FIELD BRIEF No. 4

Mobilization of Savings in the West Bank and Gaza

This FIELD Brief is the fourth in a series produced by the USAID Financial Integration, Economic Leveraging and Broad-Based Dissemination (FIELD) LWA. It was authored by Maurice Girgis of the William Davidson Institute at the University of Michigan as an element of a longer report, FIELD Report No 5. Program. Managed by AED, FIELD represents a consortium of leading microenterprise development and microfinance organizations committed to advancing practice through innovation, learning and exploration. FIELD Briefs support this objective by sharing what we have learned and inciting dialogue around key issues. For information more, visit www.microlinks.org/field.*

In an effort to better understand what steps could be taken to reach the savings levels necessary to meet private sector credit demands in the West Bank and Gaza, and subsequently fuel job creation, the AED Small & Microfinance Assistance for Recovery and Transition (SMART) Program commissioned Maurice Girgis of the William Davidson Institute, to conduct a study on appropriate options.

The objective of the study was to identify the means through which the volume of loanable funds from household and corporate savings could be made sufficient to enable the banking sector in the West Bank and Gaza to meet the demand for credit from the private sector. Credit creation is viewed as the vehicle through which lending to micro, small and medium size enterprises (MSMEs) will bolster job creation in the economy. The issue at hand is therefore essentially an issue of the adequacy of the supply of savings with respect to the demand for credit. The following is an excerpt from the executive summary of FIELD Report No 5: Mobilization of Savings in the West Bank and Gaza.

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

"National savings consists of household, corporate and government savings, with households owning the lion’s share. Annual savings, which are determined through national income accounts, measure the amount of unspent disposable income. Its development over the years 1994 to 2006 reveals two distinct patterns: (1) from 1994 to 2000, the savings rate (as a percent of disposable income) fluctuated between +5 to +8 percent, averaging 6.1 percent; (2) from 2001 to 2006 in the wake of the second Intifada, it fell steadily each year through 2004 reaching negative rates in 2003 and 2004, averaging 2.1 percent.

**In July 2011, FHI acquired the projects, staff and expertise of AED to form FHI 3*

FIELD Briefs are prepared by AED under the FIELD LWA (Cooperative Agreement No. EEM-A-00-06-00001-00). The views expressed do not necessarily represent those of USAID or the US government.

"Only in 2005 did it return to its 1995 level. Available evidence indicates that, in comparison with other countries, the savings rate is also low. Even when the two years with negative savings are excluded from the analysis, the average in WBG of 5.9 percent is substantially lower than the world average of 19.8 percent, or the average observed in Sub-Sahara Africa at 12.4 percent over 1965-1994.

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

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

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

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

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

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

"Moving forward and assuming the preservation of the status quo, can one set a target growth rate for the next five years? An attempt is made based on the consideration that rather than carrying out complex GDP projections, a GDP growth rate target is set on the condition that the economy will absorb all new entrants into the labor market each year from 2008 to 2013.

"Entrants to the labor market in 2006 were estimated at about 45,000. At a population growth rate of 3.5 percent, the flow of new entrants from 2008 to 2013 was derived; it increases steadily to 58,000 in 2013. Meantime, the declining overall average labor productivity is assumed to reverse its declining trend and start rising by a modest 1/2 percent a year. The resulting real growth rate target that will meet the pre-set condition turned out to be 7.3 percent (in real terms) in 2008, declining gradually thereafter to 6.61 percent in 2013. By then, total employment will have increased from 633,000 in 2005 to 1,022,000 in 2013. As part of the scenario, the anticipated increase in real GDP will engender additional savings estimated at $512 million in 2008 and $709 million in 2013.

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

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

First: The Government Sector

1. Energize the private sector in view of the strong and statistically significant causal link between economic growth and savings and also because of the strong evidence gathered recently by the World Bank in 2008 indicating that the investment climate is relatively inhospitable,
2. Streamline and activate the pension fund program for government employees,
3. Mandate a pension program in the private sector as is the case in most other countries,
4. Work with the private sector to initiate a loan guarantee umbrella for micro enterprises whose loans are less than $10,000, and
5. Collaborate with the private sector to raise the level of awareness and interest in health, life and property insurance.

Second: The Banking Sector

1. Diversify the product mix beyond the traditional current, savings and time deposit accounts. There is room for innovations to offer tailored accounts for the youth, education, remittances of Palestinian Diaspora, a variety of balloon certificate of deposits, Islamic accounts, and so on. Further flexibility in minimum balances, withdrawals, and interest rates are required,
2. Branching into rural areas. Current population served by a bank branch is 21,900 in WBG, in contrast to 4000-10,000 in the MENA region and 1,500 in Germany. The

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

3. Downscaling to address the pent up demand for credit by micro and small Enterprises, and
4. Transparency of banking practices, retail fees and truth in lending.

Third: The Palestinian Monetary Authority

1. Put into effect the current plan to introduce a Deposit Insurance Corporation,
2. In collaboration with commercial banks, raise the loan to deposit ratio gradually and consistently over time, downscale banks to address the needs of micro and small enterprises and build the credit provision capacities of the banking sector,
3. Envelop further expansion of bank branches into a campaign to increase the penetration of banks into rural areas by relying first on Cash Offices as a first step to broadening it to a Bank Office when conditions permit, and
4. Encourage the establishment of mutual funds through either the existing commercial banks by creating investment banking services or by allowing the private sector to launch mutual investment funds corporations. The latter has been the preferred way in many of the industrial countries.