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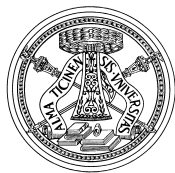
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Quaderni di Dipartimento

**Asymmetries and Economic Interaction Between
Israel And Palestine**

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ASYMMETRIES AND ECONOMIC INTERACTION BETWEEN ISRAEL AND PALESTINE

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ABSTRACT

The long-lasting nature of the Palestinian-Israeli conflict has caused a severe slowdown of economic activity within and between the two economies involved. Palestine is currently afflicted with economic stagnation and structural bottlenecks - namely sharp income reductions, low investors' confidence, and labour market segmentation. Israel must correct a large budget deficit due to a secularly high expenditure on military defence. The former has all the characteristics proper to a Southern low-income economy; while the latter is the most advanced economy of the region, with a well diversified export base and high-tech capacity.

Convergence between the two economies seems constrained by exogenous factors and structural impediments. For this reason, we believe that only an immediate effort to help the Palestinian economy recover and an inner industrial boost can restore normal economic activity and allow benefiting from the dynamic gains arising out of North-South interactions.

This paper highlights two main points: first, the present arrangements concerning the labour market prevent full use of the Palestinian potential productive capacity and are a hindrance to its short-term recovery. Second, the trade regime between Israel and a future Palestinian State should resemble a Free Trade Area that explicitly takes into account the deep asymmetries dividing the Palestinian and Israeli economies.

SECTION I: INTRODUCTION

The years of Al-Aqsa Intifada have witnessed a dramatic deterioration of the Palestinian society and fostered its economic dependence on neighbouring countries. This fact was exacerbated by the labour-exporting nature of the Palestinian economy and its reliance on worker remittances and foreign demand, particularly coming from Israel. This has caused the Palestinian economy to become highly dependent on the Israeli one, to shape its economic activities on the relations with Israel, and thus to become extremely vulnerable to the Israeli business cycle. Palestinian production is in fact largely oriented towards providing inexpensive, low value-added products for Israeli consumption or re-export, and specialization in low-productivity sectors such as construction and agriculture.

Since 1994, economic relationships between the two parties have been regulated by the Paris Protocol (PP), the economic analogue of the 1993 Oslo Agreements, signed with the promise of supporting and fostering the Palestinian economy. However, the increased representation that the Palestinian Authority obtained by complying to the economic arrangement in question were undermined by the escalation of restrictions on flows of goods and people from the Palestinian territories to and through Israel, thus significantly raising transaction costs and annihilating potential gains.

We believe that along with the framework of the Road Map to peace, which envisages the creation of an independent and sovereign Palestinian State, any eventual economic arrangement – corrective of the Paris Protocol - must take into consideration the different structures of the two economies in question. This paper maintains that while sustaining the recovery of the Palestinian economy in the immediate future, policy-makers should undertake a long-term strategy that accounts for the specific features of the Palestinian economic structure.

We analyze two major policy facets regarding the Israeli and Palestinian economic relations: the first is in a sense “short-term”, and concerns the problem of the re-establishment of a minimal economic viability in the West Bank and Gaza (WBG) even in a situation of non-existence of a politically and economically independent Palestinian State. The immediate focus is on recovery and relief, and on the economic measures which can help to improve the living-standards of the Palestinian population in the immediate future. The second aspect is of a longer-term nature, for it regards the possible final status of the Israeli-Palestinian economic relations. We pay particular attention to the labour market, whose centrality to the dynamics of the Palestinian economic system must not be neglected, and to the trade regime to be envisaged between the two countries after resumption of the conflict. The main idea guiding this analysis is that the two economies in question are characterized by deep asymmetries, which in many ways are typical of the North-South dichotomy or, otherwise said, of the economic relations between a developing country and an advanced high-income economy. Theoretical considerations and historical experiences will support the specificity of the analysis: given the particular political situation, Israel-WBG economic relationships present several peculiarities, which must be taken into account in the analysis of both the short and long-term issues, in order to formulate credible economic arrangement and avoid disillusion in the future.

Section II provides for an analysis of the current situation and highlights some of the many peculiarities of both the Israeli and WBG economies. Section III concerns possible indications about the improvement of the living conditions in the Palestinian territories and discusses some of the options that have been presented by the parties concerned. Section IV presents several considerations regarding the final economic status between the two countries in question, and defines the contours of the commercial regime to be envisaged for an adequate regional economic development. We make two specific points: first, the present arrangements concerning the labour market prevent the full use of the Palestinian potential productive capacity and may hinder the short term relief initiatives. Second, the trade regime between Israel and a future Palestinian State should resemble a Free Trade Area that must explicitly take into account the deep asymmetries

characterizing the two economies. Section V draws some final conclusions on the overall discussion.

