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Document for Discussion

Official Development Assistance and Blended Finance in Palestine

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Introduction

Blended finance aims to strategically use development finance for the mobilisation of additional finance toward sustainable development. Blending has become a mantra for donors, both bilateral and multilateral agencies, and as shown by a survey by the OECD Development Assistance Committee (DAC), most donors are increasingly participating in blending schemes (Sangaré and Hos, 2017).

There is no consensus definition of blended finance, as it varies according to different donors and analysts (OECD, 2018)[1]. The definition adopted by the United Nations (UN) in 2015 at the Addis Ababa Action Agenda (AAAA) of the Third International Conference on Financing for Development refers to blended finance as "combining concessional public finance with non-concessional private finance and expertise from the public and private sector". According to the OECD, blending can be "broadly defined as the combination of public concessional official development assistance (ODA) with private or public resources, aiming at 'mobilizing' or 'leveraging' development finance from other actors" (OECD, 2018). For its part, the International Financial Institutions Working Group (FIWG) defines blended finance as "combining concessional finance from donors or third parties alongside DFIs' [development finance institutions'] normal own account finance and/ or commercial finance from other investors, to develop private sector markets, address the Sustainable Development Goals (SDGs), and mobilize private resources". (World Bank, 2020).

In general, blended finance using different financial mechanisms seeks to shift the risk-return profile of projects in targeted countries and sectors to attract and mobilise additional commercial capital. Blended finance explicitly focuses on generating a catalytic effect crowding in commercial financing enabling viable projects that in the absence of support would not materialize. In this respect, it must be clearly differentiated from other forms of financial interventions, such as impact investing, co-financing, and public-private partnerships (DAI, 2016). Besides mobilizing additional capital, blended finance would also contribute to demonstrating that investments similar to those that are supported are also viable. Thus, it would create an enlarged market for commercial capital, and it could also contribute to direct commercial lending to underserved areas delivering financial returns while having a development impact (Pereira, 2017). OECD estimates indicate that, during the period 2012-2020, blended finance mobilized worldwide, US $ 257.6 billion from the private sector through official development finance interventions (OECD, 2021).

This report, as provided by the terms of reference examines the blended finance experience in Palestine. It focuses mainly on the case of the EU´s development finance institutions' investments in Palestine, examining, among other issues, their contribution to national development. The report is based mainly on the examination of secondary sources, and available data. A major limitation for an in-depth evaluation of the impact of blended finance is the difficulty in accessing data regarding specific blending projects, and the lack of impact assessments of the different blending financial interventions that have been implemented in Palestine over time.

This report is organized into three sections and supporting annexes. The first section presents some general features of blended finance, examining among other issues the main instruments utilized, some methodological problems which make impact assessment of blending

[1] Refer to this publication for a discussion of different definitions of blended finance.

interventions a complex undertaking, and provides some information about the effectiveness of blended finance based on the existing literature. This discussion provides the framework for the assessment of blended finance as a component of official development assistance (ODA) in Palestine. The second section examines the situation of financing to the private sector in Palestine by the financial system, mainly banks and microcredit financial institutions. It mainly aims to assess the extent of a gap between the demand and supply of finance creating an environment in which blended finance could make a real difference in promoting further private sector investments in productive activities. Section three examines the evolution of ODA to Palestine based on available information, and, in that context, the extent to which blended finance has been implemented, and its impact on economic development. The report ends with some general conclusions and recommendations.

1. Blended Finance: Some Basic Issues

The utilization of different blending instruments is not new. For a long time now, donors have implemented different programs aimed at leveraging additional finance to increase the investment ratios in recipient countries and directing investment to its most productive uses. Many donor programs have traditionally included, for example, credit guarantees and grants in their design. But more recently, the idea of blending has gained traction and is playing a growing role in the activities of both multilateral and bilateral donors. It is progressively competing with, and replacing to a large extent, the provision of subsidized developmental loans to the public sector. Blended finance has evolved from a niche activity of donors to a main facade of development finance.

The current emphasis on blended finance is the result of a paradigm shift, moving the private sector to the forefront of development efforts, while gradually retracting the historically assumed central role of the state in this regard (Oxfam, 2017). At the same time, blended finance is increasingly viewed as a market-building instrument that could help attract commercial finance to confront the lack of enough funding and resources to achieve the ambitious Sustainable Development Goals (SDG) (IATFDF, 2018; IDFC, 2019). In the case of Palestine, for example, the establishment of the *EU–Palestine Investment Platform*, with the objective of attracting investment through the mobilisation of additional public, institutional and private financing, reflects such a trend.

The growing reliance on the private sector to foster economic development, and donors to finance these development efforts, was explicit in the first EU-Palestine Business Forum in December 2022 (UN, 2022). Such emphasis on reinforcing the role of the private sector in development cannot be seen in isolation from the multiple initiatives that have been launched over time. Relentlessly promoting the political notion of "economic peace" under different programs, plans and strategies, while rebranding the same rationale i.e., Palestinians improved welfare **could** be a core element in reaching a final solution to the protracted conflict. Of course, no one would argue against improved welfare, but it is the process and assumptions made about such 'welfare' (depending on who defines it) that need further constructive criticism for the collective prosperity of Palestinians. A growing body of research is emphasising the fact that 'welfare' can never be achieved without first addressing the main cause of Palestinian anguish, which is the Israeli occupation (MAS, 2022; Radi, 2022; Harker, 2021).

There are different ways through which blended finance is thought to contribute to development. It allows more bankable projects to be brought to market readiness; it makes capital available in under-represented markets and sectors; it brings new investors and skills, while creating efficient financial markets; and it leads to fully commercial solutions thus freeing public funds for new development projects (IDFC, 2019). The creation of these outcomes should be the criteria for assessing blended finance interventions. They could be achieved through different types of intervention: technical assistance (particularly important in the early stages contributing to the preparation of projects to improve their business viability), risk underwriting (to improve the credit profile of new projects or existing firms) and market incentives (aimed at assuring the viability of projects in the absence of market fundamentals). Market incentives are particularly important for projects with high social and developmental impact (Koenig, 2022).

To achieve the development objectives and operationalize the different types of interventions, blended finance utilizes different instruments to leverage additional commercial finance to support private sector projects. The instruments utilized by donors differ depending on the

conditions in the recipient countries and sectors, particularly on the degree of financial maturity of the target country. The complexity of the instruments also varies considerably. Some instruments focus on the cost side by providing support or mitigating risk-reducing transaction costs, while others work on the revenue side by providing incentives for private investment. In the case of countries in which small and medium enterprises constitute the bulk of firms, and with highly developed financial markets the most utilized instruments are guarantees, grants and technical assistance.

Table 1 presents some of the different instruments utilized in blending. Additionally, in the literature hedging and securitization are also viewed as instruments that could support blending.[2]

Table 1 :Instruments for Blending

Intervention Type	Description
1. Guarantees	Enhance credit by strengthening the creditworthiness of the investment because of the promise from the guarantor to assume the risk in case of default. There are different types of guarantees including first loss, partial risk, or credit guarantees and trade finance guarantees.
2. Grants	Capital paid in without any expected repayment or compensation over a fixed period. Fund-specific costs and activities that decrease overall project costs and increase chances of success. It could include money for technical assistance or project preparation to bring a project to bankability, and procurement of capital goods reducing the overall cost of the project and the amount of required financing.
3. Technical Assistance	It has various uses to reduce project risks and thus making it more feasible to raise commercial capital, lowering transaction costs and risks for investors linked to new projects. It can also help improve the quality of the project—for instance, by funding impact studies—thus increasing the likelihood of success.
4. Insurance	Reduces project risk by providing protection to investors by promising to compensate for a specified loss or damage in return for payment of a specified premium. There are many types of insurance. For example, political risk insurance to protect against adverse government actions or war, civil strife, and terrorism. This also includes insurance for farmers against weather risks.
5. Junior/ subordinated capital also termed Structured finance—First loss capital	Subordinated (debt) or junior (equity) protects senior investors by taking first losses on the value of the security. That is if something goes wrong, the most junior/subordinated tranche will be paid out last. First-loss capital takes a position that will suffer the first economic loss if the assets below it lose value or are foreclosed on.
6. Equity investment	Equity investors take a percentage of the ownership of the company or project. The money provides funding for the project but also demonstrates viability and provides other comfort for investors (for instance, investors could see this as a guarantee of the quality of the project, or of a reduction in the risk that the host government might interfere)
7. Results-based incentives	For example, pay-for-performance schemes. These are Instruments that provide incentives and disincentives to achieve desired outcomes or results (tie at least a portion of payments to achievement), including social impact bonds and performance-based contracts. This type of financing is aimed at rewarding innovation and successful implementation of a project
8. Contractual mechanisms	There are various contractual and project finance arrangements to support the development of bankable infrastructure projects including public and private off-taker agreements, subsidies such as feed-in-tariffs, and tax credits. These mechanisms involve an agreement between producers and buyers of a resource to purchase or sell portions of future production

