure and to create a productive base for a self-sustaining economy in the territories.

For the most part, private investment has been concerned with building and construction works. Expenditure on residential buildings has absorbed more than four-fifths of private investment. This building has been primarily intended to meet the growing need for housing to hedge against inflation, which reached over 445 per cent in 1984, and to establish a presence on land primarily aimed at thwarting Israeli land expropriation practices. In addition, discouragement and obstacles acting against investment in productive projects in agriculture and industry have led potential investors to move into speculative dealings involving movable and immovable property and a range of other commercial

Table 2.1

General consumer price index

	West Bank	Gaza Strip	Israel	Remarks
1970	..	..	106.1	Base 1969 = 100
1971	125.9	128.1	118.8	" "
1972	148.1	153.1	134.1	" "
1973	179.9	190.3	160.9	" "
1974	256.5	294.3	224.8	" "
1975	367.4	452.7	313.1	" "
1976	114.9	113.2	411.2	Base for occupied territories is Jan. 1976 = 100. Base for Israel 1976 = 100.
1977	156.3	151.5	134.6	
1978	235.1	216.4	202.7	
1979	395.3	373.0	361.4	
1980	946.2	954.7	834.9	Base for Israel 1980 = 100
1981	2,025.2	2,000.5	216.8	
1982	4,199.5	4,294.0.	477.7	
1983	10,069.0	10,784.6	1,173.5	
1984	46,384.2	51,006.8	5,560.4	

Sources : Figures derived from Israel, Central Bureau of Statistics, Statistical Abstract of Israel 1975 (Jerusalem, CBS, 1975), p. 694; Israel, Central Bureau of Statistics, Statistical Abstract of Israel 1978 (Jerusalem, CBS, 1978), p. 774 ; and Israel, Central Bureau of Statistics, Statistical Abstract of Israel 1985 (Jerusalem, CBS, 1985), pp. 714 and 265.

activities.

The increasingly close economic links with Israel have rendered the territories highly susceptible to Israeli price movements and high rates of inflation. (see table 2.1 cn page 13)

Much of the inflationary pressure in the territories is attributed to the close economic links established with Israel. This pressure has been felt primarily through the prices of increased imports of goods from Israel, which have amounted to almost 90 per cent of all goods imported, the wages of Palestinian workers in Israel and the declining value of the Israeli currency, which also serves as the legal tender in the territories. It is equally due to the declining capacity of the domestic economy and its inability to meet the rising level of demand generated through increased income from abroad in the form of factor income and transfers. Other domestic factors such as the size of credit, government outlays and the extent of their deficit financing are not likely to have played any significant role in contributing to inflation.

The impact of inflation on the life of ordinary citizens, civic institutions and business enterprises in the occupied territories has been overwhelming, particularly since 1974 and the devaluation of Israeli currency in that year. Prior to 1974, inflation was associated with high rates of growth in real income and output, thus benefiting those who participated in their generation. The most important visible subsequent outcome of this phenomenon was the sharp and often erratic depreciation of the Israeli currency, especially when measured against the Jordanian dinar, which is the second legal tender in the West Bank. For instance, the market exchange value of the Israeli shekel dropped from Jordanian fils 1000.0 per shekel in 1971 to 1.2 fils per shekel in 1984.

The severe and noticeably erratic deterioration in the exchange value of Israeli currency has made economic planning and business activity in the territories extremely difficult and unusually risky. An overriding objective for all businessmen has been the preservation of the real value of their sales and goods in stock. One immediate measure they took for this purpose was to curtail their credit facilities to customers almost to zero, or else convert the unpaid value of goods to Jordanian dinars at the prevailing exchange rate - a measure which often proved unfair to buyers. At any rate, the deterioration in the level of prices during the period 1975-1984 was extremely hard on consumers, as it subjected them to harsh inconsistencies in the pricing system. On the other hand, it also increased the risk margin for sellers and eventually drove some out of business.

The collapse of sale credit facilities, during the inflationary period 1976-1985, was especially serious in certain farming sectors, where producers were used to procuring their farming inputs from major suppliers on the basis of loans which they usually settled after the sale of their produce. Coming at a time when the farmers had practically no alternative source of seasonal credit, the collapse of "in-kind" credit arrangements was particularly difficult to sustain.

The pronounced and continuously increasing differential in the consumer price indices of the territories and Israel has lead to a fall in the value of sales to Israeli buyers of output from local markets in the territories. In fact, it is now frequently reported that an increasing number of residents in the West Bank and Gaza Strip prefer to buy some of their consumer and durable goods from neighbouring Israeli towns, as prices there do not appear to be as high. This dual impact on demand in local markets has been an important factor in precipitating the current stagnation in economic activity in the territories.

The rising rate of inflation, especially since 1980, gradually resulted in a decline in the real disposable income of most income groups and was accompanied by a widening gap between the monetary income of families and the cost of maintaining their standards of living at the levels prevailing during mid-1970s. The grinding impact of this situation has been particularly hard on workers paid in Israeli currency, which includes all workers in Israel (close to 40 per cent of the employed labour force) and those working for the Israeli Civil Administration (around 10 per cent). The impact of inflation on the purchasing power of this category of income earners can be judged from the fact that the Jordanian dinar value of the Israeli shekel salary of a new college graduate (say, working as a teacher in a government school) dropped from JD 105 in 1976 to JD 65 in early 1985. Likewise, the value in Jordanian dinar terms of wages paid to unskilled Palestinian labourers employed in Israel has dropped from around JD 5 per day in the early 1970s to JD 3 per day in the 1980s.

These high rates of inflation have no doubt affected the economic status of the middle and low-income groups especially and caused a sharp drop in the standard of living of the professionally privileged income group (e.g. a medical doctor working for the

Government receives around $300-400 a month). The standard of living for most income groups would have dropped to very low levels had it not been for the effective role played by remittances earned abroad. However, the compensatory role of remittances is expected to be greatly undermined in the wake of the severe economic recession in the Gulf States and Jordan because of its grave ramifications for the employment potential and wage levels of emigrant Palestinian workers. Should all these adverse factors continue to bear on the occupied territories, it is certain that poverty and unemployment will undergo a dramatic surge over the next few years.

An important aspect of the territories' economy is its longstanding international trade links. Historically, the West Bank has supplied neighbouring Arab countries with certain commodities and manufactured goods, especially olives, olive oil, building stone and soap, which had a stable market abroad. Similarly, the Gaza Strip developed well-established market for its citrus fruits in a number of East European countries (inheriting some of those established by the pre-1948 Palestinian Arab citrus industry) and more recently in the Arab world. As with other developing economies, chances for the growth of the economy have always depended upon opportunities for expanding international trade relations. This is especially so in view of the relatively small local market and the difficulties in producing competitively many of the capital goods required for development or the consumer goods demanded by a population increasingly influenced by regional consumption patterns.

There are three ways in which the Israeli occupation of the West Bank and Gaza Strip influences the territories' trade. First, and most significantly, is the effect of occupation itself in creating factors which alter the established patterns and practices of trade and over which the Palestinian economy has little or no power. These include most prominently the physical barriers imposed by occupation between the territories and their hinterland, the sectoral developments which have occurred as a direct result of the domination of the territories' economy by the much more advanced Israeli economy, and the boycott policies adopted by Arab countries to prevent the import of Palestinian exports containing any measure of Israeli produced or imported raw materials. Secondly, Israel has developed a policy with regard to trade with the territories which has resulted in a number of measures having a negative impact on their trading position. Finally, there are various trading procedures and practices which also adversely affect the ability to trade competitively.

The major consideration influencing Israeli policy towards trade with the territories is that Israeli exports should be able to flow freely there while imports to Israel should be closely controlled to safeguard the interests of Israeli producers. This is a deliberate and calculated policy decision, established early in the occupation period and scrupulously applied since. The existing patterns of trade between Israel and the territories reflect this consideration, and official statements confirm this orientation. In announcing new policy guidelines for export procedures to Israel, a government official affirmed that Palestinian products "threaten Israeli firms with unfair competition". Meanwhile, Israeli policy allows the free flow of Israeli agricultural and industrial goods to the territories, disregarding the effects on Palestinian producers.

A number of specific measures have been enacted since 1967. To begin with, some of the territories' most lucrative cash crops (cucumbers, tomatoes, eggplant, melons, etc.) which could compete with Israeli produce are generally banned from Israeli markets, or, if allowed to enter, they are only imported in small and controlled quantities, thus protecting Israeli producers of these commodities. Additionally, exports of Palestinian agricultural output, notably the Gaza Strip's citrus fruit, to Western Europe and other markets secured for Israeli produce is prohibited and penalties are imposed for contravention of this order to prevent 'the threat of competition' from Palestinian manufactures. A Military Order enforces complex labelling guidelines for all Palestinian products (specifying manufacturer, contents, weight, etc.), adding further costs to an already burdened manufacturing process.

Furthermore, most Israeli links with the territories' industrial exports are geared to taking advantage of the labour-intensive stages of the production process, for example in textiles and clothing and certain wood and metal products associated with the construction sector. These are most profitably subcontracted to the labour-surplus Palestinian economy for export to Israel in partially or fully finished form. Little or no control is exerted over the quality and quantity of goods entering the territories to safeguard the interests of local production capacity.

In 1985, the occupied territories exported $283 million of industrial and agricultural goods to Israel, Jordan and the rest of the world. The trend in exports has declined in recent years, after having peaked at

$403 million in 1981. The trend in imports has been similar. After having reached the highest level of $785 million in 1983, imports fell to $668 million. External trade has exhibited a deficit which grew at an average annual rate of 14 per cent between 1978 and 1985; in 1985, it stood at some $100 million more than the total value of exports in that year. The deficit with Israel in 1985 was even larger and has been growing constantly since 1967. It is only the trade surplus with Jordan that helps to lessen the burden in trade relations with Israel. However, that surplus has recently shown incipient signs of a downward trend, falling to $75 million in 1985.

The direction and composition of trade are highly concentrated. Some two thirds of exports are destined for Israel, while most of the rest go to or through Jordan and only a small proportion to other countries. Industrial exports account for an increasing share of total Palestinian exports, reaching a record 77 per cent in 1984. Since 1978, between 79 and 88 per cent of exports to Israel have consisted of industrial goods. This growing percentage indicates domination by the Israeli market of the territories' export capacities. This is partially offset by industrial exports to Jordan and agricultural exports to/through Jordan. These, however, have recently accounted for a declining proportion of the territories' exports. On the whole, while the territories do not supply a significant part of Israel's imports (around 3 per cent of Israeli non-military imports), their own trade relations are increasingly influenced by Israel. An average of 16 per cent of Israeli exports are destined for the territories, making the Palestinian economy the second largest Israeli (non-military) export market after the United States. Despite the recent slump in Palestinian trade and economic activity, there remains a substantial movement of goods and services between the territories and neighbouring economies which continues to require a flexible and effective system for financing and regulating the transactions involved.

Crucial to the economy of the territories is the relationship between weak local productive capacity and the high proportion of national income generated from sources outside the territories. The phenomenon of migrant labour providing a substantial part of national income through remittances is not uncommon, internationally or regionally, nor is it necessarily a negative one; if carefully channelled, it can be a growth-inducing source of income in a labour-surplus economy struggling to develop its indigenous potential. Since the beginning of the Israeli occupation of the West Bank and Gaza Strip, labour force development there has undergone a number of significant transformations, in terms of size, location of work and sectoral composition.

Perhaps the most noticeable effect of occupation has been the inability of the local economy to absorb its own labour force, leading to the phenomenon of migration abroad or to work in Israel. Consequently, the size of the locally employed labour force remained stagnant over fifteen years. An important feature of the territories' labour force in the past few years has been its increasing rate of growth, outstripping that of population. Between 1983 and 1985, while population grew by an average annual rate of 2.9 per cent, the labour force grew by 3.3 per cent, so that an average of 7,000 new jobs are now required each year (assuming full employment). The difference between growth in population and labour force has been manifested by an increase in the crude participation rate. A main factor contributing to this development is a decrease in labour migration to Arab countries.

Associated with an overall recessionary climate, it is not surprising that this growing labour force found it increasingly difficult to obtain employment. The rate of unemployment in the territories had by 1985 risen to 3.7 per cent, with an average unemployed figure of 9,200 for the year. In the fourth quarter of 1985, the first signs of an improvement were witnessed, with the most significant fall in the number of unemployed Palestinians since the preceding decade. At the heart of this unemployment situation lies the fall in work opportunities for Palestinian workers in Israel and in the Arab countries, as these workers tend to face dismissal in periods of economic crisis in both markets. The nature of the local economy, which is dependent upon external demand for its output and labour, is such that there are few local alternatives.

Apart from employment opportunities elsewhere, there exist two markets for Palestinian labour, i.e. in the territories themselves and inside Israel. The main sectoral trend in the territories' resident labour force, which has greatly influenced labour developments in other sectors, has been the sharp decline in the proportion (and numbers) employed in agriculture. While employment in other local sectors grew steadily into the 1980s, its growth in industry was directly linked to subcontracting for Israeli industry. By 1985, 25 per cent of resident Palestinian labour was in agriculture, 16 per cent in industry, 11 per cent in construction, and over 48 per cent in other sectors (mostly in public services and commerce).

Since 1967, an increasing proportion of the Palestinian labour force has been drawn into work in Israel. In 1970, the 21,000 Palestinians working in Israel constituted only 12 per cent of the labour force. The number and proportion peaked in 1984, with 90,300 Palestinians working in Israel, constituting some 37 per cent of the total Palestinian work force. By 1985, the figure had dropped to 89,200, though this still represented just under 37 per cent of the total. Israeli demand for Palestinian labour exhibits trends somewhat similar to those in the local labour market. The share of Palestinian labour employed in Israeli agriculture fell from 24 per cent of the territories' labour force employed in Israel in 1970 to 16 per cent in 1985. Employment of Palestinians from the territories in Israeli industry rose in the 1970s only to fall to 18 per cent by 1985. Construction activity in Israel has always been the main employer of labour from the territories. The share of the migrant labour force in this sector fell from its high of 54 per cent early in the 1970s to 48 per cent in 1985, another reflection of the Israeli recession.

While the migration process is a necessary response to deteriorating economic conditions in the occupied territories, it has had an important role in maintaining subsistence. This is achieved by channeling part of factor income into the local economy and providing resources for the continued operation of some farms which might otherwise not be able to survive under prevailing circumstances. The process of 'labour export', while originally a side-effect of the operation of constraints upon the Palestinian economy, has increasingly become a crucial element in sustaining and influencing it. The role that this process has played in the generation of financial resources for the weakened Palestinian economy is of a significance that cannot be underestimated.

TABLE 22

Industrial origin of the gross domestic product of the West Bank and Gaza Strip at factor cost (constant 1980 prices) 1978-1984

(Millions of Israeli shekels and percentages)

Year a/	Agriculture	%	Industry	%	Construction	%	Public Serv.	%	Transp./trade	%	GDP Total	% b/	GNP	GDP as % of GNP
1978	1,505	32	410	9	813	17	744	16	1,273	26	4,745	100	.. c/	..
1979	1,116	24	405	9	921	20	705	15	1,544	32	4,691	100	..	..
1980	1,763	32	407	8	846	16	697	13	1,717	31	5,425	100	..	..
1981	1,494	30	364	7	850	17	711	14	1,567	32	4,986	100	..	..
1982	1,665	31	398	7	891	17	722	13	1,714	32	5,390	100	..	..
1983	1,491	29	414	8	893	17	740	14	1,619	32	5,157	100	..	..
1984	1,488	28	471	9	859	16	773	14	1,760	33	5,351	100	..	..

Source : calculated from Israel, Central Bureau of Statistics, Judea, Samaria and Gaza Area Statistics (Jerusalem, CBS, 1985), vol. XV, Nos. 1 and 2, tables 6 and 13, pp. 168 and 175, and 72 and 79, respectively.

a/ Sources used for calculating aggregates in constant prices (i.e. Israel, Central Bureau of Statistics, Judea, Samaria and Gaza Area Statistics (Jerusalem, CBS, 1985), vol. XV, No. 2 have revised previously published estimates on which aggregates in current prices are based (i.e. Israel, Central Bureau of Statistics, Judea, Samaria and Gaza Area Statistics (Jerusalem, CBS, 1986), vol. XV, No. 1. Accordingly, the base year figures in this table and in table 4 for the two sets of aggregates do not correspond with each other.

b/ Decimal percentage points are rounded up to the nearest figure.

c/ Two dots (..) denote that figures are not available.