SECTION II: NORTH-SOUTH UNCONVENTIONAL LINKAGES

We can rely on the main conjectures of economic growth theory to view Northern countries as growing under the Keynesian rule of demand constraint, with surplus capacity that is generally diverted to the South into the form of exports. Here investment demand and saving supply are determined by the rate of profit, and adjust to reach macroeconomic equilibrium thereby determining the growth rate. By contrast, production is constrained by supply conditions in the South, and the level of investment and growth depend on the availability of foreign and domestic saving. The South is naturally endowed with a surplus of labour, while it depends on the North for provision of capital goods. A great deal of economic theory views trade as the ultimate corrector of Northern and Southern economic disparities, functioning through a mechanism of resource re-allocation and fulfilment of comparative advantages. But while consistent capital flows from North to South stimulate the latter's productive capacity and output growth, they often provoke an adverse effect on Southern terms of trade, given the large gap in value-added that distinguishes the two productions.

In many ways, economic relations between Israel and WBG seem to pledge to the North-South configuration. Moreover, the high proximity, close to integration, of the Palestinian and Israeli economies allows for the formulation of economic considerations relevant to a dual-economy. However, the picture is not so clear-cut. Notwithstanding the above considerations, there are several economic pathologies that alter the normal vertical pattern of North-South economic relations. Understanding how the two economies interact requires first of all acknowledgement of the profound asymmetries that led their growth paths to diverge over time.

An extensive insight into the inner structure of the Israeli and Palestinian economic systems will allow identifying the dysfunctional ties between and within the two economies.

I) THE ECONOMICS OF ISRAEL

Despite being an "infant" economy, Israel is a high-income country with a GDP of New Israeli Shekel (NIS) 133,765 Million, growing at 4.1 percent until the first half of 2004¹. It is by far the most advanced economy in the region, with a well-diversified production, a large export base, and a great capacity of innovation. Historically, a growing population matched with large migration inflows² and consistent financial aid allowed for massive investment in capital accumulation. High labour productivity insured an annual rate of economic growth of 10 percent from its creation in 1948 to 1975.

Although the costs of such a rapid takeoff were high – indebtedness, inflation, and high expenditure in military defence – Israel has managed to maintain a steadily high pace of growth thanks to an adequate industrial development and important investments in R&D.

1) An odd expenditure

The long-lasting conflict and the fragile stability of the area impelled high levels of expenditure in defence and defence-related issues as a share of GDP: total defence consumption currently amounts at NIS 48,952 Million, with NIS 13,699 Million of imports. These include military and civil defence operations and administration, and defence-related applied research and experimental development.

¹ The rise in GDP was mainly due to increases in exports of goods and services, private consumption, and fixed capital formation (Israeli Central Bureau of Statistics, August 2004).

² In 1996, the population was growing at 2.07 percent, with 1.06 growth due to immigration. The corresponding values for 1990 were 5.07 and 4.04, respectively (Israeli Central Bureau of Statistics, 1995).

In 2002, defence costs to the Israeli economy (labour costs, risk premiums and compensation of employees) were estimated at NIS 58,876 Million; while in 1993, they amounted at NIS 27,168 Million³ (Israeli Central Bureau of Statistics, 2003).

2) A secularly negative balance of payments

In addition to the unfavourable geopolitics, the shortage of natural resources, raw materials, and manpower has compelled Israel to import labour and capital for long periods of time, covering only partially for outflows of goods and services: in 1950, exports accounted for a mere 14 percent of imports; while in 1995, they reached 75 percent of total imports. Added to a relatively high public expenditure, this policy has led to high levels of indebtedness⁴.

Israeli Balance of Payments 1998-2003

In millions of U.S. dollars						
	1998	1999	2000	2001	2002	2003
Current account balance	-1,149	-1,512	-670	-1,776	-1,380	101
Trade balance	-3,051	-4,214	-2,883	-3,004	-3,726	-543
Exports	23,190	25,827	31,153	27,974	27,486	7,027
Imports	26,241	30,041	34,036	30,978	31,212	7,570
Civilian imports	24,369	27,971	32,100	28,832	28,801	7,133
Military imports (defence imports)	1,872	2,070	1,936	2,146	2,411	437
Civilian trade balance	-1,178	-2,144	-947	-858	-1,315	-106
Services balance	-146	941	2,656	-553	-605	-64
Exports	9,490	11,649	15,162	11,950	10,865	2,802
Imports	9,636	10,708	12,505	12,530	11,470	2,866
Income (factor income) balance	-4,028	-4,552	-6,927	-4,627	-3,599	-888
Exports	2,508	2,799	3,759	2,881	2,852	658
Imports	6,537	7,351	10,686	7,509	6,451	1,546
Current transfers	6,076	6,313	6,483	6,409	6,549	1,595
Capital transfers	577	569	455	681	151	106
Net financial transactions	...	4,600	4,054	195	-1,739	-393
Total net direct investment	...	2,136	1,548	2,715	417	1,229
Total net portfolio investment	...	1,918	2,228	-1,487	-1,909	-474
Total net other investment	...	696	-387	-1,543	-438	-1,354

Source: International Monetary Fund (June 2004).

A long disinflationary policy⁵, consistent foreign aid, and the improved quality of exports have come to balance the large deficit accumulated in the current account. Moreover, Israel is high-ranked in UNCTAD's world estimates of inward FDI potential index, despite strong volatility in capital inflows' trends⁶.