Adapted by the author from WEF-OECD (2015) and Blended Finance Taskforce (2018)

[2] Hedging reduces the risk of adverse current price movements in an asset and its associated earning stream, while securitization aims at transforming a pool of illiquid assets into tradable financial instruments (securities).

According to a survey conducted in 2021, which covered 22 development agencies, grants for technical assistance were the respondents' most preferred instrument utilized for current and future operations, followed by guarantees and insurance (Lee, Cardenas and Pleeck, 2022).[3] Other instruments like outcome/performance payments, subordinated debt, equity, and senior debt, were also utilized by the respondents but much less frequently. The same survey shows that the principal objective of almost all the respondents (21 out of 22) is to support innovation and build new markets with development and climate change impact. Only around half of the agencies stated that the principal objective of their interventions is to expand the mobilisation of finance from the private sector and/or promote financially sustainable investments, which in principle is the main contribution of blended finance to private sector development. The main target sectors of the agencies' interventions are infrastructure and climate mitigation and adaptation, followed by SMEs and agriculture. The main obstacles to the provision of blended finance are the shortage of commercially viable projects (77% of the respondents) and the shortage of in-house investment expertise (72%), which would explain their predominant adoption of technical assistance in blended finance operations.

Core concepts in blended finance

The concept of additionality is a central element in blended finance. In general, additionality means that an intervention will lead to outcomes which would not have occurred without the intervention, explicitly implying that additionality requires establishing a causal relationship between the intervention and the additional effects. Furthermore, additionality implies that the interventions will complement or supplement existing financing alternatives and correct market failures, rather than compete with the private sector or crowd out other actors. Financial additionality refers to the additional capital leveraged in the market by private or public institutions as a result of the injection of assistance funds into blended finance. Development additionality refers to a higher development outcome as a result of the intervention, or when a development impact is secured through a commercial investment that otherwise would have not materialized.[4]

A core concept related to financial additionality is the financial leverage ratio, which is how much additional money is raised by each dollar invested in blending. Critics suggest that the ratio is very low, particularly in lower-income countries where it is estimated at only 0.37 per dollar invested, and 0.65 in lower-middle-income countries (Attridge S. and Enger L., 2019). However, data are scarce, Lee, Cardenas and Pleeck (2022) found that around 60 per cent of the agencies included in the survey reported having no data on the amount of private finance mobilized per dollar of concessional finance in blended operations. What is important with respect to financial additionality, is not only the additional capital that is raised, but also whether the additional funding is allocated to projects that otherwise would not be financed based on market fundamentals, or to unrepresented areas or sectors that otherwise do not receive the needed finance. Blending can increase the funds provided by the financial sector, but it is possible that those funds may be allocated to projects that would have been financed anyway in the absence of blending. In this case, the effect is just to mitigate the risks assumed by the banks. In situations in which the financial sector has sufficient lending resources to fulfil market demands, there is a considerable risk that blending instruments would generate such inefficiencies.

[3] The survey targeted 45 development agencies but only 22 responded. While the survey provides some very useful insights, one should be cautious in generalizing results based on such a small sample size.

[4] For a discussion on the concept of additionality refer to Winckler, et al. (2021).

Opportunity cost is an additional issue concerning development additionality i.e., what could have been achieved if the funds were used differently or if other alternatives were considered? Blended finance is replacing to some extent subsidized loans to the public sector for investing in social programs. Therefore, it would only be efficient to the extent that the blending intervention generates better results than what could have been achieved by providing funds directly to the public sector to implement its developmental initiatives.

Issues of concern

There is consensus in the literature on the complexity involved in assessing the impact of blended finance (Winckler et al., 2021; Attridge and Enger, 2019; THK Transparency Working Group 2020). Such complexity emerges from the different definitions of blended finance, the absence of a common terminology and the lack of agreement on the appropriate evaluation methods. Issues of concern also include the diverse understanding of the different dimensions of additionality and how these should be evaluated; the insufficient disaggregation of data, and how to evaluate the various financial instruments utilized. There is also an ongoing discussion on whether financial and developmental additionality should be assessed separately or jointly in the impact assessment of the different interventions.

Proper methodologies and mechanisms should be devised to accurately measure and monitor in aggregate the impact of blending finance projects. Impact assessments should be made for each of the specific interventions (see for example World Bank, 2020). One of the challenges in preparing this report has been the limited number of easily available assessment reports of the blending initiatives implemented in Palestine over time.[5] In the context of the overall ODA received by Palestine, section three discusses some blending initiatives, mainly from the EU. However, the assessment of the specific interventions is beyond the scope of this document. Such an effort is urgently required to assess if the progressive shift of ODA to blending has produced increasing "developmental fruits," which would be reflected in the improved welfare of the Palestinian population.

[5] An example of an assessment of the impact of a project is the one undertaken by the KfW Development Bank of a credit guarantee fund (2015).

2. Palestine: Credit to the Private Sector

The Palestinian financial sector is comprised mainly of banks; the capital markets are at an incipient level of development. There are also several microfinance institutions. The Palestinian banking sector, supervised by the Palestine Monetary Authority (PMA)[6], consists of 13 private banks with 379 branches operating in the West Bank and Gaza.[7] The sector exhibits a high level of concentration, with two large banks having a joint market share of close to 50 percent. Functioning in a complex political and security context and confronting high economic fluctuations, the banking sector has generally managed to remain stable and profitable. Capital adequacy, return on equity and assets, and the ratio of non-performing loans show are all within international standards. Furthermore, according to the 2020 Doing Business Report of the World Bank, Palestine ranks very well in the dimension 'getting credit', ranking 25th among the 190 economies included in the Report.[8]

Nonetheless, there is a high level of financial exclusion in Palestine, measured as the proportion of the population that does not have access to financial services as highlighted by the financial inclusion survey conducted in 2015 (see Abdullah et al., 2016). Furthermore, as noted by Abu Karsh and Deek (2019), "several studies, which were carried out in the Palestinian credit space, have uniformly agreed on the pre-existence of a significant gap between finance demand and supply in Palestine". The mismatch between financing demand and supply is present in both corporate lending and microfinance.

The financial sector in general, and banks, have an important role to play in the economy. They must facilitate transactions by providing mechanisms and networks of payments, mobilize savings for investments, and allocate savings to their more socially productive uses. The performance of those functions is what Tobin (1984) called *functional efficiency*. In this section, we briefly examine the performance of the Palestinian banking sector, in particular the degree to which it satisfies the financial needs of the private sector, and the extent to which savings are channelled to productive investment. This examination is important to assess to what extent blended finance could contribute in a significant way to improve the efficiency of the financial sector in Palestine.