2.2 Industrial Development Strategy

The successful industrial development of the Occupied Territories has been severely hampered by the policies of the occupying authorities and it continues to be. Five aspects of these policies have been especially damaging:

1. Restriction of access to markets and raw materials

2. Licensing restrictions

3. Land policies. By 1984 Israel had expropriated about 42 per cent of the West Bank's land area and 204 Israeli settlements were built. In addition the use of water resources by Palestinians were restricted. These policies directly harmed Arab agriculture, but they and the demographic shifts they induced also damaged industrial development.

4. Absence of a legitimate and effective state authority committed to economic development.

5. Absence of a financial system with financial intermediation to mobilise savings and channel them into industrial capital (as reflected in the fact that almost all industrial establishments in the Occupied Territories are financed by their owners).

Nevertheless, despite these constraints, the UNIDO Survey of Manufacturing Industry did propose an industrial development strategy with some prospect of success. A summary of its industrial development strategy is as follows:

"The Industrial Strategy"

31. We stress the need to define the aims of industrialisation in social as well as economic terms so that the criteria for assessing the efficiency of a strategy may be established and may later be used to monitor the efficiency of its performance.

We have defined these as the need to:-

(a) Increase incomes per capita

(b) Provide returning exiles with employment

(c) Integrate returning exiles with those already resident, and to avoid enclaves development, by which the Industrial sector separates from the rest of the Palestinian society.

(d) Create an equitable balance in regional development, especially between the West Bank and Gaza Strip.

(e) Provide for an adequate period of reconstruction during which those returning to Palestine may do so, in which the economy may establish itself as independent from that of Israel, and by the end of which it will have established conditions for self-sustained growth.

We recommend that early attention be paid to:-

(a) The development of the small-scale workshops, with an overseeing organisation to handle advice, marketing and finance in order to consolidate and expand an existing base.

(b) A concentrated development of agriculture to provide new products for agri-industry as well as to upgrade existing outputs.

(c) The development of an agri-industry (pacing, canning, fruit drying, oil and fruit extraction, and freezing) based on a sound and pre-formulated marketing strategy.

(d) The development of tourism;

(e) Quarrying, stone cutting and marble polishing;

(f) The development of assembly-type industries, concentrating where possible on maximising value added when consistent with the employment objective;

(g) Specialists in small-scale development requiring high skills to provide employment for surplus highly qualified labour.

We would see (d) (e) and (f) as especially suitable for attracting outside private investment, and stress the need for public investment in infrastructure and organisations to make investment by outsiders attractive".

A full discussion of that industrial development strategy is given in Chapter 9 of the UNIDO Survey of Manufacturing Industry, UNIDO/IO.584/29, 1984.

For the purpose of this study, a survey of business leaders' opinions in the West Bank was conducted regarding the existing and potential industries that could most benefit from increased industrial finance. The priorities expressed conformed to those of the UNIDO 1984 Report's industrial strategy which gave priority to strengthening workshop development and agriculture-based industries. The business leaders' responses gave priority to the strengthening of food industries; followed by shoe and leather industries; textile industries; cement; glass; agricultural tools and blacksmiths; carpentry; quarrying; olive-oil products including soap; fruit and vegetable canning and juice production; plastics and pharmaceuticals.

CHAPTER 3

EXISTING FINANCIAL INSTITUTIONS

AND FINANCING OF INDUSTRY

The weak position of Arab industry in the Occupied Territories described in Chapter 2 is associated with the absence of an adequate financial system to channel savings into productive investment in industry. In this chapter we show that the financial system in the Occupied Territories is well developed and highly sophisticated in some respects, but there is no adequate system of financial intermediation. An Industrial Development Bank would be a major innovation, able to channel funds to industry in circumstances where almost no other financial intermediaries exist to supply medium and long-term industrial finance.

The character and limitations of the Occupied Territories' financial system are determined by the political and administrative measures taken by the occupying power.

By a series of military orders, the Israeli authorities have attempted to destroy the pre-1967 financial system in the West Bank and to subordinate financial arrangements to their control. This has been effected through a series of Military Orders specifically relating to finances which, like the Military Orders in other matters, have amended Jordanian law in the territory. A similar policy has been followed in Gaza and in East Jerusalem, although the different circumstances of Gaza have led to significant differences from the West Bank's financial system, and the annexation of East Jerusalem has meant that the financial system is subordinate to Israel banking legislation rather than to Military Orders. We shall describe the position on the West Bank first.

In 1967 the occupying authorities closed all 31 branches in the West Bank of the 7 Jordanian commercial banks operating there and their assets were confiscated (Military Orders 7, 9, 21, 33). They also amended the applicability of Jordanian banking law and replaced the authority of Jordan's central bank with Israeli (Military Order 45). The power to grant a licence to operate a bank, supervision of its activities and the enforcement of Israeli banking regulations, was placed under the control of the Bank of Israel's Examiner of Banks.

The Israeli's established the Israeli currency as legal tender in the West Bank while also retaining the Jordanian Dinar as legal tender (Military Orders 76, 83, 872). Around this currency area the authorities imposed an extensive system of controls and regulations over foreign exchange and gold which replaced the foreign exchange controls previously applied by Jordan (Military Order 299).

In addition to taking control of the currency, closing the banks and taking power to control new banks, the authorities took powers over the financial institutions, especially post office banking, insurance companies and co-operative societies (Military Orders 93, 94, 295).

Order 1180 amends Jordan's Banks Law in a comprehensive manner and now has far-reaching effects. Its implications are examined in Chapter 9.

Under these laws, the authorities have permitted the establishment of branches of Israeli banks in the West Bank. They did not permit the reopening of the branches of Amman-based banks until 1986, when the Nablus branch of the Cairo-Amman bank was re-opened and permission given in principle for other branches to reopen.

Even before 1986 the occupying authorities did permit financial institutions and agents other than commercial banks to operate with varying degrees of formal or informal approval. The most important of these are the money changers. Part of their transactions (exchanging Shekels for J. Dinars in the West Bank) are formally approved, but their other financial operations which are extensive are formally prohibited and they are carried out only with the de facto tolerance of the authorities. This tolerance of money changers' foreign exchange transactions in other currencies, their arrangements for transferring deposits and financing trade, serves the authorities' purpose mainly bacause the money changers' unofficial market in foreign currencies gives some flexibility to the Israeli financial system itself. At different times, depending on the tightness of the Israeli foreign exchange regulations on Israeli residents and banks and on the strength of the I. Shekel, this black market enables the most pressing Israeli residents to obtain scarce foreign exchange, it provides a route for the flow of hard currencies from Arab countries into the West Bank and thereby to some extent into the Israeli economy. By establishing an active free-market rate between the I. Shekel and the US Dollar, it provides an important monetary indicator for monetary policy in Israel and, during the period of hyperinflation, an indicator for the US Dollar as the unit of account. At the same time as deriving benefits from the existence of the free market operated by the money changers in the Occupied Territories, the Israelis benefit from keeping it formally illegal so that the occupying authorities are able to take action against money changers at will.

Other West Bank institutions permitted by the Israeli authorities which in practice have some financial functions include an Arab-owned insurance company and agricultural marketing co-operatives.

In East Jerusalem the main difference in the Israeli laws and policies governing the financial system is that since the city was annexed by Israel, the laws and policies are in principle those which apply within the post 1948 boundaries of Israel. Thus the Bank of Israel and Ministry of Finance are directly responsible for financial activity instead of the Military and Civil Administrations of the West Bank. And the legal framework is provided by Israel's banking laws [mainly Bank of Israel Law 1954, Banking (Licensing) Law 1981, Banking Ordinance 1941, Banking (Service to Customer) Law 1981, and the Ordinance Regarding Contingent Liabilities].

Nevertheless, in practice the system in East Jerusalem is almost identical with the West Bank partly because of the absence of a border and partly because Israeli law is modified by a policy of allowing any practice which existed before 1967 to be continued after annexation. Thus, for example, money-changers established before annexation are permitted to continue to operate. Within the legal framework applying to Jerusalem an Arab financial institution was granted a licence in 1985 with the intention of operating as a non-profit shareholder company, the Arab Development and Credit Company.

In Gaza the main difference from the West Bank in the financial system's legal framework is that the I Shekel is the only legal tender although Egyptian currency circulated before the occupation. .Under the occupying authorities' regulations an Arab bank, the Bank of Palestine Ltd. does operate. Its operations are confined to accounts and transactions in I Shekels.

The occupation's effects on the framework within which money and finance operate are considerably wider than the direct regulations and policies mentioned here.

The absence of an effective legal system over civil claims (since, although a right to arbitration could be used in contracts, police powers would not execute the resulting decisions) the encroachments on land and property rights through land appropriations and through the use of house demolitions and sealings as arbitrary punishments, the licensing controls over all forms of economic activity, and the uncertainly generated by the absence of a political solution have all shaped the monetary and financial system.

In the remainder of this chapter we describe the occupied territories' financial system in more detail by examining each part:

- Arab Moneychangers
- Branches of Israeli banks in the Occupied Territories
- Permitted Arab banks and financial institutions.

In describing this system we make a distinction between monetary activities and financial intermediation. The former involves dealing in money - foreign exchange dealing, transfer of funds, clearing of cheques etc. - whereas the latter refers to borrowing and lending. The two may overlap in practice but remain distinct in principle. In this chapter the institutions concerned with giving grants are not described except to the extent that grant finance overlaps with credit and financial intermediation.

3.1 Moneychangers

Moneychangers operate in every town in the Occupied Territories with, in most cases, a shop front, kiosk, or counter which carries out the most obvious part of their work, the exchanging of one currency for another. All engage in foreign exchange dealing at this level, but the most important fact is that many have also developed a wide range of banking functions. They have operated as embryonic banks insofar as they take deposit, transfer funds, clear bills and cheques and give loans. In the West Bank alone there are more than 400 moneychangers' offices. About half of these are registered in Chambers of Commerce - a rough estimate of their total capital is JD 1.5 million.

There are, however, different types of money changers. They differ according to whether they are located in the West Bank, Jerusalem or Gaza; whether they are established before 1967 or subsequently; and whether they concentrate wholly on financial transactions or combine these with commodity dealing. Those which have in effect developed into embryo banks are the largest; they were established before 1967, are based in the West Bank or Jerusalem, and generally hold only financial assets rather than non-monetary commodities.

To analyse their significance, We examine each aspect of their business in turn.

TABLE 3.1

Distribution of Registered Changers' Offices in the West Bank*

Location	No. of Moneychangers	Capital**
Jerusalem	30	
Ramella & Bireh	40	
Hebron	27	
Tulkarim	7	
Genin	13	
Bethleham	26	
Nablus	65	
Jericho	4	
Total:	213	J.D.1.5 million

Source: Survey & records of chambers of commerce in the West Bank.

* Since moneychanging is not permitted in Gaza, moneychangers are not registered in the chamber of commerce.

** This estimate of capital is based on information from several different sources since it was difficult to get information from chambers of commerce or from moneychangers. It is a very approximate estimate.

3.1.1 Currency Exchange

Exchanging one currency for another is the foundation of the Moneychangers' business. It has flourished particularly because of the existence of a dual currency system in the W. Bank (Dinars and Shekels) and of a similar system in Gaza (Shekels and the Egyptian pound). Their money changing activities are, however, wider than the exchanges involved in these dual currency systems for they disregard all exchange controls and are therefore able to buy and sell foreign exchange to Israeli citizens, residents of the Occupied Territories, and others, all of whom have been formally constrained by Israeli or Jordanian exchange regulations to varying degrees at different times since 1967. A further reason for the moneychangers' strength as foreign exchange dealers is that the high rates of inflation in Israel during the early 1980s gave rise to a situation where the shekel price of the US dollar in the moneychangers' free market generally diverged significantly from the official rate and thereby attracted much foreign exchange business to them.

As far as pure currency exchange is concerned, moneychangers deal principally in cash with some business, especially in tourist areas, in travellers' cheques. But because this business is linked with their wider banking role, currency exchange also involves receiving and disbursing debits (cheques and drafts) on the bank accounts of customers and moneychangers in Amman. The most substantial part of currency exchange is illegal in terms of the occupying territories' law. Authorized moneychangers in the West Bank are permitted to buy and sell the two currencies which are legal tender there, the Israeli Shekel and the Jordanian Dinar but transactions in US Dollars, which are a major element, are illegal as are transactions in other currencies. In Gaza, even the exchange of shekels for dinars is illegal for moneychangers. In East Jerusalem where Israeli foreign exchange regulations are considered to apply to the annexed city, unlike the West Bank, the money-changers' situation is similar to the West Bank regarding the ability to deal in J.Dinars because of a commitment at annexation to permit the continuation of pre 1967 activities.

In fact, however, the illegal currency dealing of the moneychangers is not normally prevented by the occupying authorities. But they do use the position of tolerated illegality to take action against moneychangers either on an arbitrary basis or in connection with Israel's macro-economic policy. Examples of the former in recent years include the temporary arrest in Nablus of the W.Bank's largest moneychanger, and the confiscation of U.S. Dollars from time to time. An example of the latter was the temporary closure of the open transactions in dollars of Jerusalem moneychangers when Israel tightened its monetary policy and foreign exchange restrictions in 1985 (although examples exist of transactions continuing through clandestine arrangements at that time).

Moneychangers determine their own exchange rates taking into account local market conditions and current and expected conditions in the foreign exchange markets of Europe and elsewhere. The current exchange rates on the world's foreign exchange markets provide the benchmark for the moneychangers' daily rates but the latter diverge from them in response to two forces: expected changes in the world's market rates and the current balance of demand and supply for individual currencies in the local market. The system by which large moneychangers set prices in line with these three is as follows. The day's exchange rate for spot transactions on international foreign exchange markets is obtained. Because, under occupation, it is impossible for moneychangers (in the West Bank at least) to obtain telex facilities or high technology links to market information services they obtain the rate from other sources, in particular the world radio services such as the BBC. The rates at which they buy and sell are then set at a premium (or discount) in relation to the international market's rates to anticipate expected changes in the latter over the next one or two days, for that is the length of time it usually takes the large money changer to transfer surplus funds to (or deficits from) the international centres. Finally, the premium (or discount) is adjusted in response to any large imbalances in the local demand and supply for currencies at those international rates. A common method by which moneychangers take expectations and local conditions into account is to adjust their prices in the same direction as international market prices with a lag after a change in the latter.

In setting exchange rates the large moneychangers determine their own spreads as well as premiums; their relation between their spreads and international markets' spreads is determined by similar factors to the above. Exchange rates for particular currencies, for example, between the Israeli Shekel and the Jordanian Dinar, are determined as cross rates in relation to their individual exchange rates vis a vis the US Dollar. All exchange transactions are conducted without documentation or record keeping and, in contrast with foreign exchange purchases made by Israeli bank customers, without taxation.

Exchange rates are determined in this way by a small number of large moneychangers. It appears that smaller moneychangers follow their rates.

3.1.2 Money Transfers

The transfer of funds between the Occupied Territories, Amman, and foreign countries is integrally linked with the moneychangers' currency exchange and has been so since before the Israeli occupation.

The largest moneychangers have branches in the Occupied Territories, Amman and the Gulf. (Moneychangers permitted by the Jordan authorities to operate in Amman are in two categories: those which are permitted to have foreign bank accounts, and those which, without such permission, can only deal in bank notes). In addition, they have a network of correspondents and agents which extends at least to the international financial centres in Europe and the USA. These branches, correspondents and agents are the channel for moneychangers' money transfers. The transfers they make between centres outside the Occupied Territories (from the Gulf to Amman, or from Amman to Europe for example) are carried out through normal banking mechanisms debiting and crediting the moneychangers' accounts with banks there. But net transfers between Amman and the Occupied Territories take place by carrying or smuggling cash over the bridges, the crossing points into and out of the Occupied Territories. In general, there is a net flow into the Occupied Territories from Amman because they have a balance of trade surplus with Jordan. It is estimated that US$170 million crossed the bridges into the West Bank in the 5 months from March 1985.