³ Despite nominal increases (the authors of the survey use current prices as base), defence costs as a share of GDP declined from 14.3 percent in 1993 to 12 percent in 2002. Yet, considering real GDP growth, the magnitude is more consistent than it may appear at first sight.

⁴ It seems however that, excluding data for expenditure in defence, government expenditure continued to fall at an annual rate of 2.8 percent since the second half of 2003 (Israeli Central Bureau of Statistics, August 2004).

⁵ In 1985, Israel launched a successful programme of economic stabilization that reduced once for all inflation to acceptable standards.

⁶ See UNCTAD, World Investment Report 2004. Values for recent years oscillate as follows: US\$ 3,111 Million in 1999; US\$ 5,011 Million in 2000; US\$ 1,721 Million in 2002; and US\$ 3,745 Million in 2003.

3) A “high-tech” potential

Given the high quality of labour and the lack of primary raw materials, the Israeli industry has specialized in high value added production processes, based on advanced technologies and scientific creativity. In a short period of time, Israel became highly competitive at the world level in fields such as medical engineering, agro-technology, pharmaceuticals, and diamond refinement.

From 1995 to 1999 Israel experienced an industrial boom. The number of employed workers increased substantially, and with it the overall level of wages, particularly in the high-tech sector⁷ (Feldman and Abouganem, 2002). The following table summarizes the evolution of employment in the high-tech industry for recent years.

Employment in the High-Tech Industry 1995-2001

Thousands	1995	2001	Percentage change
Employed persons - total	1,964.9	2,270.5	15.6
Employees - total	1,669.4	1,970.4	18.0
High-Tech industry – total	109.7	197.0	79.6
Manufacturing in High-Tech	61.0	83.2	36.4
Communications	14.7	34.0	131.3
Computer and related services and R&D	33.9	79.7	135.1

Source: Israeli Central Bureau of Statistics, 2002.

The high-tech industry is divided in the following branches: manufacturing; telecommunications; computer and related services, and R&D. Manufacturing in High-Tech includes manufacture of office machinery and computers; of telecommunication, data-communication and domestic electronic equipment; of industrial equipment for control and supervision, medical and scientific equipment; of aircraft. Communications are National and private ownerships. Computer and related services include: computer consultancy; programming and system analysis services; data processing; database and data storage activities; maintenance and repair of computing, office and accounting machinery; R&D activities. The consistent increase in the latter’s share witnesses the economic potential of the Israeli economy to further enhance productivity and raise output quality.

II) PECULIARITIES OF THE PALESTINIAN ECONOMY

The political situation in the region has considerably distorted and slowed down the economic growth of the Palestinian economy, which is now trapped in structural bottlenecks and economic stagnation. Yet, Palestine maintained several reliable pillars that could sustain her in the path towards economic recovery and development.

We will briefly explore both the constraints and opportunities that the Palestinian economy is currently facing, and estimate them in the light of her relations with Israel.

1) Constraints

a) GDP-GNI pronounced differences

Since its occupation in 1967, the Palestinian economy has been sustained by total factor payments from abroad rather than by increased local productive capacity for exports and productivity growth. At the end of 2003 the nominal Gross National Income (GNI) of WBG was US\$ 1,467 and the nominal GDP per capita was US\$ 925, with figures of respectively US\$ 1,227

⁷ Wages in the high-tech sector increased of 73 percent compared to 46 percent in the other industries.

and US\$ 729 for the Gaza Strip (World Bank 2004, pp. 4, 6). With these figures WBG is just above the World Bank low-income countries level of GNI per capita and indeed it belongs to the bottom part of the group of the lower-middle-income countries. There are some economic features which cause to be the WBG economy extremely weak and dependent on both external economic shocks and on foreign assistance. Some of these features are the following:

- a. an extremely high dependence on donor assistance of approximately US\$ 310 per capita since 2001 (World Bank 2004, pp.5, 7)⁸;
- b. large inflows of workers' remittances, mainly from Israel which reached 16.4 percent of GNI in 1998 (World Bank 2002, p.78) - an exceptionally high ratio;
- c. and a systematic trade deficit in the range of 50 percent, that reached 60 percent of GDP in the late 1990s (World Bank 2002, p. 75; UNCTAD 2004, p. 6), which is much higher than the trade deficit of most other countries in the lower-middle-income group.

All this explains the volatility of the GDP growth rate in WBG since 1967 (see World Bank 2002, p. 73) and the fragility of the WBG economy which is extremely vulnerable to exogenous shocks, one being the closure of the Israeli labour market.

The economic situation described above has contributed to determine the GNI-GDP gap in the WBG; adding external aid, we end up having an 'income economy' instead of a 'production economy'. The close links between the economy of WBG and that of Israel between 1967 and 1993 and the Paris Protocol (PP) of 1994 do not seem to have provided a suitable economic environment for the Palestinian economy to enter a sustainable path of growth.

b) Inequitable labour market structure

The Palestinian labour force has long been segmented between employment within the occupied territories and employment in Israel: expected higher salaries in Israel impelled part of the Palestinian labor supply on the Israeli market, thus diverting to the outside both the use of resources and the benefits of technical expertise. The considerable wage gap⁹ that characterizes the two economies and the distortions that arose within the Palestinian labor market had negative consequences on the overall economic activity and long-term growth of WBG.