The ratio of credit to the private sector to Gross Domestic Product (GDP) is the indicator traditionally used in international comparisons of financial development and deepening.[9] In the case of Palestine, the ratio increased significantly over the past two decades, from 24.6 per cent in 2004-07 to 50.3 per cent in 2020. This reflects the development of financial services in the territory. Even though the ratio is above the average for lower middle-income countries (45.8 per cent) (the income group to which Palestine belongs), it is close to the average for the Arab World (54.1 per cent) and it pales in comparison with neighbouring countries. It stands at 106.6 per cent in Lebanon, 82.2 per cent in Jordan, and 67.6 per cent in Israel.[10] This shows that there

[6] In the absence of a national currency, the PMA focuses on fiscal policy and regulating the banking sector, financial institutions, and money changers. It is the sole holder and manager of the Palestinian foreign currency reserves

[7] 6 Palestinian banks, 6 Jordanian, and 1 Egyptian.

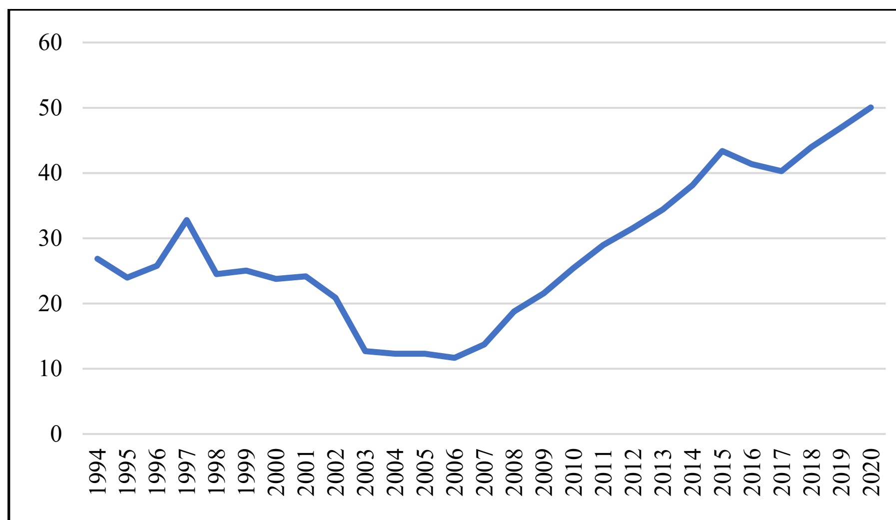
[8] The topics included in the Report to rank countries in the getting credit dimension are: strength of legal rights, depth of credit information index, credit registry coverage (% of adults), and credit bureau coverage (% of adults).

[9] As defined by the World Bank, "domestic credit to private sector refers to financial resources provided to the private sector by financial corporations, such as through loans, purchases of nonequity securities, and trade credits and other accounts receivable, that establish a claim for repayment. For some countries, these claims include credit to public enterprises. The financial corporations include monetary authorities and deposit money banks, as well as other financial corporations where data are available (including corporations that do not accept transferable deposits but do incur such liabilities as time and savings deposits). Examples of other financial corporations are finance and leasing companies, money lenders, insurance corporations, pension funds, and foreign exchange companies".

[10] World Bank Data. Development Indicators. Available at: https://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS?locations=PS

is still room to provide more credit to the private sector while maintaining/reducing the banking system lending to the public sector (which currently stands at 23% of total credit facilities).

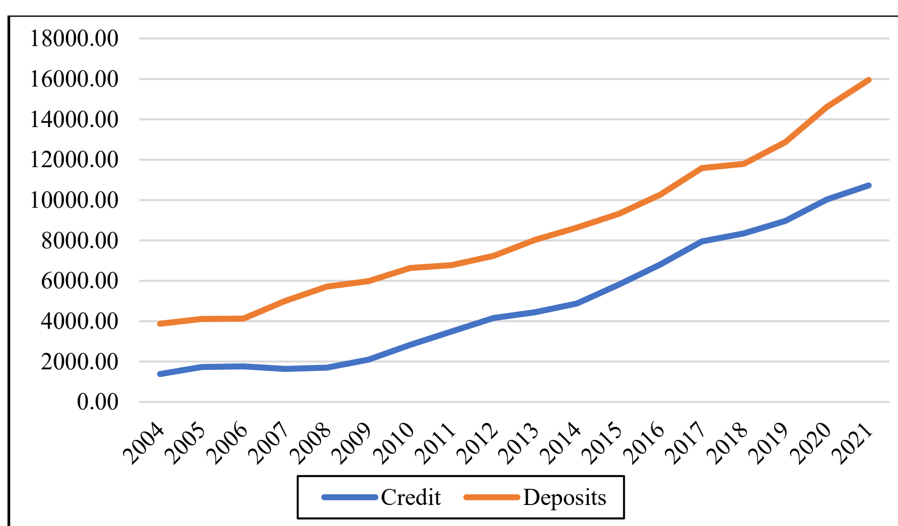
Figure 1. Credit to the Private Sector as a Share of GDP: Palestine, 1994-2020



Source: World Bank.

Historically, Palestinian banks have had sufficient resources to provide more credit to the private sector without jeopardizing financial stability, as deposits have been much higher than the total credit facilities provided to domestic clients. Figure 2 shows the evolution of total credit facilities and that of deposits of residents. If we include deposits in Palestinian banks of non-residents and of banks operating abroad, the available resources to provide credit would be slightly higher.[11]

Figure 2. Evolution of Bank Sector Deposits of Residents and Credit Facilities: Palestine, 2004-2021 (millions of US $)

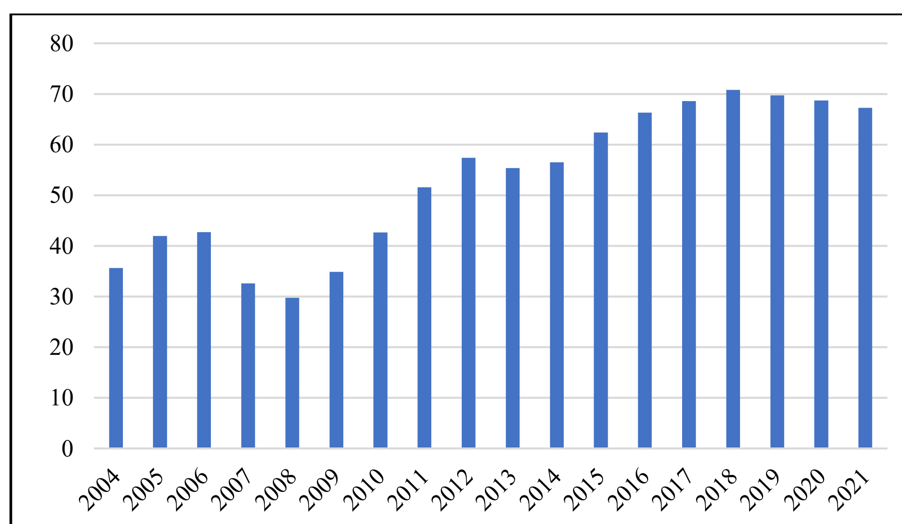


Source: Palestine Monetary Authority

[11] In 2021 deposits of non-residents in the Palestinian banks amounted to US $ 780 million Based on the statistics published by the PMA.

The ratio of credit to deposits has steadily increased over the past 25 years indicating that a higher proportion of deposits have been used to satisfy financing needs in the economy (see Figure 3).[12] The ratio particularly increased after 2008, as the PMA issued instructions that set a cap on the amount of funds that banks can invest aboard (55% of total deposits), and introduced restrictions on where and how the funds can be invested to strengthen financial stability and reduce the risk exposure of banks (Instruction No. 05 for the year 2008: Capital and Financial Indicators).[13] During 2019-2021 credit facilities amounted, on average, to 68.5 per cent of total bank deposits. Even after taking into consideration the prudential reserves mandated by the PMA (which currently stand at nine percent), the requirement to hold 3 per cent in cash in vaults, and an additional 3 per cent to meet daily customer cash withdrawal needs; the ratio of credit to deposits is still relatively low in comparison to the average in regional markets (80 percent) (US International Trade Administration, 2022). Palestinian banks' excess funds are either deposited with the PMA or in financial institutions abroad.[14] Independently of the evolution of deposits and credit facilities, a major problem that Palestinian banks are currently confronting, and that seriously hampers their operations, is the excess accumulation of physical shekel cash in their vaults due to constrained shekel correspondent cash services and Israeli ceilings on the amount of cash shipments that can be sent back to the Bank of Israel (IMF, 2022).