Carrying or smuggling cash between the OTs and Amman is the only way in which the moneychangers can carry out net transfers between those places, for the occupation itself has broken the formal channels. Between 1967 and 1986 it closed all the branches of Jordanian banks formerly operating in the OTs, there are no relations between Jordan and the Israeli banks in the OTs, and Israeli foreign exchange controls and controls on the amounts of cash that can be carried across the bridges (controls that are tightened and relaxed at different times) give currency smuggling its role as the main means of transferring net balances between Amman and the Occupied Territories.

Only net balances give rise to cash movements between Amman and the Occupied Territories;

moneychangers in the Occupied Territories receive both debits and credits on Amman and only have to move cash to the extent that these are unbalanced. Thus, for example, a person in the West Bank wanting to transfer money from Amman will obtain the cash from the moneychanger in return for a cheque on his or her bank account in Amman. The commission charged for this is between 0.5% and 1% of the cheque's value. If another person deposits an equivalent amount of cash with the moneychanger for transfer to his or her account in Amman no cash need cross the border. In that example the transactions may be closed by the moneychanger paying the first person's cheque into his account in Amman and (by unwritten agreement with the second person) instructing his Amman branch to pay a cheque from his Amman account to the second person's Amman account. Alternatively, the moneychanger may simply give the second person the first person's cheque (originally drawn in favour of the moneychanger). In that case, if the standing of the person who drew the cheque is high enough, the cheque is sometimes passed on again in settlement of another transaction and, to a limited extent, therefore circulates as money.

Transfers between the Occupied Territories and Amman are an important feature of the Occupied Territories' monetary systems since Amman is in effect, the local banking centre for the OTs. But to a large extent the transfers effected by the moneychangers are over a much wider area and Amman is a staging post. Much money transfer inflows from the Gulf to elsewhere to Amman, or to the OTs via Amman, as Palestine workers employed in the Gulf and elsewhere send their earnings as remittances to their accounts in Amman or to their homes. Similarly, moneychangers handle the significant outflow of funds from families in the OTs to children studying abroad. And moneychangers carry out many of the transfers that arise from the Occupied Territories' imports and exports.

The moneychangers' role in transferring funds depends on the existence of a high degree of trust and confidence. Agreements are oral and undocumented and, in any case, would not be legally enforceable; an individual who gives the moneychanger cash for transfer to his or her bank account or to a third party can only do so on the basis of trust, and equally the moneychanger accepts cheques in settlement on the basis of trust. This requirement limits the moneychangers' ability to expand or match the breadth that banks have in economies with similar levels of development but different political frameworks.

3.1.3 Deposits and Loans

The moneychangers' money transfer activities give rise to financial intermediation which, is very limited and partial, but similar to the financial intermediation banks carry out. That is, the large moneychangers take deposits (borrow) and lend.

In its most basic form moneychangers acquire the use of borrowed funds simply as a result of the time lag necessarily involved in transferring funds from one centre to another. Thus, when a person in the West Bank pays cash to a moneychanger for it to be transferred to the person's bank account in Amman, the moneychanger has the use of that money, interest free, for the time that it takes for instructions to be given to the moneychanger's Amman office and the payments made from the office's bank account into the person's bank account.

But moneychangers also attract deposits more actively, paying interest on deposits in JDs and foreign currencies with them (although some depositors place funds with moneychangers without requiring interest). In the third quarter of 1985 the interest paid on short-term JD deposits was between 15 and 18 per cent p.a. For short-term deposits in foreign currencies large moneychangers pay interest rates above the short-term interest rates on credits in those currencies on international markets; in the third quarter of 1985 they paid 2 per cent or 3 per cent per annum more than the international rates.

These high deposit rates are determined by competition for funds between different moneychangers and banks. They would not be sustainable if the borrowed funds were used for lending in the organised international markets. In fact, however, they are used for two forms of more profitable business: providing funds for the activity of money changing and money transfer itself, and lending within the occupied territories themselves. Moneychanging and money transfer yields profits in the form of commission (which is between 1 per cent and 1.5 per cent on large transactions in notes) and spreads. Lending yields profits in the form of interest.

Moneychangers lend short term at rates of up to 3 per cent per month to merchants and small businesses. The loan arrangements vary but none are based on formal documentation. One type of arrangement is for a moneychanger to lend money to a merchant secured only by a post-dated cheque on Amman (dated 30 days later, for example), but that small degree of documentation is the maximum. Moneychangers' lending is mainly confined to thirty-day loans, but some loans for several months are given with repayment being by instalment.

3.1.4 Evaluation of Moneychangers

Since the occupying forces in 1967 closed Arab banks in the West Bank and Gaza, moneychangers have carried out many of the functions of banks. The largest moneychangers, established before 1967, carry out a wide range of banking functions, including currency exchange, and borrowing and lending. Because of the undocumented character of their business and its generally illegal nature in terms of the occupying power's regulations, several functions of banks have not been developed by moneychangers: for example, they do not issue letters of credit or take on contingent liabilities such as guarantees to a significant extent (although there is at least one recent example of a moneychanger being willing to guarantee a client's credit). But currency exchange, money transfer, and borrowing and lending, are simultaneously well developed and subject to severe limits, a combination which justifies moneychangers being seen as 'constrained' or 'embryo' banks.

In currency exchange, the large moneychangers in the Occupied Territories are the market makers and price setters for Israeli Shekels, Jordanian Dinars and US dollars. In money transfer they transfer funds for clients in large and small amounts between the Occupied Territories, Amman, the Gulf States, the US, Europe and other centres. And in relation to these transactions moneychangers also accept deposits and make loans extensively. Nevertheless, the condition of occupation set severe practical limits as well as formal ones to the extent to which moneychangers can develop banking functions. The absence of a legal authority for most moneychangers' operations and the fear of both moneychangers and clients that documented transactions of any kind will be interrupted by the occupying authorities leads to moneychanger's transactions being undocumented and based on oral agreements. That, together with the impossibility of resorting to courts for legal remedies against default, means that their business depends on a high degree of trust and personal knowledge which acts to limit it. Large moneychangers do compete with each other and their exchange rates and interest rates are constrained by this competition; each compete for business throughout the occupied territories (sometimes using the branches of Israeli banks to transfer funds to their own account from clients based in other parts of the Occupied Territories). But, although that competition exists, each moneychangers' business is constructed around a network of clients who know and trust the moneychangers' business honesty. Thus, clan relationships and historical business relationships play an important role in underpinning moneychanger's business and therefore limiting its expansion. These relationships are only unimportant for transactions such as the over-the-counter currency exchange, where little trust is involved, hence small moneychangers with little historical record have been able to proliferate since 1967 by confining themselves mainly to such transactions.

The importance of trust and personal knowledge rather than legally enforceable documentation severely limits the ability of moneychangers, even as embryo banks, to meet the financial needs of Palestinian development. The risk in such transactions gives rise to high risk premia on interest rates which can hinder investment in working capital and fixed capital. And in the Occupied Territories even the relatively high interest rates on deposits with moneychangers have not enabled them to attract the small savings of peasants and others outside of their established network of clan-based or other relationships of trust. Indeed, many ordinary individuals who are not engaged in trade or handling large sums are unwilling even to take the risk of entrusting funds to moneychangers for the transfer of funds. Thus, moneychangers' ability to mobilise domestic savings as an element in economic development is severely limited by the risky environment.

The development of new formal financial institutions such as an Industrial Development Bank will change the environment in which moneychangers work and their functions may change accordingly. It is possible that an Industrial Development Bank may be able to use their expertise in its own operations. Their expertise in foreign exchange may enable the Industrial Development Bank to employ former moneychangers in foreign exchange business to the extent that that business develops. Their knowledge of the local business community may make it appropriate to recruit loan officers from moneychangers. However, there may be several disadvantages in doing so. First, moneychangers are at present self-employed entrepreneurs who, in general, appear to have the opportunity of high profits and it is unlikely that they could be recruited as salaried employees of an Industrial Development Bank. Second, their present style of work is informal and essentially based upon an absence of written contracts or transactions, whereas the Industrial Development Bank would be based upon formal, written and accountable transactions.

3.2 Israeli Banks

After the occupying power closed the branches of Arab banks in the West Bank and Gaza, Israeli banks opened branches in the area. They were authorised by Military Order 255 and the occupying power's actions to press the use of Israeli currency in the area. In 1982

there were 27 such branches. They are not widely used by the Palestinian Arabs, for they would choose only to accumulate bank deposits in Jordanian Dinars (which has been the strongest currency in the Occupied Territories) but are unwilling to bank with Israeli banks partly because of the danger that assets held in Israeli banks may be politically at risk and partly because of the tax charges imposed on the use of such accounts.

In a survey of Arab businesses several economic disadvantages of using the Israeli banks were enumerated. These banks conduct business only in Hebrew and language difficulties create misunderstanding in the interpretation of accounts; to deposit Israeli currency with the banks it has to be arranged in a special and time consuming way; the banks keep transfers with them for a long time before remitting to the beneficiaries; opening letters of credit for Arab importers involves difficult administrative procedures and requires the full amount to be pre-paid in cash; commission rates on letters of guarantee for Arab merchants and contractors reach 2.5%. From the point of view of financial intermediation and the supply of capital to industry, Arab businesses argue that it takes a long time to obtain a loan for, in addition to local bank approval, applications have to be approved by the military authorities and the controller of banks. Moreover, real interest rates are high, especially in periods such as late 1985 and 1986, when inflation fell rapidly but interest rates did not fall commensurately.

The factors cause the Israeli banks in the Occupied Territories to be totally inadequate as suppliers of credit. The branches of Israeli banks do not act as financial intermediaries within the Occupied Territories, in the sense of borrowing savings (accepting deposits) and lending them to businesses and people in the West Bank and Gaza. Thus, in 1984 only 8 per cent of these branches' total assets were loans to the public and these were either to Israelis or short term credit tc Palestinian merchants. Instead of the deposits with these branches being part of a process of financial intermediation within the West Bank and Gaza, the banks act as a channel to invest the funds in Israel itself: in 1984 60 per cent of these branches' assets were deposited by them in accounts in Israel (and the figure was 70 per cent in 1980 to 1982) with a further 8 per cent held in Israeli coins and notes. This policy of using the Israeli bank branches to channel funds to Israel itself reinforces Palestinian Arabs' unwillingness to use them.

So, the Israeli bank branches do not carry out significant financial intermediation within the Occupied Territories, although a significant proportion of their business is with Israelis in the Occupied Territories. Nevertheless, the Israeli bank branches do carry out two functions in the Palestinian economy, although they are judged to do so unsatisfactorily. They transfer funds and clear cheques for Palestinians whose income is paid in I. Shekels such as Palestinians employed by Israelis; and they provide facilities for Palestinian businesses' imports and exports.

3.3 Permitted Arab Financial Institutions

The occupying authorities have permitted three main Palestinian Arab financial institutions to operate: Bank of Palestine Ltd., (Gaza), the Cairo-Amman Bank (West Bank). Moneychangers are also formally approved by the Occupying Powers but since the main part of their activities are not formally approved (and not all moneychangers have approval) they are treated (in Section 3.1) as quite different from permitted Arab institutions.

3.3.1 Bank of Palestine Ltd

The Bank of Palestine is an Arab owned and managed bank in Gaza. It was established in 1960 and began operations on 13 January 1961 with a capital of LE 5000,000. It was closed by the Israeli occupying authorities in 1967 but it obtained permission to reopen for business in 1981. Negotiations to reopen the bank were unsuccessful until then, but finally succeeded after the bank took its case to the Israeli High Court. The court rejected the objections of the occupying authority (which centred on the Bank's use of the name

'Bank of Palestine') and ordered negotiations between the bank, the occupying authorities and the Bank of Israel (represented by the Examiner of Banks).

An agreement was signed in 1981 but since then it has not been implemented in full. Although the Bank of Palestine did reopen as a commercial bank in 1981 the agreement to permit operation of 'normal banking business' was abrogated even before the opening, for the authorities prohibited all foreign exchange business. Thus, all the bank's business is in Israeli Shekels, although customers' loan repayments are indexed to the US Dollar, and Egyptian currency is used as the unit of account for calculating the Bank's annual balance sheet and revenue accounts. Moreover, the agreement permitted the reopening of the Gaza City headquarters and branch with a commitment to future consideration of re-opening the Bank's branches in Khan Yunes and Rafah. In the event, permission has not been given for the branches, although the closure of Bank Leumi in Khan Yunes has left that town without any banking facilities and in that context, in September 1985 some citizens of that town signed a petition demanding permission to reopen the Bank of Palestine branch.

Operating under these restrictions the Bank of Palestine has remained small. Its total assets were LE 4,677,855 at the end of 1984. Its deposits and other customer accounts (LE 3,230,753) were less than three times the Bank's equity in capital and reserves (LE 1,245,760). This is an extremely low ratio of deposits to capital for a commercial bank. For comparison, whereas the Bank of Palestine's ratio of deposits to capital was only 2.56, an accepted ratio in the USA is between 25 and 30. This indicates that by 1984 the Bank of Palestine had not been able to attract deposits to the extent that a commercial ank operating without the restrictions of occupation is able. Another indication of its inability to develop full banking functions is that it has not developed fully as a financial intermediary. In other words, it does not intermediate significantly between lenders and borrowers by lending a high proportion of the deposits placed with it; its outstanding loans in 1984 (LE 1,700,730) were only 36 per cent of its total assets, while its cash holdings were high at 48 per cent of assets (70 per cent of deposits). More fully developed financial intermediation would lead to a proportion of those cash holdings being used for loans; for comparison, the Israeli bank, Bank Hapaolim held only 15.5% of its assets in cash in 1984.

One reason for both the Bank's low level of deposits and its low proportion of loans is the prohibition on business in foreign exchange including Jordanian Dinars. Since the bank reopened, the high rates of inflation and devaluation of the Israeli Shekel have made it costly to hold bank accounts in shekels; since the bank can only take deposits in that currency, deposits with it are unattractive. Similarly, the restriction on foreign exchange business hinders the bank from lending to importers. And the depression of the Gazan economy under occupation restricts other lending opportunities.

The Bank of Palestine lends to industry, agriculture and other borrowers. All its lending is short term with a maximum term of 10 months and repayments by monthly instalment, but the renewal of credit enables borrowers to obtain credit for periods of up to three years. The security taken for loans is three guarantees by persons (third parties) although it may require additional security on loans of over US $50,000. Although the Bank of Israel's Supervisor of Banks advises the Bank of Palestine to take mortgages as security for a wide range of loans, the Bank of Palestine does not generally do so.

The Bank of Palestine gives loans to agriculture at an interest rate of 12 per cent per annum, which is less than half the rate charged by Israeli banks. With the rate of inflation existing until mid-1985, this represented a significantly negative real rate of interest. The Bank of Palestine reasons that loans at 12 per cent are justified since the opportunity cost of these funds is only 8 per cent; the latter is the yield that could be obtained if the funds were placed in deposits at the Bank of Israel instead of being loaned.

The Bank of Palestine regards its agricultural loans as serving the development of Palestinian agriculture in Gaza. Recent examples are loans to finance new agriculture ventures; a nursery and seedling producer (approximately US $10,000); a rabbit farm; and sheep farms. And in 1983 the bank began to lend to citrus growers. Citrus production in Gaza has declined severely. Whereas the output through the Gaza Citrus Growers Union was 250,000 tons in the mid 1970s, it was 168,000 tons in 1980-81 and by 1983-84 it had declined to 146,000 before recovering to 161,000 tons in 1984-85. The decline was due to many factors, especially the obstacles the Israeli occupying power places in the way of exports; one factor is probably the absence of development finance for citrus growers, and the start of the Bank of Palestine's credit programme for citrus growers in 1983 was probably one contributory factor behind the recovery in 1984-85.

To summarise the Bank of Palestine's position, it operates under severe difficulties which prevent it from expanding and make it impossible for it to develop properly either in the sphere of money dealing and money transfer or in financial intermediation (borrowing and lending). The prohibitions on foreign exchange dealing and on opening new branches (or re-opening old ones) have impaired the Bank's development in each of these fields, and the obstacles the Israeli occupation has created for Gazan economic development in general have further hindered it by restricting the economic environment within which the bank works.

In addition the occupying authorities have taken direct actions to hinder the Bank. For example, in July 1985, the Bank of Palestine attempted to increase (triple) its capital by selling 100,000 shares to the public. Although, according to its officials, it had complied with all the legal requirements, the military closed the Bank on the day of public applications for the shares, posted soldiers at...the door and erected notices warning the public not to buy shares. The authorities claimed that legal requirements had not been met, and the action had the clear but unjustified implication that Gazans should not have confidence in the Bank.