During the 1980s and 1990s, Palestinians could freely move into their more advanced neighbour Israel and earn higher salaries. Until the first Gulf crisis, Palestinians were also employed in large numbers in Gulf countries¹⁰. Labour services were the major source of revenue accounting to the Palestinian economy, and the later enforcement of restrictions on flows of goods and people sharply destabilized this path, causing disposable income to fall by 18 percentage points since 1999 (World Bank, 2004).

The following table summarizes the current repartition of the Palestinian labour-force and accounts for its structural components.

Territory by labour force components and region (ILO standards) (%):

Region	Employment	Underemployment	Unemployment	Total
West Bank	66.3	10.1	23.6	100
Gaza Strip	58.8	1.5	39.7	100
Israel and the settlements	11	-	-	100
Total	64.0	7.4	28.6	100

Source: Palestinian Central Bureau of Statistics (April-June 2004).

⁸ The figure could be as high as US\$ 505 per capita in 2002 according to the OECD, see *Le Monde Diplomatique*, 2004.

⁹ According to Ruppert-Bulmer (2001), Palestinians earn 91 percent more in Israel than in WBG.

¹⁰ For more details on the aspects of labour migration in the Arab region see Fergany (2001).

In the second quarter of 2004, 11 percent of the total labour-force was employed in Israel and the settlements, as compared with 20.2 percent in 1995 and 13.5 in the third quarter of 2003 (Q3-03). In only one quarter (from Q3-00 to Q4-00) the overall employment rate fell by 16.7 percentage points¹¹. Wages behaved to these abrupt changes by first increasing from 42.3 NIS to 63.2 NIS in Q3-00, than falling to 57.7 in Q2-03, than pulling up again in Q2-04 at 65.4 NIS¹². The parallel increase in the rate of unemployment and nominal wages can only be explained by the mismatch in the Palestinian labour market (whereby demand for labour does not meet supply) caused by internal closures, while the decrease in real wages (9.5 percent since 2000) by rising consumer prices (World Bank, 2004).

The table below shows the unemployment rate associated with years of schooling: although below the overall average rate, skilled unemployed workers remain a consistent share of the total unemployed labour-force¹³.

Unemployment Rate for Persons Aged 15 Years and Over in the Palestinian Territories by Years of Schooling and Region (ILO Standards) (%):

Years of schooling	West Bank	Gaza Strip	Total
0	11.5	33.3	17.1
1-6	28.7	48.6	35.7
7-9	26.6	46.3	32.1
10-12	25.4	40.4	29.9
13+	16.1	28.7	20.4
Overall Average	23.6	39.7	28.6

Source: Palestinian Central Bureau of Statistics (April-June 2004).

Skilled workers preferred low-quality, high-salaried jobs in Israel to high-quality, low-paid jobs in the domestic economy. In the long-run this behavior generated a brain drain effect within the Palestinian society, decreasing productivity, high rates of unemployment, and economic stagnation¹⁴. In fact, if both skilled and unskilled Palestinian workers queued for better paid jobs in Israel, they could find employment only in unskilled economic sectors. According to World Bank data (2004), 29 percent of Palestinians currently working in Israel are employed in agriculture, 55 percent in construction, and 16 percent in other minor sectors. Within the territories, only one-fourth of domestic employment occupies the highest professional categories – civil officers, technicians, managers (World Bank, 2002). Depressed returns to investment in education, in turn, caused the incentive to invest to erode, and the queuing effect resulted in the under-utilization of the available stock of human capital. Skills’ depreciation and the declining quality of human capital exacerbated the stalemate of a *per se* inequitable labor market structure.

It should be emphasized that closures are also an obstacle to international trade in the area. In this purpose, Shaban (1999) observes that skilled workers suffer more from limited trade possibilities than unskilled workers. This is particularly harmful to the Palestinian economy given its large endowment of educated workers, and encourages their migration abroad. Arguments supporting the assumption that labor-exporting might eventually translate into higher productivity (through a process of learning-by-doing) and higher rate of investment are dimly valid in the Palestinian-Israeli contest; in the first place because Palestinian workers in Israel remain confined to low skilled sectors, with little prospects for improvement and professional growth. In addition,

¹¹ The employment rate in Q3-00 was 84.8 percent, while in Q4-00 it dropped to 68.1 percent.

¹² Median Daily Net Wages in NIS (PCBS, 2004).

¹³ Wood (1994) named this phenomenon “educated unemployment”.