Figure 3. Ratio of Credit Facilities to Deposits, 2004-2021 (%)



Source: Palestine Monetary Authority. Elaborated by the author.

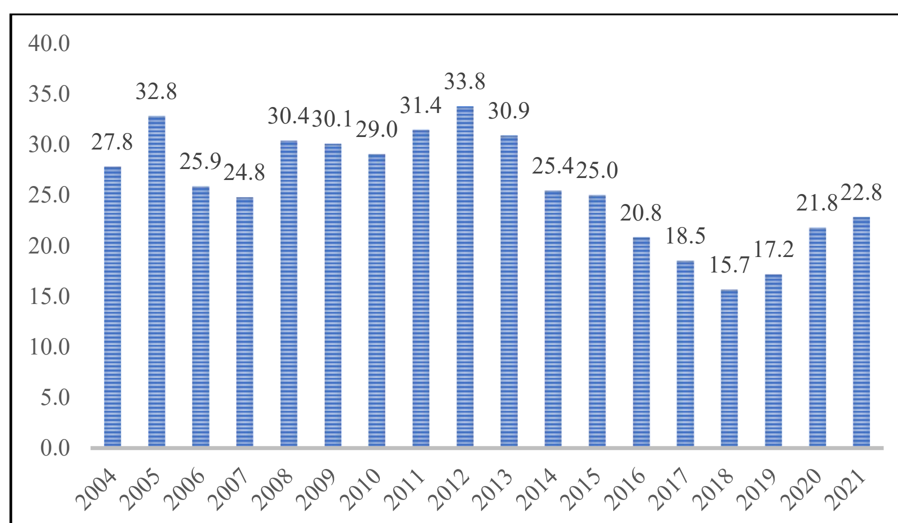
Not all credit facilities are geared to satisfy the financial needs of private sector firms and households. An important feature in the Palestinian case is the relatively high weight that the public sector has as a recipient of credit (see Figure 4). The relative importance of the PA as the recipient of credit from the Palestinian banks has been declining, but it is still significant. Of all credit facilities allocated by the banks in 2021, 22.8 per cent went to the PA. Other public entities and local governments are marginal participants in the financial system. Between 2019-2021, they received an average of US $ 19.6 million in annual credit facilities.

[12] According to the US Department of State (2022), the increase in the loan-to-deposit ratio responded to the PMA's encouragement to banks to participate in loan guarantee programs sponsored by the United States and international financial institutions, by supporting a national strategy on microfinance, and by imposing restrictions on foreign placements.

[13] https://www.pma.ps/Portals/0/Users/002/02/2/Legislation/Instructions/Banks/2008/instructions-5-2008.pdf

[14] See Consolidated Balance Sheets of Banks Operating in Palestine. PMA database.

Figure 4. Direct Credit Facilities to the PA as a Percentage of Total Credit Facilities, 2004-2021 (%)



Source: Palestine Monetary Authority. Elaborated by the author.

The weight of the public sector as a credit recipient is not only the result of the level of direct credit to the PA. As the IMF (2022b) has noted, loans to PA employees add an additional 16 per cent of the loans of the Palestinian banks in indirect exposure, and there is further indirect exposure through loans to PA suppliers with PA guarantee. Therefore, close to 40 per cent of all credit facilities are linked in some way to the Palestinian public sector. Credit to public employees is reported in the data to credit to the private sector. It should be noted that t PA employees have the highest percentage of borrowing among labour market segments since they have formal employment contracts and can use their future income as collateral. On the other hand, a large percentage of private sector employees do not have formal contracts and cannot enjoy the same benefits. Banks' preference to provide credit to more secure recipients, and in this case, it is mostly in the form of consumable loans, has limited the amount of funding that is directed towards productive purposes, which is perceived as less secure. However, the ongoing fiscal crisis of the PA, and its inability to pay public servants wages in full, could potentially alter banks' perspective of PA employees' secure income, making their level of risk more comparable to others, and opening the door for more funding directed towards other economic segments and sectors.

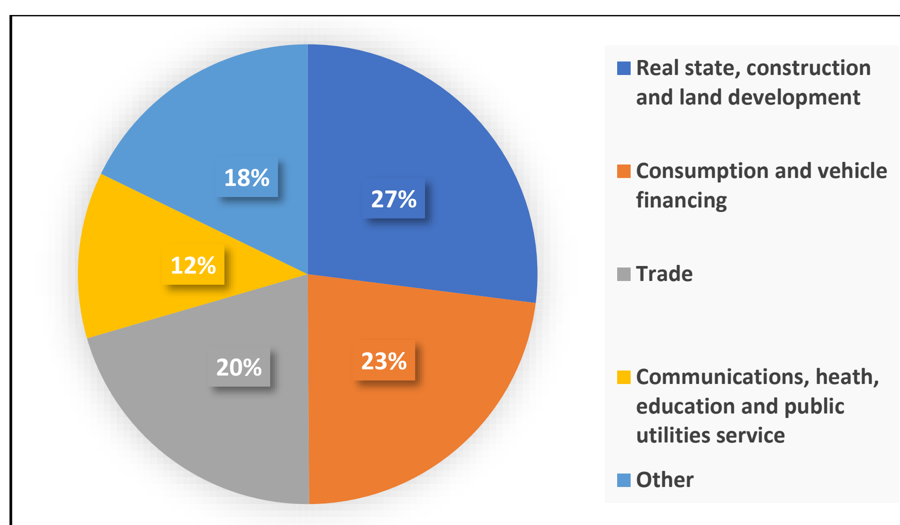
The PMA Monetary Authority and the banking sector have stated that banks can no longer provide further loans, as the PA has already exceeded established lending limits (100% of the banking system equity). Therefore, not only is the total credit in Palestine below its potential given the resources available to the banks, but also a significant proportion of the credit is given to the public sector, either directly or to public employees or suppliers with public guarantees. What is left goes to private sector firms and households other than public employees.

Figure 5 shows the allocation of bank credit to the private sector by economic activity in Palestine. One important feature is the limited provision of bank credit to productive sectors. During the period under consideration, mining and manufacturing received only 6.3 per cent of all credit to the private sector; agriculture and food processing received 1.8 per cent and tourism only 1.1 per cent. Thus, less than 10 per cent of credit to the private sector is allocated to those activities, significantly less than their combined contribution to Palestine's GDP. The bulk of credit is allocated to real estate, consumption credit to households (including public

employees), and retail and wholesale trade. This situation has not changed over time, despite the efforts undertaken by the authorities and donors through the implementation of different programs and instruments aimed at increasing the allocation of credit to productive investments, which would generate employment opportunities. The government has also launched several initiatives, but they have not been very fruitful (Morrar and Razeg, 2021).

Finally, it should be noted that credit to the private sector in Palestine is mainly short-term credit. There is a notorious absence of long-term credit facilities, which are required for productive investments.

Figure 5. Palestine: Allocation of Credit Facilities to the Private Sector by Sector of Economic Activity (Average 2018-2021)



Source: Palestine Monetary Authority. Elaborated by the author.

In Palestine, bank lending is complemented by microfinance institutions (MFIs). Microfinance has experienced significant growth since new regulations were introduced in 2011 (IFC, 2017; (Abu Karsh and Deek, 2019), both in terms of the number of clients and the size of the portfolio. MFI operations are mostly limited to lending, as they are not allowed to take deposits, offer remittances, or act as agents for banking services. Currently, there are 8 MFIs affiliated with the Palestinian Network for Small and Microfinance (SHARAKA), operating under various legal structures: non-governmental organizations (NGOs), co-operatives, non-profit companies, and donor programs.[15]

MFIs provide both consumption and business loans. The IFC (2017) estimated that 53 per cent of clients get credit for consumption and housing, while retail trade takes 20 per cent, production and agriculture 16 per cent, and services 11 per cent. Although the structure of the portfolio of MFIs differs somewhat from that of the banks, it is equally centred on consumption, housing, and retail trade. A significant proportion of the resources available for lending by the MFIs is provided by donors. It is estimated that the outstanding portfolio of the MFI is nearly US $ 500 million, with an average loan of US $ 2,500. Microfinance has still a relatively low penetration rate in Palestine. The PMA estimates that only 3 per cent of adults have at least one type of regulated credit account with an MFI.[16]

[15] ASALA, VITAS, REEF, UNRWA, PDF, ACAD, FATEN, Al-IBDAA.
[16] PMA Webpage.