3.3.2 Cairo-Amman Bank

After the closure of all Arab banks in the Occupied Territories in 1967 several initiatives were taken to open a new Arab bank or re-open former banks in the West Bank. These initiatives reached a new stage in 1984 and 1985 with pressure from some business leaders under the leadership of the late Mr. Zafir al-Masri of the Nablus Chamber of Commerce. Following a round of discussions and a feasibility study completed by Professor Harris in November 1985, permission was given for the Cairo-Amman Bank to re-open branches in October 1986. The first to re-open was the main Nablus branch but in May 1987 the Bank announced its decision to re-open another three branches (Ramallah, Hebron-Khalil, and Toulkarm). At the time of writing these branches have not yet been opened but staff recruitment has begun.

The Cairo-Amman Bank has not published information on its operations, but it is estimated that it has been successful in attracting deposits. In the first three months of its operation, it is estimated that more than 80,000 accounts were opened with the Bank to a value of more than JD 8 million. However, the Bank has not expanded its lending commensurately and, like the Bank of Palestine it is not expected to make a major, early contribution to the expansion of financial intermediation. Even when lending does expand, the Bank will not be a provider of long-term industrial development capital since it is essentially a commercial Bank.

Some aspects of the Bank's constitution set a marker for the principles new financial institutions may adopt in the circumstances of the Occupied Territories where authority over financial institutions is claimed by both the Central Bank of Jordan and the Bank of Israel. While the Bank of Israel controls deposits in Israeli shekels, the Central Bank of Jordan controls deposits in J. Dinars. The Central Bank of Jordan Law 94 of 1966 is applied with amendments concerning liquidity and guarantees. The bank is not allowed to deal with holders of Israeli nationality. At first this was interpreted to mean that the Arab citizens of Jerusalem (East) which the Israelis annexed could not use the ank, but since May 1987 they have been able to.

3.3.3 Arab Insurance Company

In advanced market economies life insurance (or long-term insurance) and similar institutions (pension funds) are, unlike commercial Banks, a principal source of long-term capital for industry. Insurance companies are active in the Occupied Territories but they are not a significant source of individual finance.

All except one of the insurance companies operating in the Occupied Territories are agencies for foreign companies. Many are agencies for Israeli insurance firms; the al Quds Insurance Agency acts for the Prudential Insurance Company of the UK; and the United Arab Insurance Agency acts for an Italian firm. They are, therefore, notsignificant investors in the Occupied Territories.

The only local company is the Arab Insurance Company founded in Nablus with a share capital of JD500,000 in the mid 1970s. It carries out general insurance business (with a high proportion of automobile insurance) and, like al Quds Insurance Agency, reinsures with Lloyds of London. In addition, it sells life insurance. The Arab Insurance Company does make loans to personal, commercial and industrial borrowers, but it is not a significant source of capital or credit for

Arab Insurance Establishment (Nablus)
Balance Sheet as at the end of the 31.12.1984
(In thousand Shekels)

	Assets		Liabilities
	Fixed Assets		
27994	Furniture, office equip. cars after dep.	782400	(Capital JD 500000)
		123618	Legal Reserve
7793	Building project (under construction)	68628	Other Reserve
35787	Total fixed assets	6058	Non-distributed profits
		980704	Total capital & Retained Earnings
	Investment		**Current Liabilities**
144	Stock at cost	170561	Life branch funds
132	Land at cost	2570951	Allocation for General Insurance Risks
402361	Loans & Financial paper		
402637	Total Investments	108779	Reinsurance Firms Credits
		301427	Provident Fund & Allocation for Tax Income and VAT
	Current Assets		
71789	Cash	156480	Profits to be distributed
3434249	Balances with banks & Time Deposits (In JD & other foreign currencies)		
211612	Accrued banking interest, prepaid expenses		
132828	Agents Debt.		
3850478	Total Current Assets		
4288902	Total Assets	4288902	Total Liabilities

Source: Arab Insurance Establishment Annual Report 1984 Nablus.

industry. As can be seen from the 1984 balance sheet reproduced on p.43 the firm held about 82 per cent of its total assets as liquid assets (Principally cash and bank deposits) and only 1.03 per cent in the form of stocks and loans. Moreover, within this small amount of lending, only a small proportion is lending to industry.

To a large extent the failure of the Arab Insurance Company to devote a significant proportionof its assets to industrial finance reflects the fact that its life insurance business is only a small part of its operation (representing 4 per cent of its liabilities). In other words, its roots lie in the fact that the firm is not well established as a financial intermediary able to mobilize savings.

3.3.4 The Industrial Development Bank of Jordan

The Industrial Development Bank is a specialised Jordanian industrial development bank. It was founded in 1965 and began operations in 1966 with the objective of financing industrial and tourist developments on a long term basis. It also has special credit facilities for small businesses (for which the maximum size of each loan is JD4000 and the interest rate is 6.05 per cent per annum). It does not accept retail deposits.

At the beginning of the Israeli occupation in 1967 the Industrial Bank had approximately JD450,000 of loans outstanding in the West Bank and nearly all that has not been repaid subsequently. In the present circumstances the IB is not willing to lend to West Bank residents as a normal part of its business because of the difficulty of appraising credit applications, monitoring credit use, and recovering debts under the occupation. However, the bank does lend money for West Bank projects, including hotel development, using funds placed with it for this purpose for the Jordanian authorities and allocating the credit in accordance with the authorities' directions. In addition, the Industrial Bank is believed to have received Community loans of 2 million ECUs (European Currency Units) for lending to small scale projects on the West Bank. All loan agreements with West Bank residents are secured by guarantee from persons on the East Bank.

CHAPTER 4

CAPITAL STRUCTURE OF INDUSTRIAL DEVELOPMENT BANK

Existing development banks in other countries have a variety of capital structures. The differences largely reflect differences in national circumstances. In this Chapter we outline the main types of capital structure in use and the considerations pertaining to their relative merits (Section 4.1). In the light of these we then set out our recommendations for the capital structure appropriate to the Industrial Development Bank (Section 4.2).

4.1 Alternative Types of Capital Structure

Existing development banks have four main types of capital structure. Their differences arise mainly from the difference in the role of subordinated loans and other special funds, and in the permitted ratios between capital and debt item. .

4.1.1 'The World Bank Model'

This structure provides a benchmark for it was developed and recommended by the World Bank for the new development banks it helped to found over the past three decades. It can be illustrated for a bank with share capital of 100 monetary units (for example, 100 million US dollars). The 'World Bank Model' capital structure is:

(a)	Share capital	100 units
(b)	30 Year Loan Subordinated to Share Capital and other debts	150 units
(c)	Other Loans (3 times a + b)	750 units
		1000 units

In this model the subordinated loan is given by a national or foreign agency. It both raises leverage and provides stability for the bank's operations and capital structure. Although non-subordinated loans are restricted to three times the borrowing base, this structure enables total debt to be nine times shareholders' capital.Leverage, is therefore, 9:1.

4.1.2 'High Leverage Subordinated Loan Model'

In several development banks a subordinated loan has an important role but it ranks above share capital and is only subordinated to other loans. In this model, the ratio of subordinated loan capital to share capital is higher giving greater overall leverage than in the basic World Bank Model, even though the ratio regulating other loans is the same. The capital structure is:

a.	Share capital	150 units
b.	30 Year Loan Subordinated to other Loans	300 units
c.	Other loans (3 times a+b)	1,200 units
		1,600 units

4.1.3 'Fund Management Model'

For some development banks the capital structure consists of 'share capital' and 'other loans' alone without any long term subordinated loans. The element of stability provided for the bank's operations by subordinated loans in the previous models is provided here by government funds which, instead of being loaned to the bank, are placed under its control to manage. In return for its responsibility for managing those government development funds the bank's profit is boosted by a fixed and secure management fee.

This arrangement does not give the boost to capital leverage that subordinated loans do.

4.1.4 'Low Leverage Model'

Some development banks operate without government- type funds such as long-term subordinated loans or managed funds. As a result their capital structure relates their 'share capital' and 'other loans' alone. The absence of subordinated loans means that the banks' constitutions or regulatory policies set ratios relating 'other loans' to 'share capital' instead of to 'share capital plus subordinated loans' with the result that, in general, the leverage in this model is low as compared to the first two.

4.2 Outline of Capital Structure for an Industrial Development Bank in the Occupied Territories

It is recommended that the Industrial Development Bank should adopt the 'World Bank Model' of capital structure. That is, the ratio of share capital to long-term subordinated loans should be 1 : 1.5. Share capital plus long-term subordinated loans comprise the borrowing base. The bank's borrowing power should limit its other loans to three times this borrowing base of long-term capital.

The arguments in favour of this capital structure are:

(i) In this structure long-term subordinated loans contribute stability to the capital structure while giving shareholders capital leverage to a significant degree.

(ii) This capital structure and the potential sources of funds it permits is particularly appropriate for the circumstances of the Occupied Territories (in addition to its successful implementation in a large number of other countries).The following paragraphs elaborate these arguments.

4.2.1 Role of Subordinated Loans

In the basic 'World Bank Model' subordinated loans are provided at the bank's foundation and consist of a loan from the government of the bank's nation or from foreign governments (in particular the United States) under the aegis of the World Bank. They are subordinated to the bank's equity and to other loans to the bank. They are long-term (30 years being typical) and at concessionary interest rates. These characteristics enable subordinated loans to contribute strongly to the bank's development and growth, specially in its early years. Three aspects of subordinated loans are particularly important:

(a) They provide an early boost to the bank's profits. They are a substantial block of funds that can be loaned immediately in addition to the funds provided by the owners' equity. Since they bear concessionary interest rates their contribution to profit is high, for the banks' shareholders receive the profit on the investment they make with these funds, after administrative costs, and after deducting the low interest cost of these funds.

(b) They increase leverage without increasing shareholders' risk. Since they are fixed interest loans they give increased leverage to the shareholders' capital (even if the interest rate is not concessionary). This leverage enables shares to obtain a higher yield than otherwise. It can be obtained through funding the bank with any type of fixed interest loans but if they are not subordinated loans they increase the shareholders' risk. If the bank's profits on its investments suffer, its obligation to pay interest at the fixed rate to its creditors remain and, in extreme cases, can reduce net profits to the point where the bank has to be liquidated. If loans are not subordinated, the shareholders' capital then has the lowest claim on the bank's assets, but in the case of a subordinated loan that creditor (the national or foreign governments) has the lowest claim and the shareholders' capital is relatively secure.

(c) Because this debt is long term and subordinated to shareholders' capital it can act as a 'high-powered' element on the liability side of the balance sheet in the same way as shareholders' capital. In other words, it is treated as part of the borrowing base against which the other borrowing is balanced; a limit on these other loans of three times this base (equity plus subordinated loans) is applied. On the one hand this is a relatively prudent limit. On the other hand, since it is able to be measured with respect to the total borrowing base (equity plus subordinated loans), it is consistent with total borrowing and lending operations being a high multiple of equity alone. As shown in Section 4.1.1, applying the factor three to the borrowing base to arrive at the borrowing limit permits total borrowing to be nine times the equity base itself. (In the example, b + c = 9a). Thus, because subordinated loans are included in the borrowing base a relatively small shareholders' capital can be the basis of a relatively large expansion of liabilities and, hence, of the bank's investments (assets).

To summarise the role of subordinated loans in the World Bank Model, they effectively act as an injection of cheap long term development finance into the economy by governments but they differ from other governmental methods of financing development because they also strengthen the effectiveness of private shareholders' capital in the development banks. By comparison, if governments directly fund development project themselves, each $1 of government funding finances $1 of development spending. Alternatively, if governments place development funds with a development bank for it to manage (the Fund Management Model, see Section 4.1.3 above) it remains the case that $1 of public funds finances $1 of development spending, but these funds strengthen the development bank by generating a management fee income for it. However, when government development funds are placed as a subordinated loan in a bank it both directly finances the bank's investment in projects <u>and</u> indirectly generates further development financing by strengthening the bank's borrowing base and enabling it to have an effective 9:1 leverage ratio on its equity. These characteristics lead us to recommend this capital structure for the Industrial Development Bank.

4.2.2 Application to the Occupied Territories

The conditions under which the Occupied Territories are administered create difficulties for the establishment of a development bank. In principle the greatest difficulty is that there is no effective state authority with recognised legitimacy and a commitment to the territories' economic development. At the same time, there are considerable private financial resources, but these are not mobilised for development. The 'World Bank Model' is able to overcome these problems better than other development bank capital structures because of the roles of private shareholders' capital and of subordinated loans in it. Together they mean that the bank does not need to have the support of a national government and that the mobilisation of private capital is enhanced. Each of the three elements in the capital structure bears upon its appropriateness.

First, under the World Bank Model the development bank is privately owned. Therefore the absence of an effective recognised state authority does not prevent the bank's establishment as it would if the development bank could only be conceived as a state agency. In addition, the shareholder's capital is itself private finance which is mobilised for development investment through the bank. The bank, therefore, provides a channel and framework for the mobilisation of private capital into productive investment and begins to rectify the relative absence of such channels in the Occupied Territories. The share capital should be subscribed by named residents of the Occupied Territories.

Second, subordinated loans, which increase the power of that mobilised private capital, do not depend on the existence of an effective recognised state authority in the Occupied Territories. In the 'World Bank Model' these loans can be subscribed from foreign sources. Because the World Bank Model has been used in several instances where foreign states subscribe subordinated loans it is appropriate for the Occupied Territories in a way which the 'Managed Funds' Model where the bank manages the development funds of the local state is not.

The third main financing element in the 'World Bank Model' balance sheet is other loans or, senior (non-subordinated) debt. These will consist in part of private funds invested by residents of the Occupied Territories and partly of loans from public development agencies. In the conditions of the Occupied Territories both such private and public sources of credit are appropriate but each has different characteristics. Private funds should be accepted on a wholesale basis, for fixed terms, at competitive commercial rates. The appropriate instruments for mobilising these private savings (deposits, certificates, etc.) are described in Chapter 5 below. Public funds should be subscribed on concessionary terms or on non-concessionary terms at the low rates determined by those agencies' capital market power and status.

In this section it has been argued that the World Bank Model does provide sound principles for the Industrial Development Bank. Nevertheless, although such a capital structure overcomes some of the capital problems arising from the occupation of the Occupied

Territories, the occupation creates more far reaching difficulties for the establishment of a bank. For example, the legal system and its administration by the occupying power can be expected to hinder both the initial establishment of a bank and its effective operation as a source of development finance and an initiator of enterprise.

4.2.3 Growth and Evolution of Capital Structure

The preceding sections have outlined and recommended the World Bank Model for the initial capital structure of the Industrial Development Bank. But as the bank's operations grow and the maturity of its debt liabilities changes the bank's capital structure will change. From the start the bank will need to have a policy regarding the evolution of its capital structure. In particular, policies are needed with regard to (a) Dividends and retained earnings (b) changes in leverage ratios.

(a) Dividends and Retained Earnings Reserves

The bank's policy on distributing dividends to its shareholders directly influences its ability to build up reserves of retained earnings for a given level of profits and a given capital structure, the higher are dividend payments the lower will be the rate of growth of retained earning. There are no fixed rules for deciding the dividend rate and the rate of growth of retained earnings instead the appropriate policy depends on circumstances. For the circumstances of the Occupied Territories it is recommended that the bank should pay a low rate of dividends and have a high rate of accumulation of retained earnings. Two circumstances, in particular, argue in favour of this policy: first, the absence of a developed capital market;and second, the importance of growth in the bank's capital base.

The absence of a developed capital market in the Occupied Territories causes the main reason against low dividend payments to be irrelevant. The main argument for substantial dividend payments is that the bank's shareholders should receive its net profits in a form which allows them to re-invest the funds wherever they choose. If profits are accumulated as retained earnings it means, by contrast, that shareholders are automatically re-investing profits in the same development bank even if its profitability is lower than alternative investments. This general argument for high dividend payouts assumes that the greatest impact of development investment is achieved if shareholders are free to invest their money in the most profitable of the range of alternative investments. In the Occupied Territories, however, this argument for high dividend payouts is not valid since the absence of a capital market (or, more generally, of well developed financial intermediation) means that no adequate channels exist to enable shareholders to reinvest their profits elsewhere. Indeed, to assist development, these circumstances necessitate a low dividend rate, for the absence of a capital market and financial intermediation mean that if they do not choose to reinvest in the development bank the shareholders are not likely to reinvest distributed profits in the Occupied Territories' economic development. Indeed (apart from consumption out of dividends or investing in housing) they will invest in foreign capital markets or foreign bank accounts.