¹⁴ Skills’ migration has considerably compromised entrepreneurial activity within the Palestinian territories.

constrained mobility within the territories deters overall economic activity and the usufruct of available opportunities.

c) The saving-investment paradox

Palestinians encountered large economic losses after reinforcement of the closure policy in the early 1990s: with workers not allowed to commute to Israel for work, national income witnessed a severe squeeze. Households' savings were harshly affected and, in turn, private investments. At the household level, moreover, sharp decreases in disposable income have required huge efforts of consumption adjustment that further slowed down demand for both domestically-produced and imported goods.

The large flows of foreign aid that entered WBG since the start of the second Intifada helped sustaining GDP by over 30 percent¹⁵, and despite inner differences between the West Bank and Gaza¹⁶, the magnitude of domestic savings in the WBG has considerably recovered from the depressed trends of 2002. However, the level of investment continues to drop. By 2002, the rate of investment within the Palestinian territories as a share of GDP fell by 44 percent (World Bank, 2003). Investors' confidence deteriorated substantially since the start of the second Intifada, and, according to previsions, investment plans are likely to remain the same in the near future. Together with the decline in banks' lending activity and in residents' deposits, and assets' depletion (i.e. loss of collaterals), an unfavourable business climate discourages private and foreign investors from undertaking productive activities in WBG, thus exacerbating the already large drop in domestic output.

Later studies and trends have emphasized the role of Foreign Direct Investment (FDI) for the growth of low-income economies. It is viewed as a desirable means of acquiring resources such as capital, technology and skills, and facilitating higher levels of productivity required by economies transiting towards higher levels of development. However, effectiveness of FDI rests in large part on the ability of governments to insure reliable public institutions, physical infrastructure, and adequate human resources. Policies favourable for domestic investment very often attract FDI; similarly, policies that make domestic investment unattractive often discourage inward FDI and encourage outward FDI, as local companies and residents look abroad for better uses of capital. Moreover, the stock of existing FDI in a given country is often a good predictor of future FDI flows.

The business environment and the conflict itself have significantly reduced capital investment in WBG, and closures have restrained the possibilities to access alternative (neighboring) markets. It remains, however, given the adequacy of saving, that a reverse situation is attainable if conflict is ended and the bases for reconstruction arranged.

2) Opportunities

Despite structural constraints, the Palestinian economy claims several opportunities for growth-enhancing.

a) Labor surplus

In the early 1990s, population growth reached a 6 percent annual rate, two times the 1980s' respective figure. A fast-growing population and increasing labor force participation saw the growth rate of labor-force attaining 4.4 percent in the past few years (World Bank, 2002). At present, the

¹⁵ Of which 20 percent went to support households' disposable income (World Bank, 2004).

¹⁶ Higher rates of poverty and unemployment in the Gaza Strip allow for lower savings' availability than in the West Bank, where residents enjoy greater family connections with neighbouring countries and thus greater access to financial support besides personal earnings (World Bank, 2004).

Palestinian labor-force counts 831,000 participants, compared with 816,000 in Q1-04 and 735,000 in Q3-00 (PCBS, 2004).

As previously shown, the Palestinian economy relied on export of labor services to sustain income and contain unemployment. On their part, Israeli firms preferred to employ Palestinian workers because of cultural proximity and specific working arrangements (e.g. commutation)¹⁷.

b) Entrepreneurial skills

The following table witnesses the high level of human capital present in the Palestinian economy: 81.6 percent of total labor-force holds a graduate degree; while on average 21.5 percent of skilled workers are currently unemployed.

Labour Force Status that Completed Associate Diploma and Above by Specialization (ILO standards):

Specialization	Employed (%)	Unemployed (%)	Total (%)	Labour Force (%)	Outside Labour Force (%)
Teacher Training	84.3	15.7	100	72.5	27.5
Humanities	80.8	19.2	100	78.3	21.7
Social and Behavioural Science	75.3	24.7	100	87.6	12.4
Commercial and business Administration	74.5	25.5	100	80.0	20.0
Natural Science Programs	88.6	11.4	100	90.1	9.9
Mathematics and Computer Science	71.2	28.8	100	81.4	18.6
Medical Diagnostic and Treatment	88.3	11.7	100	82.8	17.2
Engineering	78.8	21.2	100	88.5	11.5
Other programs	72.8	27.2	100	81.3	18.7
Total	78.5	21.5	100	81.6	18.4

Source: Palestinian Central Bureau of Statistics (April-June 2004).

The overriding literature on endogenous economic growth¹⁸ states the importance of education in the path to development. This literature identifies two ways in which educational investment can contribute to growth. First, human capital can directly participate in the production process as a productive factor. In this sense, the accumulation of human capital would directly generate output growth. Second, human capital can contribute to raising technical progress since education eases innovation, diffusion and adoption of new technologies. In this way, the level of human capital affects productivity growth.

Moreover, one of the major determinants of foreign direct investment (FDI) is the level of managerial and entrepreneurial skills available within a country. Together with costs, the market size, the business climate, and the quality of infrastructure, skills are an important ownership advantage, and are positively related to the amplitude of foreign capital inflow within a country.

Under new conditions, much can be done to exploit the largely unutilized endowment of human capital that characterizes the Palestinian economy¹⁹. Together with physical capital availability and adequate infrastructure, entrepreneurial capacity would allow enhancing the volume of productive economic activity within WBG.

