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Palestine Economic Policy Research Institute

**Strengthening the Role of the Palestine
Securities Exchange in Attracting
Foreign Investment**

2008

The Palestine Economic Policy Research Institute (MAS)

Founded in Jerusalem in 1994 as an independent, non-profit institution to contribute to the policy-making process by conducting economic and social policy research. MAS is governed by a Board of Trustees consisting of prominent academics, businessmen and distinguished personalities from Palestine and the Arab Countries.

Mission

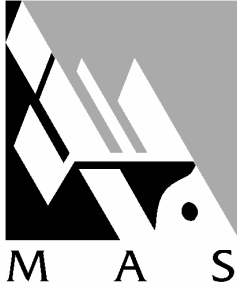
MAS is dedicated to producing sound and innovative policy research, relevant to economic and social development in Palestine, with the aim of assisting policy-makers and fostering public participation in the formulation of economic and social policies.

Strategic Objectives

- ◆ Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- ◆ Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- ◆ Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- ◆ Disseminating up-to-date socio-economic information and research results.
- ◆ Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
- ◆ Strengthening economic and social policy research capabilities and resources in Palestine.

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This study was prepared by Palestine Economic Policy Research Institute (MAS) research team, particularly by the following researchers:

Research Team:

Dr. Mohamed Nasr,	General Director
Muhannad Hamid,	Research Associate
Fause Ersheid,	Research Associate
Wajeih Amer,	Research Assistant
Ibrahim Shikaki,	Research Assistant

Reviewers:

Dr. Basim Makhool, Economist.
Dr. Atef Alawneh, Director General of PCMA.
Dr. Sulaiman Abbadi, Dean of Faculty of Administrative and Financial Science, AAUJ.

Editorial Assistant:

Abdel Ruhman Y. Abu Shamaleh (Arabic)
Jake Lomax (English)

Layout:

Lina Abdallah

Funding:

This study was funded by The International Development Research Centre, IDRC, Canada.

Palestine Economic Policy Research Institute (MAS)
Jerusalem and Ramallah

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Foreword

Stock exchanges play a crucial role in economic development, attracting foreign investment while keeping national savings in the country and transferring them into productive projects, thus contributing to lower unemployment and poverty and a higher standard of living. Many countries in the world are competing to attract foreign investment through providing incentives, investment guarantees, and a business environment that offers reasonable returns and acceptable risk.

The Palestinian Securities Exchange (PSE) has developed remarkably in the years since it was established. The number of firms listed has increased from 18 in 1997, with a capital not exceeding \$82 million, to 35 companies with a capital of around \$950 million by the end of 2007. The number of shares owned by foreigners more than doubled during the period 2001-2006, and the value of foreign investment increased from \$283 million in 2001 to a peak of more than two billion dollars in 2005. These indicators reflect the ability of the stock market to attract and absorb foreign investment if the necessary requirements are met.

The goal of this study is to evaluate the attractiveness of the stock market to foreign investment, the obstacles which hinder it from doing so, and the steps that need to be taken to increase these investments. We hope that the study's recommendations will contribute to the development of policies that enhance the role of the stock market in Palestine and increase its capacity to attract foreign investment, which will have a significant impact on the Palestinian development process.

I would like to extend my thanks to all those who contributed to this study. In addition to the research team, I would like to thank the PSE, the Capital Market Authority, the brokerage firms and the other experts we interviewed whose comments and ideas we benefited from. For the same reason, I am grateful to all the participants at the workshop during which the study was presented and discussed. Thanks also go to Dr. Basem Makhool, Dr. Atef Alawneh, and Dr. Sulaiman Abbadi for reviewing and refereeing the study. Last but not least, I want to extend my thanks and appreciation to the International Development Research Centre (IDRC), Canada, for funding this research.

Dr. Mohamed Nasr
Director General

Executive Summary

The study focuses on analyzing the role of the Palestine Securities Exchange (PSE) in attracting foreign investment, by presenting the enabling factors with the objective of proposing policies and mechanisms to activate the role of this market in attracting external investment into the Palestinian economy.

The relationship between capital markets, investment and economic growth has been a major interest for economic decision-makers, researchers and analysts. Many countries have tried to boost economic growth through amending capital market regulations, such as phasing out restrictions on capital with the aim of encouraging foreign cash flows into their markets to boost development. Previous studies have shown that stock markets can promote economic growth by directing accumulated savings into real investments. Other studies have examined the factors that determine the investment appeal of such countries, such as the investment environment, macro-economy, and governance among others.

The Palestinian stock market has a number of key players, including the Palestine Securities Exchange, public listed companies, brokerage firms, the Capital Market Authority (CMA) and shareholders. The Palestine stock market was created in 1996, performing its first deal early in 1997. It evolved quickly in the last ten years, the number of listed companies reaching 35 with a capitalization of US\$ 950 million. Total transactions amounted to around US\$ 2 billion in 2005 as the Al Quds (Jerusalem) index bypassed 1000 points, before falling again when the fluctuating political situation since mid 2006 affected the market.

Companies listed on the PSE operate in five major sectors: banking, insurance, investment, services and industry. Shares in these companies are traded via nine intermediary companies, which play a major role in attracting foreign investment into domestic markets and in mitigating the flight of national capital.

The CMA oversees PSE compliance with the regulations, including the Securities Law, Capital Market Authority Law, and other regulations governing operations and relationships with listed firms, brokers and local and foreign investors.

The Securities Law neither specified permissible individual ownership shares for local or foreign investors, nor the permissible total ownership share for foreign investors, as these are left to the listed companies' bylaws. Notwithstanding, some of the listed companies refer to their supervising authority to determine this share, like banks that fall under the oversight of the Palestinian Monetary Authority. Listed companies in PSE vary in the restrictions they impose in their bylaws on foreign investment in their assets. Some companies restrict foreign investment to five or ten percent, while others allow for unlimited foreign individual and corporate ownership.