Accumulation of retained earnings reserves strengthens growth in the bank's capital base. This growth is important for any development bank because it enables the bank either to expand its total operations without increasing its leverage ratio, or to maintain the same level of operations with a reduced leverage ratio. In the latter case, the strengthened capital base acts to reduce the risks borne by shareholders and subordinated creditors. For this reason, development banks' subordinated creditors may require a guarantee that a certain proportion of profits will be accumulated as retained earnings. In the Occupied Territories that aspect is of great importance since their economic and political circumstances greatly increase the bank's operational risks. Therefore, this is the second reason for recommending a low rate of dividend distribution and a high rate of accumulation of retained earnings reserves.

This paragraph now illustrates the argument made in the previous one: that growth in the bank's capital base enables the bank either to expand with unchanged leverage or to reduce leverage (or achieve a mix of both). If share capital is subdivided into initial paid-up capital and retained earnings reserves, after a period of operation when retained earnings of 50 units have been accumulated but no subordinated debt has matured and no other loans have charged the bank with a 'World Bank Model', capital structure would have liabilities of:

(a)	Share capital:	
	(i) Initial paid-up	100 units
	(ii) Retained earnings	50 units
(b)	30 Year Loan Subordinated to Share Capital and to other loans	150 units
(c)	Other Loans	750 units
		1050 units

If the standard borrowing limit of c=3 x (a+b) is applied the bank will be under-borrowed and can increase its other loans to 900, thereby increasing its total balance sheet to 1200. In that way its operations will have grown on an expanded capital base with an unchanged borrowing limit applied to its borrowing base (defined to include the whole of (a) plus (b) in the borrowing base). On the other hand, if the borrowing base is calculated only as shareholders' initial paid-up capital plus subordinated loans (a(i)+b) the growth of retained earnings reserves reduces the leverage ratio, for then the accumulation of 50 units of retained earnings would lead to no expansion of borrowing and the ratio of share capital to total debt would decline from 1:9 to 1:6 without a decline in the size of the balance sheet (in fact, with some expansion of it).

From the point of view of risk reduction, the accumulation of retained earnings reserves has different implications for different parties. For shareholders these reserves reduce risk only if they are accompanied by a reduction in the leverage ratio. For subordinated creditors, on the other hand, retained earnings always reduce their risk. In the event of the bank collapsing, senior creditors have a prior claim on assets, shareholders have a prior claim up to the value of their initial paid-up capital, while retained earnings are the principal source of funds for reimbursement of subordinated creditors in the event of liquidation.

In conclusion, because in the Occupied Territories there is no capital market and the bank's need for growth in its capital base is enhanced, we recommend that the bank distribute a low proportion of its profits and accumulate retained earnings at a high rate. We recommend that dividend payments should be no higher than 25 per cent of profits.

(b) Changes in Leverage Ratios

The preceding paragraphs have indicated that the accumulation of retained earnings affects the bank's leverage ratio in a way which depends on the base chosen for the calculation of the borrowing limit. In addition, as the bank matures other forces, particularly debt redemption, will affect the leverage ratio and will require a policy decision to counteract them or not. As the bank matures two forces, the accumulation of retained earnings reserves, and the retirements of subordinated debt combine to reduce the 'true' leverage ratio. This will require a policy decision to change the borrowing limit to achieve the desired leverage ratio. It is unlikely that the desired ratio will be the one generated by the accumulation of retained earnings and retirement of subordinated debt. The safest decision will be to restore it to the initial ratio of the 'World Bank Model' (1:9), but there may be grounds for increasing it above that since the successful operation of the bank will have lowered the estimated riskiness of the economic environment in which it operates in the Occupied Territories.

The following example illustrates how the accumulation of retained earnings and the retirement of debt causes the decline of leverage. Column A shows the position at the initiation of the bank (assuming it is able to borrow up to its limit). Column 8 shows the fully borrowed position after a period when retained earnings of 50 units have been accumulated (it is the position discussed above in 2.2.3a when retained earnings reserves are included in the borrowing base). Column C shows the position in a subsequent period when more retained earnings have been accumulated and a position (half) of the long-term subordinated debt has been repaid. As can be seen the combined effect of these forces is to lower the leverage ratio. Our recommendation is for reviews of the capital structure every five years to alter or confirm existing ratio requirements.

Evolution of Capital Structure

	A	B	C
(a) Share capital:			
(b) Initial paid up	100	100	100
(c) Retained earnings	0	50	100
(d) Total share capital	100	150	200
(e) Subordinated Loan	150	150	75
(f) Total borrowing base (d+e)	250	300	275
(g) Other loans (3 x f)	750	900	825
(h) Total capital	1000	1200	1100
Leverage ratio ([g+f]/d)	9:1	7:1	4.5:1

(Note: In this table's example of the evolution of the capital structure it is assumed that subordinated loans are not all of fixed long-term maturity. It is also assumed that shareholders are content that retained earnings are maintained as a high level of reserves instead of being capitalised through the issue of new shares).

CHAPTER 5

THE MOBILIZATION OF LOCAL SAVINGS

The previous chapter has outlined the capital structure of the Industrial Development Bank. Although the capital structure is not to be considered as static and will require periodic review it will not be the subject of daily operations. By contrast the bank's mobilisation of savings, its lending and loan monitoring, and its general administration will be. In this chapter we examine operational policies with respect to savings mobilisation while in subsequent chapters we consider lending and administrative operations.

The mobilisation of savings by the Industrial Development Bank will have two distinct elements: the channelling of foreign investment funds into the Occupied Territories, and the mobilisation of local savings. In Section 5.1 we discuss the general principles of the operation to mobilise local savings and in Section 5.2 we discuss the financial instruments and the interest rates used in this mobilisation.

5.1 Principles of Mobilising Local Savings

It is recommended that 'Other Loans' in the bank's balance sheet should include local, private funds. They should be actively sought and accepted as wholesale funds, for fixed terms, at competitive commercial interest rates. The rationale for each of these characteristics is as follows.

The bank should only accept wholesale funds in minimum units equivalent to US $15,000. (In the next section we outline the relative advantages of deposits, negotiable certificates and other instruments for these funds.) This recommendation precludes a banking operation designed to attract small savings through special schemes or branch banking. One reason for it is that wholesale banking incurs lower administrative costs. The costs of administering special schemes or of maintaining a system of branches are avoided; and the most important administrative saving arises from the economies of scale that arise because the transaction costs in receiving and disbursing sums are almost constant, irrespective of the size of the sums.

Another reason for concentrating on wholesale funds is that the potential risk of a new development bank in the Occupied Territories and the difficulty investors will have in estimating the risk make its liabilities unsuitable for the portfolios of small savers.

Local savings should be attracted through fixed term instruments, the varieties of which are explained below. This recommendation is to ensure that the administrative costs of handling unpredictable or partial withdrawals are avoided. It also ensures that financial planning and the bank's investment strategy can be developed on a long-term, stable basis.

These local savings should be attracted at competitive commercial interest rates. Sometimes banks are able to obtain funds at lower explicit interest rates than other borrowers because depositors receive other services (such as access to the payments system), because of favorable tax treatment, or because of barriers to competition in credit markets. None of these will apply in the case of the Industrial Development Bank. At first sight, it may appear that barriers to competition in the credit markets of the Occupied Territories make competitive interest rates inapplicable, but, in fact, there is considerable competition for residents' savings, especially in wholesale amounts. Residents of the Occupied Territories place large sums of savings with banks in Amman or, ultimately, in the international credit and capital markets of Europe and the US, although this is prohibited by Military Orders 952, 973, and 998. Access to these investment channels is facilitated by the extensive moneychanger system, and credit market information is available on a reasonably comprehensive basis. Therefore, although imperfections in the credit market make it difficult for industry in the Occupied Territories to borrow at competitive rates of interest, they do not prevent residents placing their savings abroad at competitive rates. As a result, the Industrial Development Bank should offer savers interest rates in line with those competitive rates in order to attract the funds it needs to carry out its function of mobilizing savings. The Industrial Development Bank will issue savings instruments in the context of the existing channels operated by moneychangers.

5.2 Instruments and Interest Rates

The type of financial instruments the development bank issues to savers is closely linked to the question of how the interest rate paid for these funds is determined. Three types of instrument can be considered: (1) ordinary savings deposits; (2) negotiable certificates of deposit; (3) bonds. We review each of these and recommend the bank initially issues bonds but may issue the other types of instruments after the bank is established and has achieved a successful operational record.

The simplest instrument for mobilising wholesale savings is the fixed term, non-negotiable deposit, paying a fixed interest rate determined by the bank. Such deposits can be made available with a range of maturities from 3 months to 3 years. Similarly, a range of interest payment arrangements can be offered (including, for example, automatic compounding with withdrawal of interest at maturity; three-monthly encashable vouchers; or other arrangements). If such deposits are offered to savers, the appropriate mix of maturities and interest arrangements cannot be rigidly fixed in advance, for it will depend both on the demand for particular types of deposits and, from the supply side, the mix which contributes to the bank's profit maximising and risk reduction goals (for example, even if there is a high demand for very short-term deposits the bank may choose not to accept them in order to avoid a dangerous imbalance between 'borrowing short' and 'lending long'.)

However, such fixed-term, non-negotiable deposits have several disadvantages for both savers and the bank. For savers, the main disadvantage is the illiquidity of being 'locked in' to a fixed term deposit. This problem can be overcome if large depositors hold a mix of deposits of different maturities but the provision of such a mixture imposes costs on the bank (as well as bringing it benefits). The administrative costs of creating and maintaining a mixture of different types of deposits are high, especially in the bank's early years when economies of scale are minimal. Finally, in administering the interest rate, the bank faces great difficulties in choosing an appropriate level. As argued in this Chapter, it should be the competitive interest rate but the bank does not know what that rate is: it will not generally be the same as the interest paid in Amman or international markets which are alternative attractions for savings, for a deposit in the bank offers the saver different combinations of risk and non-interest advantages from those attached to other investments.

Negotiable certificates of deposit are an alternative instrument for mobilising wholesale savings. They are preferable to simple, non-negotiable deposits because they overcome the disadvantage relating to interest determination and savers' illiquidity. Being negotiable, savers can buy and sell such certificates and thereby achieve liquidity whatever the term of these certificates. And, since they can be traded at a discount or premium, their yield can vary even though the interest rate (coupon rate) is fixed. This last quality means that their yield is determined by market forces and the interest rate the bank sets in issuing new certificates of deposit can be varied from time to time in order to keep in line with their market yield.

If the Industrial Development Bank does issue negotiable certificates of deposit the benefits they have over ordinary deposits will only materialise if there is an active market in them. The existing unofficial money market institutions of the Occupied Territories, based on moneychangers' activities, cannot be relied on to operate such a primary market, since their transactions are based on informality and they are relatively unstable. It may be necessary for the bank itself to establish a market by setting up a separate department. This department would act as a money maker, buying and selling the bank's certificates on its own account and for clients. Because of its responsibility for market making, this department would have no responsibility for the issue of new certificates of deposit. This independent market-making department would eventually form the basis of a capital market dealing in a wider range of instruments.

Bonds issued through offers for sale which are underwritten are a third form of instrument. Their issue and registration involves the bank in fewer administrative difficulties than ordinary savings, deposits or negotiable certificates of deposit. Underwriting the issue of bonds ensures stability in the process of fund-raising and assures the bank of the ability to raise funds even in its early days, when its liabilities bear a high level of risk. We recommend that underwriting be carried out by Amman-based financial institutions (or other foreign banks) for a commercially calculated underwriting fee.

Bonds are issued at fixed interest rates and price designed to reflect market yields. We would recommend, however, that in the early years of the bank they have limited transferability and are designed to be held to maturity by the initial purchasers. This would avoid the difficulty of having to create and administer a market ab initio. Over time, as the financial experience of the bank and perception of its liabilities matures, these bonds can develop into fully negotiable instruments traded on a local market.

The issue of bonds which, in the early years at least, have limited transferability, leaves unsettled the question of how the bank can determine the interest rate (or yield) it pays, for it means that no comparable local market rate exists. The solution is to base its rate on the equivalent bond rate in the Amman market since that is the dominant competitor for funds. Moreover, if bond issues are to be underwritten by Amman institutions, their yield must be competitive with borrowers based in Amman, its risk-return characteristics are not identified with theirs, so although the yield it pays should relate to Amman yields it should not be identical.

CHAPTER 6

FINANCE FOR INDUSTRY

The Industrial Development Bank's mobilisation of savings and its acceptance of foreign capital expand the liabilities side of its balance sheet and its assets grow concomitantly. Some of these assets should be held as liquid reserves; we recommend that 10 per cent should be held in the liquid, marketable bonds of foreign governments. The remainder should be used to finance industrial development and renewal and should consist of the debt of industrial borrowers.

In this chapter we outline the character of the lending programme; lending interest rates; the repayment periods; and collateral.

6.1 Financing Programmes

There are significant differences between the financial needs of different types of industrial enterprise. To meet these diverse needs the Bank will have to exercise different skills and methods of operation in different cases. In order to achieve this it should operate distinct programmes of financing. We recommend two programmes should be operated:

- small business programme
- project finance programme

The small business programme should be the biggest element in the bank's finance for industry, and it should be the most intensively staffed. Because of the high proportion of funds to be devoted to it, and its intensive staffing, the small business programme will be the most important of the bank's industrial financing programme, at least in the early years. This conforms with the industrial strategy proposed in the UNIDO 1984 report (summarised above in Chapter 2) under which industrial development is to take small businesses as its base. We give detailed recommendations for the small business programme in this Chapter and Chapter 7.

The project finance programme is intended to finance large investment projects. Under this programme, packages of long-term credit will be made available. A typical operation under this programme may be, for example, a ten to twenty year loan to finance a new cement factory and associated infrastructure with a five year period of grace on amortisation payments.

The project finance programme will be an extremely important part of the Industrial Development Bank's operations, although the total size of this program will be lower than that of the small business programme. Its significance stems from the fact, identified in Chapter 2, that the industrial sector is presently characterised by small workshop production instead of large plants, and industrial infrastructure is at a low level.

The UNIDO Survey did not identify major large scale investment projects within its industrial strategy, and at an early stage in the process of establishing an Industrial Development Bank it would be necessary to carry out a comprehensive exercise to this end. It is expected that major cement and chemicals plants would be sound projects together with agro-industrial food processing and packaging complexes.

The bank's responsibility for project financing would be both technical and financial. Its technical role will be to carry out detailed project appraisal and to monitor the development and operation of the project. Financially, the bank's function will be to arrange 'soft' loans as project financing from foreign governments. The finance will enter the bank's balance sheet as a liability under 'Other Debt'.

6.2 Interest Rates

The basic principle to be decided regarding the interest rates to be charged on individual finance is whether the bank should offer 'soft loans' at subsidised rates.

We recommend that interest rates on all the loans should be set to yield profits to the bank. Nevertheless, interest rates should be 'soft' because a large proportion of the bank's liabilities are expected to be subscribed by external government agencies at low (subsidised) interest rates. These low lending rates will assist the industrial sector in addition to the boost given by increased availability of finance.

The recommendation to set lending interest rates at profitable levels means that the Bank has to determine the spread between its lending and borrowing interest rates. In Chapter 8, we have given an example of interest rate spreads which yield positive profits.

It may be argued that setting a fixed spread between lending and borrowing rates involves anomalies, but such a policy is general practice and it is recommended because of its simplicity and because attempting to correct its weaknesses would engender worse ones. For example, it may be argued that a fixed spread is calculated on a gross basis and takes no account of variations in the bank's costs. As a result, it does not guarantee any net profit. It would be wrong, however, to use a net margin, setting the lending rate as a margin over borrowing rates plus costs, for that would remove any incentive to keep administrative costs low. Another possible anomaly is that a fixed spread between lending and borrowing rates does not guarantee that lending rates will be positive in real terms at times of inflation. For example, relatively low rates of inflation with concomitantly low nominal interest rates in Jordan may co-exist with high rates of inflation in Israel and the Occupied Territories (as did happen over a long period). Then a lending rate set as a fixed margin over the borrowing rate which, in turn, is related to the competitive Amman rate will be negative in real terms after the Occupied Territories' inflation rate is taken into account. Negative real lending rates would have a damaging effect on resource allocation in the Occupied Territories; to avoid such an anomaly it will be necessary to review the interest rate spread at regular intervals.