¹⁷ In Ruppert Bulmer's analysis of the Palestinian labour market (2001), Palestinian workers are "close technical substitutes", but not perfect substitutes, of foreign workers to Israeli firms. This for political reasons: although more costly than foreign labour, demand for Palestinian unskilled labour remained high until late enforcement of the closure policy in 1996. Diwan and Shaban (1999) share a similar view.

¹⁸ For more information about endogenous growth theory see, among others, Arrow (1962), Romer (1986), Lucas (1988), and Mankiw et al. (1992).

¹⁹ According to Diwan and Shaban (1999), the Palestinian economy is running at one-third of its potential considering its large stock of human capital.

c) Proximity to similar economies

The geographical position of the Palestinian territories can and should be viewed as an anchor to be grasped. Jordan, Egypt, and Lebanon, as well as the Gulf countries are potential trading and business partners for WBG, and rapprochement with them would allow the Palestinian economy to diversify its trade linkages.

If commercial infrastructure is improved and sovereign borders fixed upon consensus, opening to the eastern and western gates would ultimately benefit the whole region and boost economic growth: raw and semi-finished labour-intensive regional products may be transformed into high value added exportable goods, thanks to better technologies that might be found around the corner²⁰ (Diwan and Shaban 1999).

d) A diversified *diaspora*

Many Palestinians are refugees in their own land, while many others are hosts of neighbouring countries. The Palestinian *diaspora* is mostly concentrated in Lebanon, Syria, and Jordan, but part of the community has reached the overseas lands of Europe, Australia, and the Americas. Palestinians abroad count around 4.5 millions; Diwan and Shaban (1999) estimated the wealth of their assets as ranging from US\$40 to US\$ 80 billions²¹. Many of these funds have already been directly transferred in the territories in the past and mainly directed towards support of humanitarian activities – i.e. educational and medical infrastructure.

Palestinians have started to be recognized by their high specialization in fields such as management, business, banking, engineering, and medical care. They have cumulated knowledge, skills, and expertise in all directions, and returnees could act as catalyst for economic growth thanks to their entrepreneurial capacity and acquired technical know-how. It is widely recognized²², in fact, that if supported by adequate capital inflows, return of refugees (both skilled and unskilled) could become an asset in two major ways: it will attract additional international aid because of the need to adapt infrastructure, services, and housing to a larger population - hence stimulating aggregate demand (Ahiram, 1993); it will ensure a transfer of knowledge and generate a process of learning-by-doing that would stimulate economic activity.

III) Identifying economic pathologies

In the light of the above analysis of the Palestinian and Israeli economies, we identify the following aspects as illustrative of the North-South dichotomy:

1. Palestinian dependence on Israeli demand for goods and services;
2. Palestinian labour force divided into domestic employment and employment in Israel: this “labour market dualism” reflects the Harris-Todaro (1970) assumption on labour migration based on expected earned wages²³;
3. sharp differences in income per capita and output components;
4. foreign constraint and low level of investment in the Palestinian territories vs. high entrepreneurial activity in Israel.

²⁰ More on this issue will be investigated in Section IV.

²¹ Current estimates must inevitably be higher.

²² The Jewish Diaspora is a case in point: skilled immigrants coming from the ex-USSR have contributed raising the level of productivity and innovation within the country, especially in the construction and industrial sectors.

²³ Following Basu’s analysis (1984), we find appropriate to refer to the Harris-Todaro model as illustrative of the short-run dynamics in migration and unemployment occurring in a dual-economy, while we view the Lewis model as more efficient in describing changes over time. The latter, in fact, does not account for existing or generating unemployment when labour is allowed to move from one sector to the other, and assumes that the “urban” (“capitalist” in the original text) sector can fully absorb the workers coming from the rural sector in any period. For our analysis of the Palestinian-Israeli economic pathologies and eventual formulation of corrective policies, careful attention to the behaviour of the labour market and wages is imperative. Moreover, the model’s assumption on fixed wages in the urban sector can be adapted to our discourse by simply asserting that Palestinians do not influence the wage rate in Israel.

Palestinian reliance on labour demand from Israel did not generate real GDP growth, but rather it reinforced mutual dependence at the expenses of economic development. We have seen that shortage of natural resources and manpower has compelled Israel to import labour and capital, and that the closure policy was ultimately detrimental for Palestinian workers as well as Israeli firms, because of low substitutability of Palestinians with foreign workers.

Migration of Palestinian labour towards Israel was an inevitable result of the wage differential that divides the two economies, and higher job opportunities due to different production bases. According to the literature on labour theory in open economies, mobility of factors of production and trade of goods lead to the same result – i.e. (factor) price convergence. Not only did this path not occur in the case of Israel and Palestine²⁴, but also steady migration flows of skilled Palestinian workers to Israel have provoked mismatches and structural losses: the fact that human capital was leaving Palestine and entering Israel as manpower translated into diversion of resources and dispersion of skills.