The objectives of blended finance are to leverage additional funds from other actors, private or public, to bridge the existing investment gaps by reducing the actual or perceived risk for private investors, and to channel investment to their more socially productive uses. Therefore, it is important to assess the current situation in Palestine, as the existence of a gap between financing demand and supply is a recurring theme raised by analysts, and as the previous analysis has shown there is a significant margin, under the present conditions, to increase bank lending which is below its potential. It should be noted that the situation in the West Bank and that of Gaza differs radically in terms of the performance of banks and other financial institutions' lending to the private sector and of investments in general.

Businesses' access to finance
The World Bank Enterprise Surveys provide important information to assess the situation of corporate financing in Palestine. First, the degree of bank utilization by firms in Palestine is not significantly different from the average in the Arab World (AW) or that for all countries included in the survey (AC). While 83.6 per cent of firms in Palestine have a checking or savings account, the percentage is 83.3 and 87.6 for the AW and all countries, respectively.

Second, the proportion of firms that identify access to finance as a major constraint is not significantly different from the average in the AW and AC included in the survey. In Palestine, 26.1 per cent of firms identify access to finance as a major constraint, in the AW and AC the proportions are 25.6 and 22.6 per cent, respectively. However, the results for Palestine are highly biased by the situation in Gaza where 50.9 per cent of firms identified access to finance as a major constraint. In the West Bank, only 16.9 per cent of firms identified this as a major constraint, a proportion significantly below that in the AW and AC. The data indicates that access to finance is not generally perceived as a major problem by firms in the West Bank, while it is a major constraint in the suffocated and isolated Gaza Strip.

Third, very importantly and closely linked to the previous observation, is that a high proportion (67.5 percent) of the firms in Palestine indicate that they do not need a loan. This is much higher than the percentages observed in AW (57.4 percent) and AC (50.5 percent). Again, the aggregate data for Palestine is strongly biased by the results in Gaza. While 51.5 per cent of firms in Gaza indicate they do not need a loan, in the West Bank, an astonishing 73.6 per cent of firms indicate they do not need loans. To the extent that the World Bank data correctly reflects the situation in Palestine, it is clear that there is insufficient demand for bank financing and more than enough financial resources available to the banks to increase lending. The survey data shows that 90.1 per cent of firms in the West Bank, and 87 per cent in Gaza finance investments internally, a significantly higher proportion than in AW (72.2 per cent) and AC (72.7 percent).

Table 1 presents selected results of the World Bank 2019 Enterprise Survey related to access to finance. Data is self-explanatory and we will not dwell much on it. However, it is important to highlight the issue of collateral. High levels of collaterals are frequently presented as an explanation for the limited bank lending penetration in Palestine. Data from the survey suggests that this perspective needs to be seriously examined. In the case of the West Bank, survey data indicate that the value of collateral needed for a loan, expressed as a percentage of the loan amount, is on average significantly lower than the average in the AW and AC included in the survey.

One of the rationales behind the programs offering credit guarantees is to minimize the effect of collateral as a barrier to access to credit, thus minimizing the risk for the lender. In the case

of Palestine, the amount of the collateral required does not seem to be the main issue explaining the low reliance on bank credit. The main explanatory factors are the lack of demand due to the absence of profitable investment opportunities and firm size.

Table 1. Palestine: Indicators of Access to Finance in Comparative Perspective

	Palestine	Arab World	All countries in the survey
Percentage of firms with a bank loan or credit	West Bank 14.0 Gaza 5.8	27.6	33.0
Percentage of firms using banks to finance investments	West Bank 7.8 Gaza 8.4	28.0	25.5
Proportion of investment financed by banks	West Bank 5.9 Gaza 3.0	14.7	14.3
Percentage of firms using banks to finance working capital	West Bank 16.5 Gaza 3.0	29,5	28.7
Proportion of working capital financed by banks	West Bank 6.7 Gaza 1.2	13.3	11.1
Percentage of firms using supplier/customer credit to finance working capital	West Bank 17.4 Gaza 30.2	22.5	24.8
Proportion of loans requiring collateral (%)	West bank 83.0 Gaza 63.1	82.5	75.0
Value of collateral needed for a loan (% of the loan amount)	West Bank 133.8 Gaza 488.3	204.7	197.3
Percentage of firms whose recent loan application was rejected	West Bank 12.4 Gaza 27.9	10.6	10.1

Source: World Bank. 2019 Enterprise Survey.

In Palestine, informality is widespread and 98 per cent of the total number of firms are micro and small enterprises. Most of these businesses are sole entrepreneurships, which mainly use personal accounts as opposed to business accounts for their transactions. Therefore, the separation of corporate loans and personal loans is complicated. It is important to examine data on access to banking services by individuals and not only by firms.

Financial inclusion

The World Bank Global Findex Data Base 2021 provides some important information on the utilization of financial services at the individual level.[17] In addition, an IFC survey among households, farmers and micro, small and medium-sized businesses in May and June 2021 (IFC, 2022) provides useful additional information on the use of financial services in Palestine.[18]

According to the Findex Data Base, which allows international comparisons, 27 per cent of adults in Palestine have an active bank account, up from 20 per cent in 2014. Most of them have only savings accounts. Other sources indicate that the most used type of account is the checking account to receive salaries and obtain loans.[19] This level is much lower than in Jordan (41 per cent) and Israel (89 per cent). This low demand for bank accounts results from the fact

[17] The Findex Data Base includes 300 variables. We have only used selected ones that are relevant for our purpose. Available at: https://www.google.com/search?q=Global+Findex+Data+Base+2021&rlz=1C1VDKB_esPE1004PE1004&oq=Global+Findex+Data+Base+2021+&aqs=chrome..69i57j0i13i512l2j0i390l4j69i60.3040j0j15&sourceid=chrome&ie=UTF-8

[18] We have not been able to access the raw data of the IFC survey. Data is extracted from the publication.

[19] Financial inclusion surveys 2016, and 2022.

that 46 per cent of adults indicate that they do not need a bank account, and an additional 25 per cent indicate they do not need an account because somebody in the family has one. Furthermore, 16 per cent state that they do not have a bank account for lack of money, and 14 per cent for religious reasons.

Data shows the limited use of credit by individuals in Palestine. Only 5 per cent of adults formally borrowed money in the year before the survey, including through credit cards. This contrasts with 10 per cent in Jordan and 80 per cent in Israel. The average for lower middle-income countries is 12 percent, and for all developing countries 22 per cent. In Palestine, there is more reliance on borrowing from relatives and friends, as 31 per cent of adults had borrowed from these sources during the year before the survey.

The IFC survey shows a relatively higher level of traditional account ownership among respondents, compared with the Findex survey figures. However, it confirms the limited access to and usage of financial services in all three categories included in the survey: households, farmers, and MSMEs. An important result of the survey is that 90 per cent of respondents indicated that access to financial institutions, banks, and MFIs, is very easy or easy. Therefore, the low adoption of formal financial services is not the result of transactional barriers but is the result of low economic development and lack of resources. The survey shows that only 19 per cent out of the 55 per cent who hold bank accounts have taken out a loan, and that less than 5 per cent of households frequently make use of credit cards. This indicates the prevalence of savings accounts as the means of using financial services. However, only 51 per cent of respondents indicate their preference to save in bank accounts, with the rest keeping cash at home or in gold.