6.3 Repayment Period

The project finance programme should provide long term finance. Loans should be up to fifteen years and periods of grace of up to five years should be offered on amortisation payments.

The small business programme is designed to provide finance for fixed capital renewal and expansion. It is not designed to finance working capital, although its loans may be part of a co-financing programme which include credit for working capital from other sources such as commercial banks. Because this finance is to facilitate fixed capital formation there is a presumption that the bank's loans should be on long repayment periods of up to eight years. But there are arguments in favour of financing capital renewal and expansion through shorter term loans. We recommend that the small business programme should principally provide revolving short-term loans with repayment periods of two years.

The argument in favour of basing the small business programme on a short-term loan is as follows:-

The existing industrial base is extremely weak. As we noted in Chapter 2, it mainly consists of small workshops where the owner works as well as investing personal savings. Their old and fully depreciated machinery is an indicator of the failure of this process as owners have not invested enough to renew or expand fixed capital. The low level of investment results from the owners' profit incomes being low on average and unstable (and also from the attractions of alterative investments in housing, jewellery and banks in Amman), and low and unstable incomes provide a rationale for the bank giving short-term loans rather than lending long-term.

Specifically, the small-business programme loans should be for relatively small amounts (an average value of US $10,000) to be repaid in thirty-three monthly installments. These monthly installments are to begin six months after the disbursement of the loan and to include both capital and interest payments. Thus, the loans are designed to buy one or two machines and pay off the debt instead of financing a substantial investment in a new factory. But although they are short-term these loans can finance a substantial and long-term expansion of an enterprise's fixed capital, for the small business programme is designed to finance a succession of short loans; when a borrower successfully repays one small loan it is eligible for another to finance another machine or items of plant.

The rationale for this programme of small, short-term loans is that it has two advantages in the context of the low and unstable income of the workshops of the Occupied Territories. The first is that it discourages default, for borrowers are unable to obtain further loans until the first is fully repaid. The second is that it permits the industrial enterprise to expand and finance the expansion in a flexible manner.

On the other hand, it could be argued that if the repayment period of a loan is spread over a long term, the borrower's repayment installments would be lower so that long-term loans are more suitable for the low-income industrial enterprises of the Occupied

Territories. The two arguments against this and in favour of short-term loans are that with a long-term loan (for, say, a substantial re-equipment of a workshop) there are few effective sanctions against default if repayments begin to fall into arrears; and that a long-term loan commits the borrower inflexibly to a long-term repayments plan, although prospective income and the general economy is unstable.

In this comparison between long-term and short-term loans it is important to note that the size of repayments depends on the size of the initial loan, and on the interest rate, as well as on the repayment period. The recommendation that short repayment periods (of three years) rather than long periods (of up to ten years) should be arranged is linked with the recommendation that the size of each loan should be small. An enterprise's re-equipment and expansion on a larger scale is to be seen as a cumulative process employing a succession of short-term loans from the development bank.

6.4 Collateral and Security

One of the main problems facing development banks is the risk of defaults and borrowers' failures to meet amortisation and interest payments on schedule. This problem can damage both the bank's cash flow and its capital strength. One measure which can give the bank some protection is securing adequate collateral from the borrower for this both discourages the borrower from defaulting and gives the bank some recovery of assets if default does occur. In the Occupied Territories several things weaken the usefulness of collateral. In particular, there are difficulties for the enforcement of loan contracts and the appropriation of collateral, whichever of the three following types is considered.

6.4.1 Real Estate

Buildings and land are widely regarded in Europe and North America as the best collateral for any type of credit. In the case of industrial development loans, the buildings and land of the enterprise itself (the workshop or yard, for example) may act as collateral, or the borrower's residential property may be used (if the two are separate).

However, collateral of this type is not able to provide a secure base for the Industrial Development Bank's lending. One reason is the general problem created by the difficulty of enforcing contracts through the legal system. More specific problems are believed by some to arise from the occupying authority's arbitrary actions towards land and buildings. The Israeli' confiscation of Arab lands, the bulldozing and sealing of houses as military punishments, and the effect on land values of Israeli control of water resources, all prevent land and buildings from being secure assets which retain their value with a high degree of certainty. In addition, there is a long tradition against mortgage credit in Arab countries which will deter borrowers from using development bank finance if the bank requires real estate as collateral. This dislike of mortgage debt is strengthened by the political and economic instability of the region, for the additional risk of losing one's property through mortgage foreclosure is not willingly undertaken by potential borrowers.

6.4.2 Liens

The bank may take a charge on the fixed assets or inventories of the borrower or a floating charge on the borrowers' assets in general, although it should be noted that this is difficult to impose under local law. However, apart from the difficulties created by the absence of an effective legal system, collateral in this form does not give the bank effective security for two reasons. One is that the marketable value of liquidated stock and second-hand equipment is precarious; the other is that it is difficult to prevent a delinquent borrower from liquidating such assets before the bank attempts to obtain them. Nevertheless, the development bank should take this form of collateral. In addition, leasing will be a means of financing fixed assets in these circumstances.

6.4.3 Personal Guarantees

In countries with a well-established system of limited liability companies within an established legal framework personal guarantees from the directors of a company provide some security for lenders because they break down the principle of limited liability and make the directors' personal assets liable to be forfeited in case of default. In economies like the Occupied Territories' personal guarantees of that type are not of great value to a small business lending programme since most small enterprises are not incorporated but, instead, are already inseparable from the owners' own assets.

Third person guarantees, however, are common. Under these, a borrower has to provide guarantees from another person with adequate assets to cover the loan in case of default. In the Occupied Territories, when third party guarantees are required by lenders from Amman and other lenders, they have to be guarantors from Jordan (the East Bank). This is a great weakness in the Occupied Territories' financial system for it both prevents the establishment of an autonomous, integrated financial system, and it makes it difficult for poor individuals or small businesses without connections with such guarantors to obtain finance. Because of these disadvantages, we do not recommend that the Industrial Development Bank ties its small business loans to personal guarantees.

6.5 Monitoring, Technical Advice, and Borrowers' Groups

In view of the difficulty, outlined in Section 2.4, of arranging satisfactory collateral and security, the Industrial Development Bank has to place extra emphasis on monitoring and assisting the successful conduct of the borrower's business. In effect, the bank's security for its loans will stem from the soundness of the business as a going concern rather than from the soundness of its assets or guarantor's assets, when the business is in liquidation as a dead concern. Monitoring and advising the borrowers requires the establishment of structures on the side of both the bank and the borrowers. Our recommendations on these are outlined in the next chapter.

6.6 Special Financial Packages

In addition to its own loans which stem from financial intermediation, an important function of the Industrial Development Bank will be to facilitate direct lending by other sources of finance.

One type of special package is co-financing under which the development bank provides funds to finance fixed capital renewal and expansion together with a commercial bank which provides finance for working capital. We recommend that such co-financing is actively encouraged.

Another type is where the development bank acts as the manager of funds subscribed by international development institutions for large development projects. The Industrial Development Bank should actively seek and stimulate such finance.

In addition to co-financing under Special Financial Packages, the Industrial Development Bank's investment finance will normally be complemented by finance for working capital to be arranged from sources such as the Cairo-Amman Bank .

CHAPTER 7

CREDIT MONITORING, TECHNICAL ADVICE AND BANK ADMINISTRATOR

A major function of development banks is to link their credit with a programme offering borrowers advice on business development and the use of credit. The Industrial Development Bank will have a considerable responsibility in this respect. This technical advice is linked, in turn, to the appraisal and monitoring of loans. The process of appraisal and monitoring is the is the most important factor in reducing the problem of defaults. In order to carry out appraisal and monitoring appropriate administrative structures have to be established within the Bank. Experience shows that, in addition, the Bank's role is strengthened if the borrowers themselves establish credit monitoring and appraisal structures with the assistance of bank staff,

In this chapter we examine the process of monitoring and appraisal. In Section 7.1 we make recommendations concerning the borrowers' monitoring and appraisal organisations (Business Development Associations). In Sections 7.2 and 7.3 we recommend an appropriate administrative structure for the Bank's advice, monitoring and appraisal functions and relate this to the Bank's overall administrative costs.

7.1 Business Development Associations

We recommend that the Small Business Programme should give loans only to enterprises which are members of a Business Development Association (BDA) recognised by the Bank. These BDA's are borrowers' associations established in order to assist the business and appraise and monitor the loans given to the member enterprises. In order to obtain a loan from the Industrial Development Bank an enterprise has to join an existing BDA or participate in setting up a new one.

Each BDA should consist of five enterprises and all BDA's in each town or district should meet every month. At the monthly meeting interest and amortisation payments should be settled and new applications by member enterprises should be appraised.

In carrying out these functions, each BDA will have three broad purposes.

First, it will encourage enterprises to use development credit from the Bank, and ensure that only proposals which have been thoroughly prepared and considered will reach the Bank. In carrying out this role, the BDA with the officials of the development bank will educate potential borrowers in the role of credit, necessary accounting policies, and key aspects of business practice. The importance of this role stems from the fact that, as noted in Chapter 2, industry in the Occupied Territories is at a low level of development, based upon small workshops with many financial and accounting weaknesses. It is particularly important because the virtual absence of financial intermediation for almost two decades after 1967 has meant that businesses have little experience of handling formal credit.

Second, the monthly meetings will enable the BDA and Bank officials to monitor the borrowers' progress regularly. Any delinquency in an enterprise's payments of interest or amortisation will be evident and discussed at the monthly meeting.

Third, the BDA exerts great pressure against default. The group responsibility deters an individual borrower from defaulting and encourages mutual assistance to borrowers who are in danger of defaulting as a result of external factors.

These roles for the BDAs are extremely important for the Industrial Development Bank. They assist and stimulate industrial development which would be one of the main aims of the Bank. And they raise the quality of the Bank's assets (loans) by stimulating good business practice and acting against default. As we noted in the previous chapter, the forms of formal collateral and security the Bank can obtain are limited and weak so that the Bank should seek its security in the strength of the enterprise as a going concern, instead of in the assets of a business which has been liquidated. Therefore, by stimulating good business practice and discouraging default, the BDAs perform a crucial function for the Bank.

The principle that borrowers should be organised in such associations has been adopted by several development credit organisations in other parts of the world. It has taken its most developed and successful form in the Grameen Bank of Bangladesh (although that

Bank's customer base is different from the Industrial Development Bank's). This principle has been highly successful in ensuring low default rates and we would expect it to achieve the same benefits in the case of the Industrial Development Bank, even though the circumstances of the Occupied Territories are unique.

The Business Development Association are to operate with an informal style. Instead of having professional officers, their only officer is a chairperson chosen by the members from among themselves. Instead of having established premises and office overheads they can meet in one of their member's premises or in community premises.

Although the BDAs are to operate with these general principles the details of their operation are to be determined at the time they are established. For example, each BDA may have more than five borrowers as members, and it may meet less frequently than monthly.

7.2 Bank Loan Officers

The bank's lending staff will work with small business borrowers through the BDAs. These loan officers' responsibilities, therefore, include the identification of potential borrowers whose enterprises can benefit from development credit and the task of encouraging them to join or form an BDA.

The loan officers are responsible for helping to administer the BDAs and should attend the monthly meetings. In that context, they will be the principal source of technical advice and education of small business in the use of formal credit, basic accounting requirements, business planning and good business practice.

In order to fulfil their role of stimulating, initiating, monitoring and guiding the use of business development loans, the Bank's loan officers will be carrying out a high proportion of their work outside the Bank's offices. Three loan officers should be based in each main town of the Occupied Territories to represent the Bank in the BDAs which are centred on the town. They should be supported by a small technical team of loan officers at the Industrial Development Bank's headquarters who, in turn, are the channel through which the Bank's other departments (legal, accounting etc.) are linked with loan applications and servicing.

7.3 Bank Administration and Headquarters

The recommendations made in Section 7.2 define the staff structure required for the lending side of the Bank's operations. Thus, there will be a small central team under the Chief Loan Officer, who will be responsible to the Managing Director. Under the Chief Loan Officer there will be a team of field loan officers based outside of head office. The loan officers will relate to the Business Development Associations. The Chief Loan Officer will be head of this department and it will be called the Investment Department.

For mobilising savings a smaller administrative structure is required than for administering loans, since it is not intended that the Bank will seek retail savings deposits. For mobilising wholesale deposits locally, a small number of officers within the Treasury department will be adequate. In addition, the Treasury department will have responsibility for receiving and administering loans made to the Bank by Industrial Development agencies and for handling the Bank's own cash and liquid assets. The Treasurer, who heads this department, will be responsible to the Managing Director. In addition, a small legal department headed by the Bank's secretary will be based at headquarters and an Accounting Department, headed by a Chief Accountant, will be based there. The Managing Director will be a member of the Board of Directors and the Secretary will act as Secretary to the Board.

The Board of Directors should include directors appointed by the shareholders plus non-executive directors nominated by interested parties. For example, a non-executive director nominated by the World Bank, one nominated by an associated regional development bank and one nominated by other international development agencies, should be members.

Thus, the bank's administrative structure should be as follows.

Board of Directors

Managing Director

Investment Dept	Legal Dept	Treasury	Accounts Dept

The headquarters of the Industrial Development Bank should be within the Occupied Territories in a major commercial centre such as Ramallah.

The administrative costs of the Industrial Development Bank maybe expected to be higher than for development banks in other countries, because it will operate without the general support and infrastructure provided by a national government. It should be anticipated that the bank's annual administrative costs should be limited to 2.5% of total liabilities minus retained earnings, although in the early years, they may be higher, because economies of scale will not have been realised.

CHAPTER 8

EVALUATION OF FEASIBILITY AND STEPS TO PROJECT REALISATION

In this chapter we evaluate the feasibility of establishing an Industrial Development Bank and outline the steps towards project realisation.

The two principal conditions that must be met by the Industrial Development Bank if it is to be a feasible institution, meeting the goals of the project, are:-

(a) It must be financially sound, in the sense of being able to operate at a satisfactory rate of profit;

(b) It must be able to provide finance, for which there is an unsatisfied demand in the context of a Palestine industrial strategy;

This chapter addresses those issues in the following sequence.

In Section 8.1 and 8.2, we analyse financial soundness in the context of a Base Scenario. The financial projections here are derived from the parameter assumptions implicit in the analyses and the recommendations of the previous chapters.

In Section 8.3 Alternative Scenarios regarding financial stability are derived from different assumptions about the parameters and policy variables of the Industrial Development Bank.

Section 8.4 considers the Industrial Development Bank's prospective ability to meet unsatisfied demands for finance in the context of a Palestine Industrial Strategy. It also considers the political circumstances affecting the feasibility of the project.

Section 8.5 considers staffing requirements.

The chapter concludes with an outline of the steps that would have to be taken to effect the realisation of the project.

8.1 Basic Scenario Financial Projection: Assumptions

To assess the financial soundness of the Industrial Development Bank, we have to examine its prospective profit and loss accounts, balance sheet ratios and cashflow, in order to evaluate its rate of profit and its liquidity.

The prospective performance of these accounts depends on the assumptions made regarding the size and structure of initial liabilities and assets, the interest rates paid and charged, dividend policy and administrative costs and bad debts.

8.1.1 Basic Assumptions

The assumptions we make in formulating these projections are related to the recommendations of previous chapters. They are as follows:-

1. The structure of the Bank's liabilities between equity, subordinated debt and other debt (bonds) respectively will be in the ratio of 1: 1.5: 7.5.

2. The Bank's industrial loans will be divided between small business loans (short-term) and project loans (long-term) in the 60:40 ratio by value.

3. The interest rate on subordinated debt will be soft, but its level will depend partly upon financial market conditions as well as political negotiations at the time it is subscribed. In these projections, it is assumed to be 5% per annum.

4. The interest rate on other private debt (bonds) will depend on market conditions. Here it is assumed to be 10% per annum.

5. Dividend payments are to be no more than 25% of net profits. Here it is assumed they equal that maximum.

6. Administrative costs will have both a fixed portion and a variable component, which depends upon the size of balance sheet assets and its division between small business loans and project loans. To simplify the projections, it is assumed here that all administrative costs are 2.5% of the bank's total assets. That ratio is

assumed to reflect the higher cost this Bank will face because of the weak infrastructure of the Palestine economy and its responsibility for advisory and technical services.