It is important to understand the behavior of both labor-exporting and labor-importing countries. Generally, capital-surplus economies are characterized by labor shortages: this structural obstacle can be easily overcome in the case of tradable goods, as imports from world markets allow to meet local demand. In the case of non-tradable goods, however, the only alternative is to import labor if local demand is to be met (Shafik, 1992). Labor-surplus economies, on the other hand, usually adopt import-substitution policies that tend to sustain capital-intensive production, and are thus afflicted with high rates of unemployment and underemployment that they tend to cure by exporting the excess labor supply. With 36 percent of the labor-force employed in services (PCBS, 2004), the Palestinian economy should rethink its productive base and create the necessary effort to produce a reallocation of resources aimed at setting the bases for an export-led development strategy. Without having to divert physical resources from domestic sales, the Palestinian economy can hope to boost its export capacity through enhanced utilization of factor endowments and take advantage of the largely available labor force in the production of labor-intensive goods.

SECTION III – RELIEF INITIATIVES FOR WBG: RESTORING THE FUNCTIONING OF THE ECONOMIC SYSTEM IN THE SHORT TO MEDIUM-RUN

In the light of the considerations expressed above, we assume that the major aim in the short to medium-term is support to the Palestinian population against unemployment and poverty. Opportunities should be considered in both the short and long-term perspectives.

Wages' behaviour will be central in the transitory phase, when the Palestinian economy will shift from labour-exporting to a goods-based export policy. While wage flexibility would insure a systematic adjustment of the productive capacity to changes in factors' availability, wage stickiness implies that future policies should focus on creating job opportunities for both new-comers (given the high rate at which grows the Palestinian labour force) and returning workers, and should be directed toward the expansion of the private sector, to avoid the risk of overloading an already large bureaucratic machinery.

It is important that any measure directed toward regulation of labour mobility be part of a wider plan for economic recovery set by a legitimate and sovereign Palestinian State, in consistence with phase three of the Road Map to peace. Quotas and a Palestinian tax on work permits²⁵ could be possible policy options, and would also be a source of public revenue accruing to the Palestinian Authority. Flows of people would be carefully regulated and controlled, though not suspended all at once. The economic measures taken to this purpose should not become an impediment to overall

²⁴ Astrup and Dessus (2002) explain that the actual limited availability of work places in Israel has prevented wage equalization in the two markets to occur.

²⁵ See the Aix Group for an extensive exposition of the opportunities available to Israel and Palestine on the labour market's final arrangement.

economic activity, as external and internal closures have been until present, especially given the fact that the availability of domestic saving is an asset to grasp in the short-run effort towards recovery.

The recovery phase that will follow after settlement of the current crisis will witness the opening of various projects for reconstruction, foreign capital inflows, and the private sector expansion, thus ascertaining the creation of job opportunities and the natural attainment of labour market equilibrium. Until then, however, international assistance could reveal crucial in supporting the Palestinian population and government, as has been the case in the past. Moreover, donors' disbursements and foreign investments may contribute to boost economic activity in the Palestinian territories. Yet, correcting distorted incentives to restore the business climate will be a major challenge for policy-makers, and will probably go along with the settlement of the political question²⁶.

In order to reach a viable and sustainable growing path, the Palestinian economy must at least reduce some of the weaknesses that characterise its weak production base. A first set of problems is related to the particular political situation, which has grown worst since September 2000 and the eruption of Al-Aqsa Intifada. A second group of elements are more related to the structure of the economy and are typical of small-open-non-high income economies. The resumption of the peace process and further stability in the region could help reduce the first type of imbalances. Easier and less expensive communications, including lower transportation costs; more Foreign Direct Investments, like those that were taking place in the Gaza Special Industrial Zone before the second Intifada; more workers going to Israel, even if the numbers should not go back to the peaks of the late 1990s; less dependence on Official Development Assistance; and, more generally, all policies aimed at improving and diversifying the production and export base, including support for the manufacturing activities, could put the Palestinian economy on a sustainable growth path.

In this view, the following options have been identified as means to re-start an adequate functioning of the Palestinian economic system in the very short-run, which we consider crucial not only for humanitarian purposes, but also in view of long-term arrangements between Israel and a future Palestinian State. Notice that none of these measures alone would be effective, but need to be undertaken in concomitance.

1) Additional Official Development Assistance

As we mentioned earlier in this paper, foreign aid to the Palestinian territories has always consisted in large flows and trends from international donors show that the path is upward sloping. At this date, World Bank data account for US\$ 1 billion per annum of donor disbursements, and plan to add US\$ 500 million to current values by 2006. In this way real personal incomes are expected to grow of about 12 percent (World Bank, August 2004). But foreign assistance in all its forms should ultimately be viewed as the financial capital enabling investment activity; otherwise additional aid flows would only aliment further Palestinian dependence on the outside world and prevent inner efforts for economic take-off.