Regarding receiving loans, the IFC survey shows that just over 10 per cent of the household respondents had borrowed money from a financial institution, banks, or MFIs, which is a higher proportion than the one of the Findex Data Base. Around 80 per cent of farmers and MSMEs respondents indicated that they did not frequently make use of deposit accounts, personal loans, business loans, credit cards or debit cards. The results of this survey confirm the high level of financial exclusion prevalent in Palestine. Finally, the survey indicates that digital financial services are still underdeveloped in Palestine, though some progress has been seen in recent years with the licensing of 5 digital payments companies in 2021 and the launch of Palestine's first Neobank in 2023.

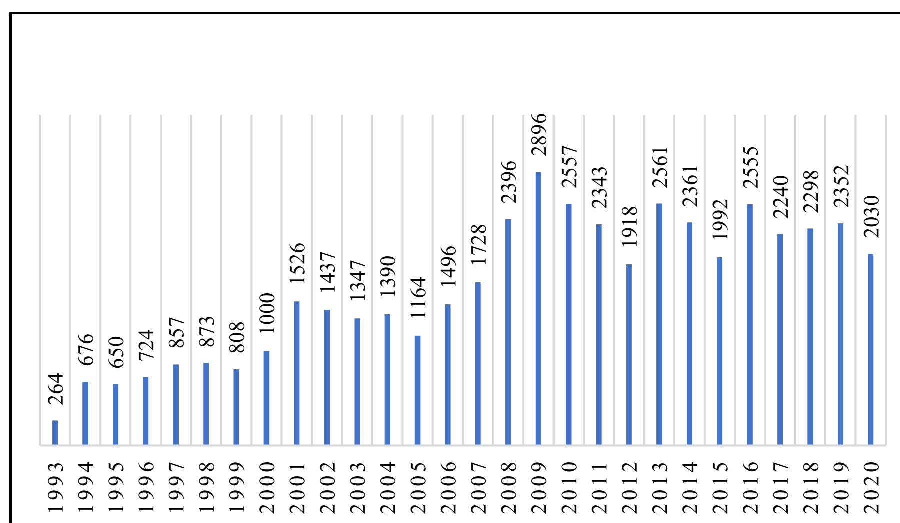
The main purpose of blended finance is to leverage additional funds through the utilization of different instruments to satisfy the demand for credit and channel them to the most productive uses. The central question regarding blending is to what extent the utilized instruments achieve additionality by facilitating credit that would not have been made in the absence of the scheme. Available data strongly suggests that in Palestine there is no strong demand for credit, either by firms or households, while banks have sufficient resources to provide higher levels of credit to the private sector. In the eventuality that loans to the PA are further constrained due to the high risk involved given the fiscal situation, the funds available to the banks for financing the private sector would be significantly higher. In this situation, there is a high probability that blending instruments would be supporting loans that banks would have made anyway, but are hesitant to provide as there is still a growing demand for loans from non-productive sectors, particularly real estate and housing, which are more profitable and secure. Scrutiny and further in-depth analysis are needed to identify the underlying factors generating the above-described situation in Palestine, both of firms and individuals, in terms of the limited reliance on formal financial institutions (and a larger reliance on informal not-for-profit alternatives like deferred

payments secured by personal cheques, lending from family and friends, saving and lending groups (ROSCA), etc.). The results of these efforts would certainly contribute to identifying the type of interventions that are required for enhancing the efficiency of the financial sector in Palestine so it can emerge as a handmaiden of growth and development.

3. Official Development Assistance and Blended Finance in Palestine

Palestine, since 1993, has been one of the main recipients of official development assistance (ODA) in the world. According to OECD data, Palestine received since that date US$ 46.4 billion of ODA until 2020, in constant 2020 prices. However, we should note that there are some shortcomings concerning data on ODA, and different sources present various estimates (Aid Watch Palestine, 2016).[20] Moreover, besides ODA, Palestine has received significant amounts of humanitarian aid through UNRWA. During the period 2008-2021, UNRWA had US$ 15.1 billion to finance its activities in Palestine, Jordan, Lebanon, Syria and elsewhere. And while not all of UNRWA´s budget is expended in Palestine; a significant amount is. Figures 6 and Table 2 present data on ODA and humanitarian aid available to Palestine. Some of UNRWA interventions also have a developmental goal, therefore the distinction is not a clear-cut.[21] In both cases, ODA and humanitarian aid, the European Union (EU) and its member states have been the main donors.

Figure 6. ODA Provided to Palestine, Constant 2020 US$ (1993-2020)



Source: OECD.

Table 2. Contributions to UNRWA's Budget by Source, 2008-2021 (Current million US$)

	Total	EU Members	EU Commission	Total EU	EU/Total (%)
2006		155.9	143.2	299.1	
2007		194.4	133.5	327.9	
2008	799.3	235.3	190.3	425.6	53.2
2009	1012	228.0	249.5	477.5	47.2
2010	840.7	226.4	165.2	391.6	46.6
2011	972.7	270.0	175.4	445.4	45.8
2012	907.9	453.5	204.0	657.5	72.4

20 The OECD data set does not clarify whether the EU member states' contributions include only bilateral aid to the West Bank and Gaza, or if they also include member states' contributions to European Union institutions that are designated for aid to the West Bank and the Gaza Strip.

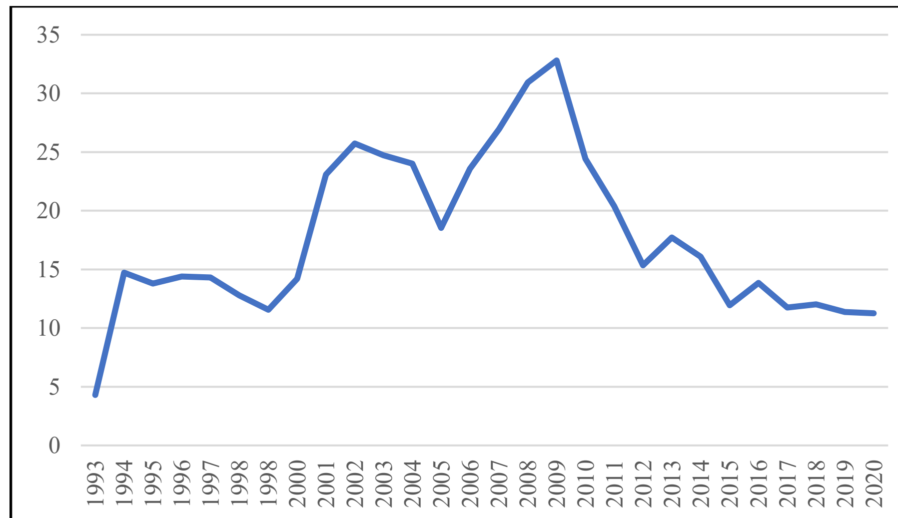
21 Some UNRWA projects include microfinancing and guarantees.

	Total	EU Members	EU Commission	Total EU	EU/Total (%)
2013	1219	305.0	216.4	521.4	42.8
2014	1323.8	344.0	139.0	483.0	36.5
2015	1246.0	329.3	136.7	466.0	37.4
2016	1242.9	309.3	159.7	469.0	37.7
2017	1221.1	308.5	142.5	451.0	36.9
2018	1276.4	464.8	179.0	643.8	50.4
2019	972.4	453.5	131.7	585.2	60.2
2020	940.3	408.8	157.0	565.8	60.2
2021	1188.3	427.9	117.6	545.5	45.9
Total 2008-21	**15162.8**	**4764.3**	**2364**	**7128.3**	**47.0**

Source: UNRWA website. Elaboration by the author.

As it can be observed in Figure 6, inflows of ODA into Palestine are still significant in constant terms. However, there has been a clear downward trend in recent years, along with its diminishing importance in stimulating the Palestinian economy. Figure 7 presents ODA as a percentage of Gross National Income (GNI) in current prices. During the peak years 2006-2009, ODA represented on average 28.5 per cent of GNI. It has declined to 12 per cent of GNI on average during the years 2017-2020. ODA per capita is another important indicator of its relative importance, and has also witnessed a similar trend (see figure 8). In 2020 ODA per capita in Palestine was US$ 422, while in the peak year 2009 it reached US$ 766 per capita.