7. It is assumed that the outstanding value of the Bank's total loans to industry will be fifty million dollars within three years of starting its operations. These comprise loans of $30m outstanding from enterprises linked to Business Development Associations and $20m invested in large project finance.

8.1.2 Assumptions Regarding Amount of Loans

Assumption 7 is based on an assessment of the capital requirements of the industrial sector of the Occupied Territories. This demand side approach is based on the assumption that the supply of finance to the Industrial Development Bank will not act as a constraint. The elastic supply of finance stems from there sources: first, the existing of a large stock of Palestine owned financial assets in Amman and in other finance houses which will be invested in the Bank through portfolio switching. Second, the supply of new savings (the average and marginal propensity to save in the Occupied Territories is assumed to be 15% by UNIDO Survey of the Manufacturing Industry in the West Bank and Gaza Strip). Third, foreign loans are assumed to be forthcoming from governments supporting the Bank.

The basic approach to the demand for capital funds has been applied in the UNIDO Survey. There, the two-gap model of development finance is applied by postulating alternative target rates of growth and calculating total and external capital requirements under certain assumptions. It is assumed that the average and marginal propensity to save is 0.15, that the incremental capital output ratio is 3 and assumptions are made regarding demographic changes. The resulting estimates of capital shortfall are presented in Table 8.1 on page 78.

These estimates yield a maximum level of capital requirements. However, for a feasibility analysis of the Industrial Development Bank's loans, we have to be concerned with the level of finance that industry can feasibly absorb. This will be for several reasons. The principal constraints are the availability of management skills and the structure of existing enterprises which limit the economy's ability to utilise finance from the small business programme for fixed capital formation.

The UNIDO survey found only 3,541 industrial establishments in the West Bank and Gaza and their mean number of employees was approximately four. Only 67 employed more than 20 workers. Their use of modern techniques of production was limited and it may be assumed their familiarity with the management techniques and accounting systems required for the commissioning and operation of large-scale fixed capital, is inadequate.

Therefore, the industrial sector's ability to absorb and utilise new capital is limited by the number of existing establishments and their management skills. The Business Development Association proposed in this study will increase the number of establishments to some extent and strengthen management skills, but the existing base acts as a limit.

On the basis of these considerations, it is assumed that the maximum loan outstanding to any one establishment compatible with its constraints will be $10,000 and that no more than 3,000 establishments will be in receipt of such loans. This is compatible with the Industrial Development Bank employing a staff of thirty loan officers in the field, servicing 20 Business Development Associations each. Therefore, the maximum amount outstanding in a small business programme will be US $30m.

8.2 Basic Scenario Financial Projections

8.2.1 Balance Sheet End Year 3 (US $ million)

Liabilities		Assets	
Equity:		Fixed Assets	0.5
Paid up shares	5.0	Cash	0.7
Retained Earnings	1.2	Liquid Investments	5.0
Subordinated Debt	7.5	Small Business Loans (short-term)	30.0
Other debt:		Project Loans (long-term)	15.0
Non-negotiable Bonds	10.0		
Loans (from governments and agencies)	27.5		
	51.2		51.2

TABLE 8.1

Capital Requirements and Shortfall, 1985-94, with Growth in GDP Per Capita of 2½%

Year	1 GNP Per Capita ($000s)	2 Population at beginning of year	3 GNP ($mn)	4 Change in GNP ($mn)	5 Loss of Remittances & earnings from Israel ($mn)	6 Total change in output is change in GDP ($mn)	7 Increase in GDP generated by saving ($mn)	8 Capital Shortfall ($mn)
1985	1.098	1,372,460	1604.2	246.1	52.6	298.7	75.2[(1)]	670.5
1986	1.123	1,558,624	1750.3	264.4	52.6	317.0	87.5	688.5
1987	1.151	1,750,382	2014.7	283.8	52.6	336.4	100.7	707.1
1988	1.180	1,947,893	2298.5	304.6	52.6	357.2	114.9	726.9
1989	1.210	2,151,330	2603.1	324.4	52.6	377.0	130.2	740.4
1990	1.240	2,360,870	2927.5	347.5	7.5	355.0	146.4	625.8
1991	1.271	2,576,696	3275.0	372.1	7.5	379.6	163.8	647.4
1992	1.303	2,798,997	3647.1	395.2	7.5	402.7	182.4	660.9
1993	1.335	3,027,967	4042.3	425.8	7.5	433.3	202.1	693.6
1994	1.369	3,263,806	4468.2	452.5	7.5	460.0	223.4	709.8
1995		3,506,720	4920.7					

(1) On ~~our~~ the assumption of 15% savings ratio and ICOR of 3, each year's increase in GNP will generate extra savings which increases investment and therefore output in following years.

8.2.2 **Profit and Loss Account Year 3**
(US $ million)

Revenue			Costs	
Interest:				
Liquid Investments	(11%)	0.55	Administrative Costs	1.25
Small Business Loans	(10%)	3.00	Interest on bonds (10%)	1.00
Project Loan	(10%)	1.5	Interest on government and agency loans (6%)	1.65
			Interest on subordinated debt (5%)	0.375
		5.05		4.275
			Profit	0.775

N.B. It is assumed that depreciation of fixed assets is negligible for the purposes of analysis.

8.2.3 Profit Rates

These balance sheet and profit and loss projections imply that in year 3 the rate of profit on total assets will be 1.5%. However, the high gearing ratio implies that the following rates of return to shareholders will be achieved in year 3.

Total profit yield on paid up capital	15.5%
Total profit yield on equity (paid-up capital and retained earnings at end of year 2)	14.0%
Dividend yield on paid-up capital	3.9%

These rates of profit and yields can be seen as justifying the establishment of the Industrial Development Bank, for they satisfy the two different objectives of a private development bank: the objective of making capital available for industrial development and of offering equity owners a satisfactory return.

The development objectives conforms with the low rate of profit on total assets, which indicates that the burden of interest charges on industrial profits is at a minimum. It also conforms with the low dividend yield, which indicates that a high proportion of the profits are accumulated as retained earnings to finance capital expansion. The ownership return objective is satisfied by the total profit yields, which indicate the rate of increase of owner's equity, including potential re-investment of dividend receipts.

8.3 Alternative Scenarios

Several phenomena would alter these projections and reduce the profit rate. Four are enumerated here.

8.3.1 Inadequate Growth of Balance Sheet

A constraint may be imposed on the size of the balance sheet by a failure of private investors to purchase bonds in the numbers projected. A similar constraint could arise from the asset side if the assumption about industry's ability to absorb new capital is too optimistic.

Since we assume that paid-up shares and subordinated loans are fully subscribed at inception, such constraints would reduce the leverage ratio and hence returns to equity as well as total profit. There are two alternative possibilities: a constraint on bond sales would be alleviated by raising their interest rate, but although this would enable the projected leverage ratio to be achieved, it would reduce profits and yields on equity. A constraint on absorption of loans could be overcome by investing a high proportion of assets in liquid investments, but that would defeat the bank's development objective. The possibility of such a constraint on absorption on the asset side is discussed in Section 9.4

8.3.2 Defaults

The projections make no provision for bad debts on the grounds that experience in other countries has shown that the type of group monitoring of debtors to be carried out by the Business Development Associations is able to minimise defaults.

Nevertheless, defaults may be significant for several reasons and could reduce profit rates and yields. Defaults also may create cashflow problems. Alternatively, a given default rate can be compensated by an increase in interest rates on loans, which may be justified as a risk premium.

8.3.3 Taxes

No allowance has been made in the projections for taxes on profits or transactions. Any tax liability will reduce net profits. Alternatively, taxes may be shifted by increasing average interest rate spreads.

8.3.4 Interest Rates

The interest rates used in these projections are illustrative only. The rates which will apply will depend partly on financial market conditions at the time the Bank is established. However, the robustness of the projections depends on the average spreads, rather than the levels of interest rates.

8.4 Circumstances Affecting the Banking Environment

The ability of the Industrial Development Bank to achieve its development objective of providing finance for Palestine industrial strategy, depends on whether political and economic circumstances provide a suitable environment for industrial development.

The situation in 1988 is not favorable. In the 20 years of occupation, the Arab economies of the West Bank and Gaza have been reshaped into a pattern of dependency and fragmentation, which has impoverished them. One important aspect of this for industry is Israeli restrictions effectively preventing independent trade and controlling trade routes. In 1988 increased military activity by the occupying forces has been accompanied by economic sanctions. For example, it has almost closed the routes for financial transfers via moneychangers between the West Bank and Amman, which we described in Chapter 3. Although no firm data is available, reports indicate that gross domestic product, including industrial activity, has declined sharply in this period. A pre-condition for the establishment and success of the Bank is that the occupying power relaxes restrictions or independence is achieved. If the Bank is to be established before independence, it is necessary that the occupation authorities be willing to approve the establishment of the Bank and support that approval with a liberal policy on licensing new industrial establishments, the expansion of existing ones and the development of international trade by Arab and Palestinian firms.

To establish the Bank's initial finance and legal position, it is necessary that foreign states agree to subscribe to subordinated and other debt. The pre-condition for that is principally a political strategy of supporting Palestinian development which, in turn, is subject to wider regional political processes.

The prospects for the Industrial Development Bank are extremely sensitive to these wider economic and political circumstances. If the framework for economic development is not liberalised, the industrial sector's willingness and ability to absorb additional finance and utilise it profitably, will be very much lower than that assumed in the projections, and the Bank should not be established.

The legal circumstances surrounding the establishment and operation of the Bank are described in Chapter 9.

8.5 Staff Requirements

The Industrial Development Bank staff will be recruited into three broad categories, each of which will have a graded structure of posts.

1. Senior and middle management. This category ranges from the Managing Director to the line managers of sections in the headquarters department. Initial recruitment to this level should not exceed 15.

2. Loan officers. It is anticipated that 30 loan officers will be recruited.

3. Secretarial and clerical. A maximum of 45 should be recruited to this category.

Senior and middle management recruits should have an accomplished record of experience in similar posts in banking. Loan officers may be recruited from people with experience in bank lending, business administration or accounting.

The Industrial Development Bank should enter into agreements with banks in other countries for training and for the development of technical expertise.

8.6 Steps Towards Establishment

If it is decided to establish an Industrial Development Bank on the basis of this feasibility study, the following initial steps will need to be taken.

1. Further industrial study. Existing knowledge of the industrial sector in the West Bank and Gaza is based on the UNIDO survey which was conducted in 1983 and relies to a degree on even older data. Moreover, it provides little data on the financial structure of existing industrial enterprises. A study to update and complete this data will be necessary. It should be designed to provide the detailed specific information on potential credit demand that the Industrial Development Bank will face.

2. Project evaluation and planning. A significant element of the proposed lending is to be long term for large scale industrial projects and the viability of these projects will be an important determinant of the willingness of governments and other agencies to invest in the Bank. Prior to seeking that support, therefore, it will be necessary to identify suitable projects and carry out detailed project appraisal. This should be one of the objectives of the aforementioned industrial study.

3. Suitable shareholders should then be identified and draft articles of association approved by them.

4. A public limited company with those articles of association will be registered and apply to the occupying authorities for a licence to carry on banking business in accordance with Jordanian Companies Law and Jordanian Banks Law amended by order 1180.

   The legal aspects are summarised in Chapter 9.

5. Simultaneously with steps 3 and 4, foreign governments and agencies will be approached to seek their agreement to subscribe to the bank's

debt. It is expected that this agreement would be linked to the willingness to use their good offices to facilitate the agreement of the Israeli and Jordanian authorities to the establishment of the bank in line with the legal conditions summarised in chapter 9.

6. Simultaneously with these steps, financial institutions will be approached to agree underwriting terms for the issue of non-negotiable bonds.

7. When these legal and financial steps are complete, suitable premises should be obtained and, at the same time, both headquarter staff and the first field loan officers engaged.

8. In taking these steps, the close link between economic and political developments will mean that the views of the governments of Jordan, Israel and the United States will have to be sought.

law provides that only a licenced bank may carry out banking activities in the Kingdom. Such licences are only given to companies in accordance with the provisions of the Banks Law.

Subparagraph (b) of the same article 4 of order 45 provides that if a bank obtains a licence from the Inspector of Banks to carry on banking business in accordance with article 3 of the Jordanian Banks Law, and this bank was a foreign company according to the Jordanian Companies Law, this bank shall not be obligated to register as a foreign company by virtue of chapter 12 of the Jordanian Companies Law.

The outcome of the orders mentioned above has been that all non-Israeli banks in the occupied area were closed and none were given a licence to continue with banking business. Meanwhile, Israeli banks were allowed to open branches in the area. Article 4 of order 45 seems to have been added by the area commander to allow Israeli banks to open branches in the area without the need to be subject to the Jordanian Banks Law or the Jordanian Companies Law. Israeli Banks have been given licences to operate in the occupied areas and have indeed been doing so without being subject to all the provisions of the two above mentioned Jordanian laws.

Until October 2nd, 1986, only Israeli Banks were operating in the area. Moneychangers were allowed to operate: specific military orders were issued to control their operations which had been growing gradually. The primary aim of these orders were to ensure that these institutions will not operate as conduits for money being channelled into the occupied areas by organisations which Israel considered hostile.

9.2 Military Order No. 1180 amending the Jordanian Banks Law

There are a variety of financial institutions in the occupied territories which carry out in differing degrees banking business and money lending in various forms. It would have been necessary to describe in full the military orders that pertain to these institutions and to recommend whether any of the existing structures which these institutions have could be adopted for the proposed development bank. However after Military order number 1180 was issued in September 26,1986, this is no longer necessary.

For the sake of presenting the full picture, the orders pertaining to moneychangers and their effect on the subject of this study are briefly discussed, bearing in mind that a fuller expose has already been given in Chapter 3 and that the issuance of order 1180 has decreased the significance of these orders.

The orders pertaining to moneychangers were issued in 1982. The main objective of the military in issuing these orders appears to have been to enable it to exercise more control over the operations of moneychangers as well as all other institutions which deal in any way with foreign currency including Non Governmental Organizations which bring foreign currency into the country to finance their development programs or to give as low interest loans to small businesses.The main thrust of the orders is to prohibit in a general way the import of foreign money except as authorized by the general permit issued by the head of the civilian adminstration. According to this general permit, the amount allowed to be brought in, changes from time to time. In early 1984, for example, it was announced that individual travellers across the bridges coming from Jordan can only bring in a maximum of JD 400, but before the uprising which began in December 1987, there was no limit on the amount an individual could bring in. The new restriction, according to the coordinator of activities in the occupied West Bank, was imposed in order to prevent the Palestine Liberation Organization from sending funds to supporters there to encourage the strike of laborers and shopkeepers, as well as other activities.

However, after the issuance of order 1180,the relevance of a study of the laws pertaining to the establishment of an Industrial Development Bank of orders relating to moneychangers has become less important. This order defines a new relationship between licenced banks and the military authorities, a relationship not identical to that which the Jordanian law has determined between the licenced bank and the Jordanian government. According to order 1180 the Head of the civilian adminstration can, for example,interfere in the bank's operations if he deems this necessary for security reasons. No such right existed for any government organ according to the Jordanian law.

The full range of the changes in the Jordanian Banks Law number 94 of 1966 (hereafter The Law) brought about by virtue of order 1180 entitled Order Concerning the Amendment of the Banks Law, dated September 26,1986, is as follows:-

First: It established as Inspector of Banks, the Israeli officer appointed by virtue of Order 45.

Second: It amended article 3 of the Law. This article is of four sections which state as follows:

"3(a) Only a licenced bank can carry on banking business in the Kingdom.

(b) The central bank issues a licence according to the provisions of this law.

(c) A licence can only be issued for a company.

(d) The banks licenced by this law to carry on banking business shall be considered licenced banks according to this law and they shall therefore be provided with new licences."

The following were the amendments made by the military order:

sub-section (b) was amended by the addition of the following provision:

"It is possible to determine by permit the scope of the bank's work and the way it is administered. It is also possible to provide any condition to ensure that the bank fulfill its obligations and administer its operations properly."

- at the end of sub-section (c) the following was added:

"This provision does not apply to foreign banks."