The researcher, in analyzing the PSE role in attracting foreign investment, faced a number of methodological difficulties, most importantly: what is meant by 'foreign investors' in order to monitor pertinent changes upon adopting certain policies. Although this could seem like a minor problem in some countries, it is much more complicated in the Palestinian case where there are many Palestinian expatriates who do not hold Palestinian ID, but they are born in Palestine or reside therein.

A second difficulty is the lack of detailed information on foreign investments in Palestine to enable conducting the necessary analysis of the PSE role in the economy especially that under the Securities Law, PSE is not allowed to disclose such data, which entails seeking other variables in order to estimate and analyze changes in such investments. It appeared that the rate of foreign owned shares in PSE amounted to around 40% of total shares in 2001 – 2006, and that the value of such investment fluctuated over the same period, but was high in banking and low in industry.

A third difficulty is the lack of available time series data. This renders standard econometric analysis impossible, and instead this study uses descriptive analysis to identify factors affecting the PSE's ability to attract foreign investment. A major challenge, then, is to identify the factors that enable the evaluation of the country's attraction of foreign investment help evaluate the PSE according to its ability to attract foreign investment portfolios. These determinants are classified in this study as: macroeconomic factors; PSE specific factors; investor protection factors; and awareness and marketing factors.

Macroeconomic factors

Israeli measures and policies have resulted in extreme political and economic instability that reflected on macroeconomic main indicators, with around 30% decrease in domestic product in 2006 in comparison with

1999, and doubling the unemployment rate during the same period. Unsurprisingly, this is not conducive to attracting foreign investment portfolios to the PSE.

Despite the clamor surrounding PNA performance, many studies and reports have indicated that taxation policy in the Palestinian Territory is reasonable, that corruption and bribery have decreased, and transactions are processed faster than in several other neighboring countries. The PNA is taking significant steps in pushing this forward, particularly through passing new legislation.

The banking sector has witnessed a high level of stability and competence during recent years, following strong growth in the sector since the Oslo Accords. Twenty-two banks, with 153 branches, are operating in the Palestinian Territory. The strength of this sector builds confidence and contributes to attracting foreign investors to the PSE.

PSE-specific factors

The study indicated, upon analyzing the factors related to PSE, that the number of listed companies is small, investment instruments are few and mostly trade in shares. This reflects weakness and reduces attractiveness to foreign investment. While the return on investment in these companies is relatively high, it is fluctuating, which reflects high risk. On the other hand, the analysis of the factors related to PSE efficiency indicated that it makes good use of IT in trading and in monitoring PSE activities, which contributes to promoting investment.

Investor protection factors

In terms of investor protection, the study revealed the legislative environment regulating the PSE ensures free and unrestricted flow of capital to and from the Palestinian Territory. Furthermore, the Securities Law, the CMA Law and PSE-specific regulation support good governance and transparency while prohibiting manipulation of the stock market, and so help to protect the interests of local and foreign investors. The CMA has approved regulation on the following issues: disclosure, listing, the PSE trading system, PSE membership, the PSE Code of Conduct, and on the establishment of dispute resolution and arbitration procedures.

To support these steps, the CMA, through a national committee and several technical committees, is working to establish governance standards applicable to all listed companies. The PSE, for its part, is supporting these

measures and will reward companies that demonstrate high levels of transparency, integrity and good governance.

Awareness factors

The PSE has developed an investor awareness program that aims to spread knowledge about the stock market among different groups within society. Furthermore, it intends to conduct promotional activities and publish information on its website about the exchange, its mechanism, listed companies, brokers in the Palestinian Territories, and the laws and regulations that govern the PSE. The PSE continuously seeks to improve its access to foreign investors through conferences and workshops, as well as linking to news channels, particularly satellite channels. In addition it has made attempts to merge with other securities exchanges in the region.

Recommendations:

- ❖ Create an enabling environment for investment. Particularly important in this regard are enforcing the rule of law, taking measures to improve security, reforming the Judiciary, and completing the process of updating economic legislation.
- ❖ Adopt sound economic and financial policies in order to achieve fast development and to derive maximum benefit from the large financial support pledged by the donor community following the Annapolis Conference.
- ❖ Encourage unlisted companies to list on the PSE. This will deepen the market and enhance confidence, as there are currently many shareholding companies that are not listed despite the law that makes applying to be listed mandatory.
- ❖ Promote Palestinian shares in external markets, particularly in countries such as the Gulf States that host large Palestinian communities.
- ❖ Enhance and ensure application of principles of governance in the PSE, broker firms, and listed companies. Speed up the adoption of governance rules the National Committee and CMA have been preparing; cooperate with institutions concerned with transparency and governance, such as the Transparency Palestine Coalition for Integrity and Accountability (AMAN) and others.
- ❖ Set up an on-line trading system for foreign investors directly payable by credit card.
- ❖ Continue to issue the Annual Directory of listed public shareholding companies, and distribute it to investors in other counties through Palestinian Embassies and Representative Offices.

- ✧ Provide detailed statistics that enable researchers to conduct in-depth studies on the impact and role of PSE that will contribute to formulating appropriate policies and take the right steps that lead to attracting foreign investments.
- ✧ Encourage local brokerage firms to continue their advances, particularly in the area of on-line trading, to expand their external relations and to link themselves to global brokerage firms in order to attract foreign investments.
- ✧ Link PSE to satellite channels and other media outlets, and increase the number of media outlets that cover PSE news locally and abroad.