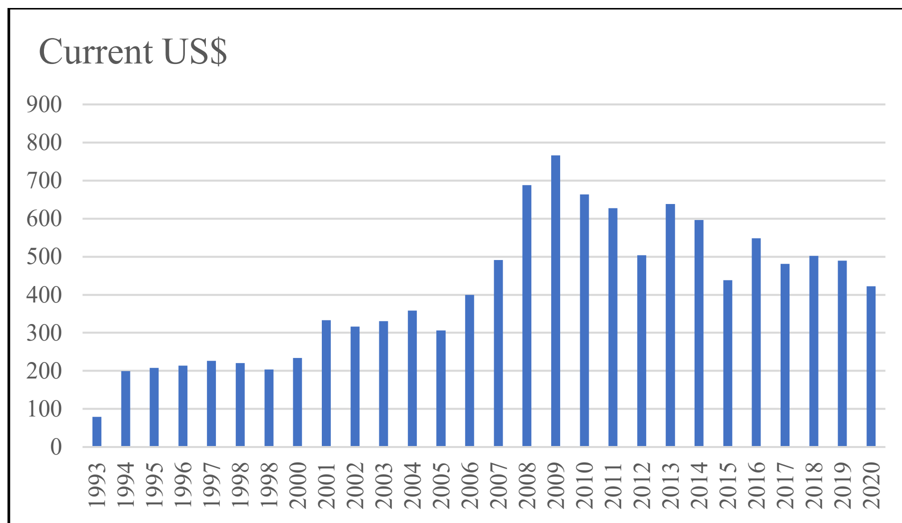
Figure 7. ODA as a Percentage of Gross National Income (GNI) between 1993 and 2020 (%)



Source: World Bank

The relationship between foreign assistance and development is one of the most debated topics in development policy. The debate shifted from discussing the rationale for mobilizing foreign resources to boost economic growth, to assessing the effective impact of aid on poverty and inequality. The results of different studies are not conclusive, and many analysts tend to suggest that it depends on many factors, including institutional quality and the degree of economic freedom prevalent in the recipient country.

Figure 8. ODA Per Capita, 1993-2020 (current prices, US dollars)



Source: World Bank

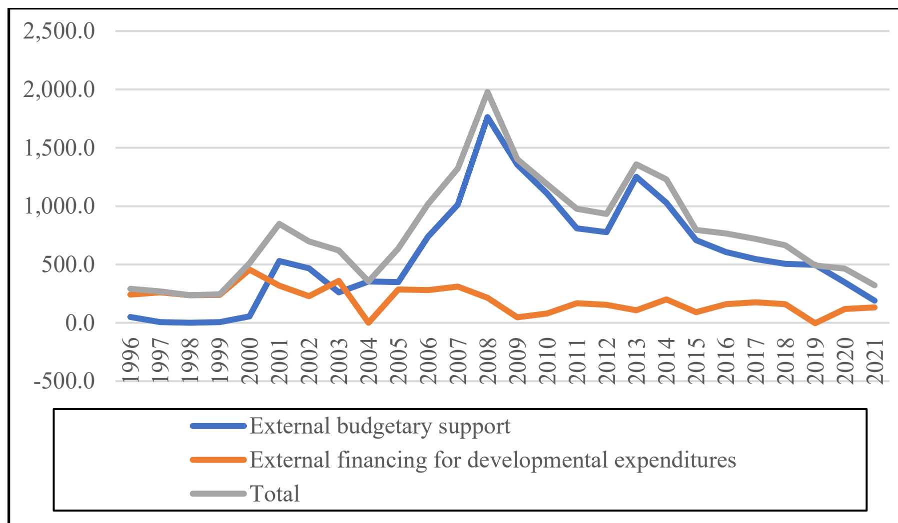
We will not dwell on the long-term effects of foreign assistance in Palestine, as this issue has been long and widely debated, equally with conflicting conclusions. However, available indicators of the ground realities in the Palestinian territory would clearly indicate, that despite the enormous ODA and humanitarian aid committed since the establishment of the Palestinian Authority (PA), there is not much to show for it. Palestine is a low-middle income country, with a GDP per capita, adjusted for purchasing power parity (PPP), that stands at less than half of comparator countries.[22] Unemployment has remained stubbornly high affecting around 20 per cent of the workforce. Similarly, the Palestinian Human Development Index (HDI) is 0.686, placing Palestine 119th out of 189 countries and territories.[23] According to the humanitarian needs assessment (OCHA, 2018), some 2.5 million people are in need of assistance, almost half the population, and 1.9 million people are targeted by humanitarian interventions. Furthermore, Palestine has developed a malformed economy, sustained by low-productivity services activities in a context of high informality and de-industrialization, the collapse of the agricultural sector, and a dysfunctional integration into the global trading system (MAS, 2021). All of these issues, and the limited impact that the enormous amount of aid has had on economic development in Palestine, are the result of Israeli policies and control over all aspects of Palestinian lives, which has long constrained and crippled the Palestinian economy. However, one can only imagine how even more severe the situation might have been if such aid was not available to help mitigate some of the suffering that Palestinians had to endure.

Independently of the growth and welfare effects of foreign aid in Palestine, what is certain is that ODA has sustained the PA, while contributing to the provision of some basic governmental services. In the context of the overall decline of ODA, the bulk of ODA received by Palestine has been for budget support. Figure 9 presents the flow of ODA in support of the PA. Since 2005 there has been a sharp increase in budget support, and then a declining trend. A significant proportion of budget support funds were for current expenditures, such as payroll and general expenses. The funding allocated to development expenditures was relatively limited, less than 20 per cent of the total on average for the last couple of years (Figure 10). The sharp contraction of budget support funding has aggravated the fiscal situation of the PA, which in turn has reduced its spending on social protection.

[22] World Bank data.

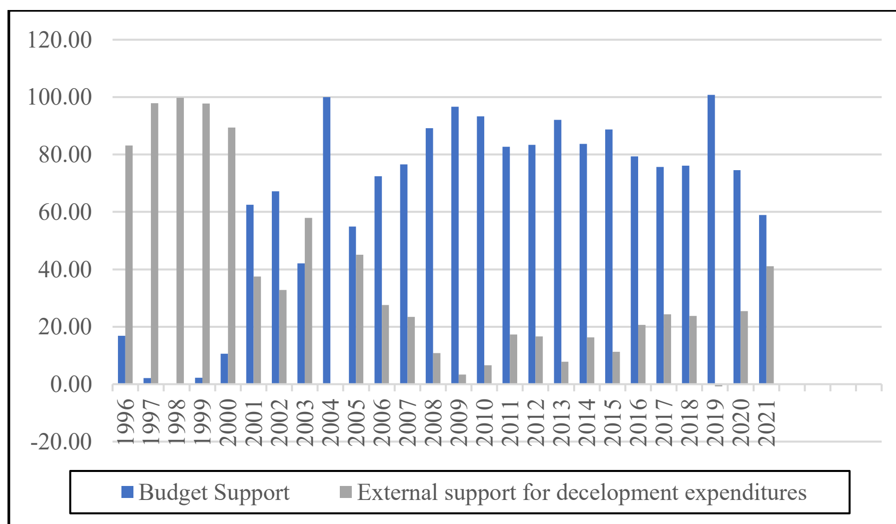
[23] UNDP 2018 data, before the Pandemic-

Figure 9. Grants and Donations to the PA, 1996-2021 (Million US $)



Source: Palestine Monetary Authority

Figure 10. Palestine: Grants and Donations by Purpose 1996-2021, Percentage of Total