- sub-section (d) was referred to as (e) and the following replaced it as (d):

"The following provisions shall apply to the branch of a bank whose opening was authorized by virtue of article 1 of the order concerning the prevention of trading and carrying banking transactions (banks) number 7 of 1967:

(1) Concerning any provisions dealing with the bank's capital, capital of the bank shall be considered as the excess of the branch's money over its obligations provided that the inspector authorizes that amount.

(2) Concerning any provision dealing with the bank's administration or its board, these shall also apply to the board appointed in the area [the West Bank] for the administration of the bank in the area.

(3) Concerning any provision dealing with licenced banks, the branch shall be considered for this purpose as a licenced bank."

Third: It amended article 5 of the law.

This article deals with the minimum capital which a local and foreign banks must have in Jordan. It was amended by the inclusion of the following new subsections:

"(c) A licenced bank may not reduce its paid up capital in the area without the agreement of the inspector and provided that the capital should not fall below the minimum amount provided in subsection (a).

-(d) the inspector can determine that a licenced bank should keep specific kinds of properties in specified proportions." -At the end of article 5 , article 5A was added. This article reads as follows:

> "5A A licenced bank whose main office falls outside the area [the West Bank] shall appoint a district manager residing in the area to manage the branches of the bank in the area. This appointment shall be through a letter of appointment which authorizes him to receive any official document to do with the work of the bank. A copy of this letter of appointment legalized by the notary public shall be submitted to the inspector."

Fourth: Article 7 of the Law is deleted and replaced by the following article:

"(a) The inspector may take the following measures against any licenced bank if it violates any of the provisions of this law or of a regulation or instruction or proclamation or the orders given by virtue thereof or the orders made by any legislation or security legislation:

(1) Warning.

(2) Reduction of or suspension of the fiduciary services given to a licenced bank.

(b) In the case of the repetition of the offence or of a violation of any of the provisions of this law, or regulation or instructions or orders given by virtue thereof or of any provision of a legislation or a security legislation, the inspector can then do the following:

(1) Order the licenced bank to refrain from doing specific operations or to impose, as the inspector sees appropriate, any restriction on any fiduciary service to the licenced bank.

(2) Prohibit the bank from distributing any shares or any profits for shareholders of the licenced bank and from

giving any services to the members of the bank's board, the directors or the holders of the right to sign on behalf of the bank.

(3) Suspend or restrict the authority of any member of the bank's board, manager or holder of a right to sign on behalf of the bank.

(4) Suspend or dismiss the director or the managing director.

(5) Appoint a licenced manager to manage the work of the licenced bank.

(6) Cancel the licence of the licenced bank.

(c) A licenced bank whose licence has been cancelled by virtue of a legislation or a security legislation is similar to that of a licenced bank for the period of three years from the date of the cancellation.

(d) The inspector may order the licenced bank whose licence has been canceled to manage its operations in any way he sees as necessary to protect the bank's debtors and the bank's other clients who entered into contracts with the bank before its licence was cancelled. This provision does not exempt the licenced bank from the responsibility to execute any undertaking it made before its licence was cancelled."

Fifth: Article 9 of the law concerning the need to acquire the permission of the Central Bank before opening new branches is changed by the addition of the following subsections at the end of the article:

"(d) The inspector may cancel the licence given by subsection (a) [i.e. the licence to open a branch] after giving the bank the chance to present its reasons in the following circumstances: (1) If the licenced bank did not commence its operations or it terminated them.

(2) The licenced bank violated a basic condition of the conditions of the licence.

(3) The licenced bank violated a basic provision of the legislation or security legislation.

(4) Public interest necessitates the cancellation of the licence. (e) If the licence is revoked for any of the reasons mentioned in (d) above, the licenced bank must

stop its operations."

Sixth: Article 11 in the chapter entitled "prohibited transactions" is amended by the deletion of subsection(c) and its replacement by the following subsection:

(c) A licenced bank may not give any fiduciary exceeding 1000 Jordanian dinars in value to any member of the Board of Directors, to a bank employee or his relatives or to a holder of the bank's shares of whatever kind, the nominal value of which exceeds ten percent of the bank's capital or to the owner of more than ten percent of any kind of shares in the bank except with the approval of the inspector. What has been said in this sub-section applies also to fiduciaries to a juridical body which has one or more members who holds more than 25% or more of any kind of shares in the bank.

-subsection (g) is deleted and replaced by the following: "(g) A licenced bank may not grant loans or advances exceeding in its total 20% of its deposits for the purpose of building housing units or units for commercial purposes or for possession unless the licenced bank is specialized in granting loans for housing or has received the approval of the inspector for this."

Seventh: Article 15 of the Law, which deals with the requirement to publish the bank's budget, is amended by the addition of sub paragraph (d) which reads as follows:

"(d) At the times fixed by the inspector, a licenced bank must prepare and publish a financial report organized according to accounting principles and other rules as determined by the inspector. The inspector may order the way the report is to be published. He is also entitled to determine the inspection and scrutiny, which must be undertaken by the certified accountant."

Eighth: Article 17 of the Law, which deals with the minimum of assets which the bank should have, is amended as follows:

-sub paragraph (b) is deleted and replaced by the following: "(b) the inspector may order the licenced bank to keep liquid assets at a certain percentage and according to a certain ratio to other kinds of assets and securities. If there is any doubt about the classification of assets or kinds of classification then the inspector shall rule on this."

-subparagraph (d) is amended by replacing the ratio of the fine which the bank has to pay if its assets fall below the minimum with a ratio that is determined by the inspector according to regulations.

Ninth : Article 18 which imposes on the bank the duty to provide the Central Bank with periodic statements is amended whereby the word "period" is deleted. After the amendment the licenced bank will have to provide the central bank with the information which it demands. However it is unclear when and how often this should happen.]

Tenth: Article 20 of the Law concerning inspection of the bank records by representatives of the Central Bank, provides in subparagraph (b) that the information which the representatives of the Central Bank acquire in the course of the inspection shall be considered secret and confidential. This article is amended as follows:

-At the end of subparagraph (b) the following is added: "It is permissible to make public information or details which the inspector came to know if the inspector saw that there is a need for the purposes of a criminal investigation or for submitting a charge sheet or for the purposes of the security of the area or if the information or the document were received from a licenced bank because of approval which he(the inspector) gave."

-removal of sub paragraph (e) which empowers the Central Bank of Jordan to cancel the licence of a bank which repeats its violations of the orders of the Central Bank issued by virtue of this article.

- The insertion of the following after article 20 to be referred to as article 20A and 20B:

"20A If, in the opinion of the inspector, a certain debt due to the licenced bank is in whole or in part composed of perishable material or that the possessions of a licenced bank are registered in the bank's deeds in excess of their real value at the time according to the amount it would fetch if a merchant were to sell it out of his free will to a buyer out of his free will, then the inspector may order the licenced bank to allocate to an appropriate fund an account equal to what is requested for that purpose."(sic!)

"20B The above instruction mentioned in the above article shall be considered as a written notice according to article 20C."

Eleventh: Article 21 of the Law concerning the appointment of a certified accountant is amended, making it necessary that the appointment of the accountant be approved by the inspector.

Twelfth: Article 23 , which states that if the bank is late in appointing an accountant, the Central Bank can appoint one for it, is amended such that if three months pass before the appointment is made, the inspector can make the appointment.

Thirteenth: Article 24 providing for the takeover by the Central Bank of the affairs of a bank that stopped working or whose operations were suspended by the Central Bank for any reasons, is deleted and replaced by the following article:

> "If a licenced bank is about to stop making payments or did stop making payments for any reason or if a decision by a competent authority in the area was made stopping the bank's operations altogether,the inspector may take over the management of the affairs of this bank and he is authorized to take care of its assets, documents, and deeds in the way which he sees appropriate to safeguard the interest of the depositors.

Fourteenth: Article 25 of the law which deals with the instances when the central bank may order the withdrawal of the licence of a bank is amended by the addition of the following sub section:

> The head of the civilian adminstration, may for reasons to do with the security of the area or public interest, exercise his powers as mentioned in article 7(b) with the appropriate changes."

After article 25 the following articles are added:

> "25A Every licenced bank must pay to the civilian adminstration a licence fee with an additional fee for every branch. The rate of the fee and the time of its payment shall be fixed by the inspector.
>
> 25B: In every case when according to this law or to any regulations, orders or instructions issued by virtue thereof, the licenced bank is obliged to pay a fine, the head of the civilian administration, in addition to any other action he may take,may issue orders to the inspector to transfer to him the amount of the fine in return for registering the amount on the account of any deposit of the licenced bank held by the inspector.
>
> 25C: (a) The inspector may issue orders in general or to a specific licenced bank concerning the make-up of any Board of Managers of a licenced bank or concerning the subjects on the agenda before the board of the licenced bank.

(b) Despite what was mentioned in article 104(a) of the company law number 12 of 1964 , the inspector may determine that for a company which is a licenced bank,the board of directors may exceed eleven members but not fifteen. This determination could be general or for a single company."

Fifteenth: After Article 27 of the law, which deals with the need for the board of directors of any bank to take the necessary measures to comply with the provisions of this law the following article is added. It reads as follows:

"27A (a) Licenced banks shall be closed on the days and for the periods determined by the inspector.

(b) the inspector may, in cases of emergency or in special cases, announce the suspension of the work of licenced banks or any of them in all or any of their branches for the period that he decides."

Sixteenth : Articles 28 and 29 were deleted. They deal with the fines to be paid in the case of violating different articles of the law and in the time and manner of payment of the fines.

Seventeenth: After article 33 ,which is the last article in the Law, another article was added. This article, numbered 34, reads as follows:

"34. The inspector may exempt from the provisions of this law or from part of them, a licenced bank which is a branch of a banking institution registered in Israel if it appears to him that the banking institution follows the laws in force in Israel. The bank which has been so exempt by this article will be subject to the Israeli laws with the appropriate adjustments as needed."

As is clear from the above, military order 1180 amends in a substantial way the Jordanian Banks Law. Following the issuance of this order, another unnumbered order dated October 2,1986 was issued by virtue of order number 7 . Order number 7 ,which has been mentioned above, had ordered all banks closed. The new unnumbered order is entitled "Order Concerning the Opening of Closed Places''.It amends order number 7 which had declared ALL banks closed by declaring that a bank whose name is mentioned in the schedule of the order may commence operations if it obtained a licence from the head of the Civilian Administration or from the Inspector of banks according, to order number 45 concerning banks .The bank's opening can be through one of its branches .It must be in accordance with the conditions which are specified in the licence and can continue for as long as the licence is valid.

In the schedule only the Cairo Amman Bank is mentioned.

What this means is that for those banks which had existed in the area, or which had branches in the area when the occupation began, the order declaring them closed is cancelled when a licence is issued to them, as happened in the case of the Cairo Amman Bank. This licence will have special conditions, which in the case of the Cairo Amman Bank cannot be described here because they have not been made public. In addition to the special conditions, the bank that is allowed to re-open will have to operate in accordance with the amended Jordanian Banks Law. As to those banks which were not operating before the occupation and which now want to acquire a licence to carry on banking business, these will have to apply to the inspector of banks or to the head of the civilian adminstration, who operate according to amended Jordanian Banks Law of 1966. the

Several things become clear from the above:

One: That there are two kinds of banks that can operate in the Occupied West Bank: foreign banks(meaning Israeli Banks) which are exempt from the provisions of the Jordanian Banking law, and local banks, which are subject to the conditions of the licence granted to them by the inspector of banks and to the provisions of the Jordanian Banks Law as amended by military order 1180.

Two: The Jordanian Central Bank Law has not been amended. However, certain powers of the Central Bank, as declared in the Banks law have been assumed according to order 1180 by the inspector appointed under order 45 by the Head of the Civilian Adminstration. The relations of a bank operating in the occupied area, whether it is independent or a branch with the headquarters outside the area and whether or not it is in a country which is in a state of war with Israel, to the Israeli central bank and to the central bank in the country where its headquarters are, has not been specified by any military order, but are presumably left to be determined by the conditions of the licence. It is there that the power of supervision of the Israeli Central Bank will be defined.

Three: Any person or body interested in establishing a bank in the occupied area can do so by applying directly for a licence according to the amended Jordanian Banks Law. If such a bank is already registered in Israel, it will still need a special licence to be allowed to operate in the area; however, it could be exempt from all or some of the provisions of the Jordanian Banks Law according to article 34 which was added to the Jordanian Banks law by order 1180. The decision in all cases lies with the inspector of banks who has wide discretion.

9.3 Methods of Incorporation

According to article ˘ of the Jordanian Banks Law licence to operate a bank is only granted to a public limited company.

The law relating to companies in the West Bank is the Jordanian Companies Law number 12 of 1964. Two kinds of public limited companies can be registered which could apply for a licence to carry out banking business: a local public company or a foreign company. The requirements for each are as follows:-

One: A local public company.

(1) The law requires that the following be submitted to the Registrar of Companies with the application to register a local public limited company:

(a) A memorandum of association;

(b) Articles of association.

'2) There are several specific provisions which the law requires that the articles of a public company should include. These provisions are outlined in Section 9.4 below.

(3) The share capital of the company must not fall below JD 30,000; and the number of shareholders must not fall below seven.

Two: A foreign Company:

(1) The law requires that the following be submitted to the registrar of companies with the application to register a foreign company:

(a) Certified copy of the company's article and the certificate of incorporation or any other documents through which the company was registered.

(b) Proof that the company has obtained approval by local authorities to carry on its business and investments in the West Bank.

(c) Names of the members of the Board of Directors and the citizenship of each; and

(d) certified copy of the power of attorney by virtue of which the company empowers a person residing in the area to carry on its business and receive summons and notices on its behalf.

(2) The decision to accept or refuse registration is made by the Minister of Finance, who has been replaced here by the officer in charge of finance in the military government.

(3) Three months prior to the end of every fiscal year, the company that has been registered must submit a report of its operations and a copy of its balance sheet certified by a chartered accountant.

(4) It is difficult to estimate the time required to complete the registration. The preparation and submission of the documents required does not take much time. However, obtaining the permission of the officer in charge of finance is the unpredictable part, and depends to a large extent on the political atmosphere in the area.The fees for registration are at the rate of 1 JD per 1,000 JDs of the capital value of the company.

(5) Once registered in the West Bank, it would be possible for the company to record liens on assets and receive title. The company would also become liable for payment of tax.

9.4 Guidelines for the Preparation of a Bank's Articles of Association

One: According to the Jordanian Bank's Law No 94 of 1966, the applicant to the Jordanian Central Bank for a licence to operate a bank must be a Public Limited Company. The application must be submitted before the company is registered.

Two: The share capital of the bank must not be less than 250,000 Jordanian Dinars.

Three: The method of incorporation of a public limited company is described in the Jordanian Company Law no. 12 of 1964. This has already been described above.

Four: The memorandum of incorporation of the public company should include those provisions normally included in such a document namely:

a. the name of the company

b. objectives for which it was established

c. amount of share capital and how it is divided (provided that the value of each share should not fall below one Jordanian dinar).

d. the limits of liability of shareholders

The memorandum must be signed by all the founders before the Notary Public.

Five: The articles of association should include the following:

a. details about the kinds of shares available and the number and value of each.

b. The power to lay an attachment over the shares as guarantee for any liabilities towards the bank.

c. The manner in which it is possible to transfer the shares including the manner of its devolution in case of the death or bankruptcy of its owner.

d. The organization and management of the bank to include the constitution of its board of directors, manner of appointment, length of service, frequency of meeting, remunerations powers, organization of meetings. The Board may not have less than five members and not more than eleven. The articles must specify the number of shares that a shareholder must have to qualify as candidate to serve with the Board. There are restrictions which were made by the amendment made to the Bank's Law by the military order number 1180 concerning the privileges of Board members.These have already been discussed above.

e. Meetings and proceedings. The articles must specify how often the general meeting of the company should be held. The Jordanian company law specifies that general meetings may be called by the Board of Directors or upon the application of shareholders holding not less than one quarter of the shares, or by application of the inspector of companies or the auditor upon the request of the holders of not less than 15% of the shares if the inspector of companies is convinced by their reasons.

f. Appointment of an auditor which, according to the amendment by Military Order 1180, is conditional upon the approval of the Israeli Controller of Banks.

Six: the Jordanian Company Law does not provide model memoranda nor articles. These have to be drafted taking into consideration the wishes of the founders, provided that the requirements specified in the Bank's Law, the Company Law and Military Order 1180 are complied with.