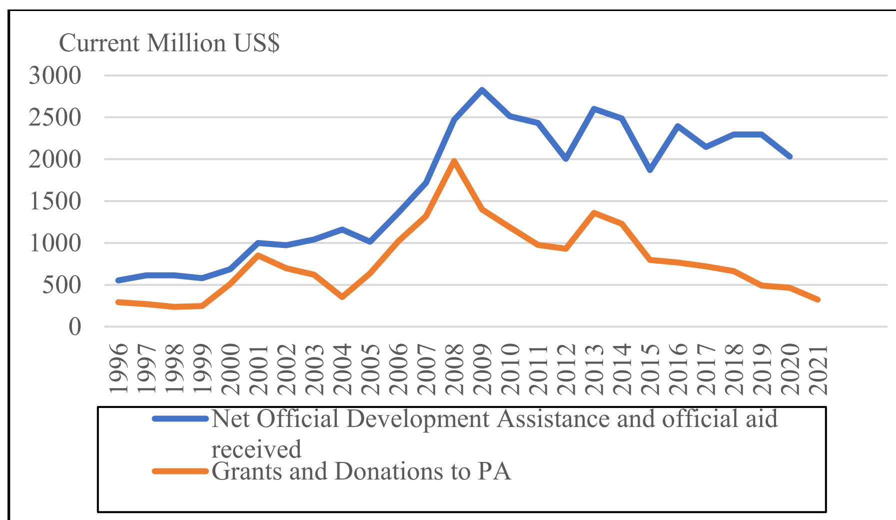


Source: Palestine Monetary Authority.

A significant trend has been the progressive contraction of the share of the PA in total net ODA received. The decline of net ODA has been significantly less pronounced than that of funding to the PA. The reasons that have generated the decline in support for the PA are varied, including that of the US subjected to the vicissitudes of its relations with Israel and as a means to exert pressure on the PA, the current split between the WB and Gaza, where some countries do not want to be seen as supporting Hamas, political issues raised in the EU Parliament, and the loss of trust in the PA institutions, in the light of perceived increasing corruption. This means that donors have reallocated their support to Palestine operating through other stakeholders. This shift coincides with the progressive new emphasis given to the private sector and non-government organizations (NGOs) as an important factor in development finance and initiatives. There is no disaggregated data easily available of where the non-PA funding was allocated. Just during the period 2015-2020 US$ 9.1 billion of aid came to Palestine and were

not channelled through the PA. A portion of this amount was channelled through the banks, MFI, and NGOs, and some through blending instruments, as demonstrated below.

Figure 11: Palestine: Net Official Development Assistance and Official Aid Received and Grants and Donations to the Palestine Authority, 1996-2020



Source: Net official development assistance and aid received from the World Bank. Grants and donations to the Palestinian Authority from the Palestine Monetary Authority.

The utilization of blended finance in Palestine is not new. In the past many projects included guarantees, grants, and technical assistance (Abdullah and Hinn, 2016). What is new is the volume that this type of operations has acquired. There is no data available at the project level that would allow a comprehensive assessment of blended finance in Palestine and of its effects. One partial source is the data provided by Team Europe in its publication "European Union-Palestine Investment Review, of February 2022. The data cover regional and Palestinian projects since 2015 with their description. Therefore, it allows to identify the utilization of blending instruments. The interventions follow the EU External Investment Plan aiming at crowding in private and institutional investors, "where viable business proposals meet social needs, and where limited public funds can attract private money". It works under three pillars: mobilizing finance, providing technical assistance, and fostering a favourable investment climate.

According to Team Europe the ongoing investments in Palestine, those which started in 2015, reached a total of EUR 1.420 billion, of which 60 per cent were committed in 2020 and 2021, which would be EUR 850 million in those two years. Given that the average GDP of Palestine for those two years was US$ 16.5 billion, the injection of capital was around 5.6 per cent of GDP, which constitutes an impressive investment shock.[24] In January 2022 other operations to be implemented through Palestinian banks with a value of US$ 200 million were further agreed.[25] Moreover, the European Investment Bank (EIB) has opened an office in Jerusalem for Palestine and has announced further investments through Team Europe. Analysing the performance of the Palestinian economy in recent years, it is hard to identify any significant

[24] EURO was converted to the average against the dollar for that year.

[25] https://www.eeas.europa.eu/delegations/palestine-occupied-palestinian-territory-west-bank-and-gaza-strip/team-europe-signs_en

improvement as a result of the increasing funds, particularly when it is hard to isolate the impact of political developments, and the generally adverse political situation, on the Palestinian economy. Not to mention that the COVID-19 pandemic created a major economic shock, and the fact that not enough time has passed since the injection of these new funds to generate measurable impacts. The relationship between ODA, economic growth and welfare has been widely debated in the case of Palestine. In light of the new trends in ODA, this line of inquiry becomes today even more important.

The project listed in the Team Europe publication in aggregate consisted of loans (71%), microcredit (5%) and guarantees (17%). Loans were given to Palestinian banks or MFI institutions to further lend to firms, and most projects included a certain level of guarantees. In total 84 per cent of the funds were allocated to SME finance. Therefore, the most traditional instruments of blended finance were the ones mostly utilized in the case of Palestine. Grants only accounted for 3 per cent of the funds, and equity investment and technical assistance 2 per cent each one.

We analysed the different projects of Team Europe to assess the amounts lent to the banks and MFIs, which would leverage additional funding that is the objective of blended finance. Our review showed that in bilateral operations Palestinian banks received US$ 409 million and in portfolio projects additional US$ 55 million, making a total of US$ 464 million. On their part, the MFI received an amount of US$ 74.4 million. Given the total credit facilities in the Palestinian financial system, these amounts are not that impressive. We have not been able to find assessments of the utilization of the funds by the banks or MFI. What is needed is a case-by-case assessment of the utilization of the funds to explore if more credit was leveraged, or the banks just utilized these funds instead of their own, to what sectors the credit was allocated, and if allocation differ at all from the normal practices of the banks. Also, some research should be done on the performance of other instruments, such as the impact bonds recently introduced in Palestine.[26]

[26] https://www.ebrd.com/news/2019/ebrd-addressing-youth-unemployment-in-west-bank-and-gaza.html

4. Final Thoughts

A major limitation in preparing this report was the lack of data at the project level that would allow identifying the different blending instruments utilized, and the absence of ex-post assessment of the different interventions. Lack of assessments of the effect of this type of interventions is not a prerogative of Palestine, but as discussed in section 1 of the report is a general shortcoming. A necessary next step, if we want to grasp the results of blended finance in Palestine is to conduct an assessment, based on a representative sample of interventions, that would permit estimating how much, and if, additional credit was leveraged and the additional developmental benefits they generated. That exercise was outside the scope of this undertaking.

The type of analysis suggested above is particularly important in the case of Palestine, where there is no lack of resources in the banks to provide more credit facilities as discussed in Section 2. The main issue in Palestine is the absence of a robust demand for credit by the private sector, which would indicate that under the current restrictions and constraints imposed by the occupation (including control of land and resources; and distorting the labour market), there are limited investment opportunities, and an aversion to productive investment given the high degree of uncertainty on the future, coupled with limited access to resources, unfair competition from Israeli firms, and distorted exchange rate and labour costs. In this situation, it is highly probable that additional funds given to the financial institutions would not leverage additional investment. It might be the case that it replaces banks' own resources available to the financial institutions. Blending might reduce the risks for the lenders, but with questionable developmental gains if not addressed within the larger geopolitical and institutional setting. This is the case with the more traditional blending instruments, such as guarantees, which are the ones mostly utilized in Palestine.

In the absence of investment projects by the private sector, another type of interventions might be more fruitful than just increasing available lending funds and guarantees. Technical assistance in the pre-investment stage, helping in the preparation of the investment projects, might produce interesting results. This coupled with grants, reducing the total cost of the investment for the investors, and equity investment could be a better approach given the ground conditions in Palestine.[27]

[27] In Jordan, the EU financed three projects, with a total amount of EUR 54 million, which included grants given through a competitive procedure, which was quite effective in generating interesting new project ideas and new investments. See for example Jordan Services Modernization Program.

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