As a case in point, according to Missaglia and De Boer (2004), food-for-work programs are ultimately damaging to local development: food assistance compromises domestic production as people substitute domestic produce with imported, cheaper goods. Given the importance of the food sector to the Palestinian economy, this policy would not only reveal sub-optimal, but could also act as a hindrance to the recovery of the local productive capacity. In fact, one could expect some increase in the economic activity of areas such as Bethlehem, Nablus, and Hebron, at least for what concerns private services and basic consumption goods. Hence the cash-for-work perspective should be reinforced with respect to the food-for-work one. Inserted in particular employment-generating schemes oriented towards the support of labour-intensive sectors, monetary assistance

²⁶ Also because investment activities require a well-defined legal framework and territorial jurisdiction.

would eventually act as a built-in stabilizer, and insure the continuity of the rehabilitating productive process.

2) Bottom-up stabilization policies

Given that in the short-run it will be difficult to restore trade patterns, in particular vis-a-vis Israel, the local development perspective must be prioritising. In particular, rehabilitation of local infrastructure, and promotion of credit and investment in small local enterprises should not await final economic arrangements²⁷.

Rehabilitation of basic and commercial infrastructure is a top priority for the Palestinian Authority: it will set the bases for economic and social development within the Palestinian territories. Given the high risks that characterize investment in public utilities, a way to attract funds for the provision of infrastructure would be introducing co-financing facilities (Diwan and Shaban, 1999) or providing investors with access to guarantee funds that would allow them to amortize risks of expropriation and would thus induce private investments in public works. Moreover, inserting employment-generating schemes within public and small-scale operations could reveal socially efficient and would allow absorbing the largely unemployed Palestinian labour-force.

Major efforts should also go to build an efficient banking system to enable banks and financial institutions to transform deposits into loans for investment programs and productive activities. Although long-term lending is inhibited by political and economic uncertainties and lack of collaterals, the financial resources accumulated by Palestinians thanks to the large inflows of remittances and their high propensity to save should not be wasted, and could serve to finance micro-enterprises and small-scale operations. Moreover, the loss of collaterals due to asset depletion²⁸ and the conflict itself can be overcome by lending under risk-sharing methods, as UNRWA has done in its latest projects with women micro-enterprise owners (Diwan and Shaban, 1999).

By the same token, reform of the pension system and adequate social security networks should be envisaged in the short to medium-run. The high population growth and the increasing rate of unemployment, added to lower inflows of total factor payments from abroad, have increased dependency ratios and reduced the potential of inter-generational support. Pension funds and insurance companies may be thought of as examples of medium-term investment plans that would improve the overall quality of the social system.

It must be noticed that Israel would be the first to benefit from the re-start of economic activity in the Palestinian territories: not only will this fact improve the living-standards of the Palestinian population thereby reducing discontent and promoting cooperation in peace-making, but geographical contiguity will also insure availability of new opportunities for undertaking joint-ventures with Palestinian firms.

3) Structural change in the Palestinian economy

The main liability of the Palestinian economy is the composition of output by sector and the structure of employment. Three major weaknesses can be identified:

- 1) a large share of agriculture in overall employment, 15.7 percent in 2003, as well as in GDP, 12.1 percent in 2003 (UNCTAD 2004, p.8); moreover, in recent years there are no indications that these two shares are decreasing;
- 2) a very high level of employment in the public sector, which is in the range of 20 percent, but reaches levels of 32 percent of total employment in the Gaza Strip (World Bank 2002, pp. 41-2; UNCTAD 2004, p.8);

²⁷ This approach is widely stressed in the Plan for the Reconstruction and Development of the Palestinian Economy proposed by the Italian government in 2002.

²⁸ Many Palestinian households had to sell part of their wealth to cope with increasing poverty conditions.

- 3) a low share of employment in manufacturing, which counts a mere 17 percent in the West Bank and is only slightly higher than the figure for construction, which is 14 percent (World Bank 2002).

These three elements indicate that in order to become less vulnerable to exogenous economic shocks and less dependent on foreign intervention, and to correct the large trade deficit, the WBG economy has to undertake a process of structural change in the domestic production of goods and services. This is also the only possible way to achieve some exports diversification, a crucial problem for the growth possibilities in many non-high-income economies. In particular the role and share of manufacture should increase even within the industrial sector, which sees still a large share of construction activities²⁹. In 2001, the total share of industry's value added in GDP was 27 per cent in WBG, and manufacturing accounted for only 15 percent (World Bank 2003, p.192). Construction still plays a big role inside the industrial sector and this not only with respect to workers looking for jobs in Israel but also inside the WBG economy. WBG do not seem to have entered that process of accelerated growth in some manufacturing activities yet, which have been the starting point of the process of output and export diversification in many of the Asian economies that witnessed high growth rates during the past thirty years³⁰. Moreover, a strong and rising manufacturing sector, with increasing share in the GDP, provides a good stimulus to productivity growth and in particular to the so-called Total Factor Productivity.

The WBG economy is becoming largely dominated by the tertiary sector, and that seems to be a fate similar to that of many other developing countries. There is nothing wrong *per se* in producing services, provided they can be at least partly exported; if they belong to the group of non-tradable goods then trade and current account deficits tend to persist. Unfortunately, the dominant type of services in WBG consists in rather traditional ones such as transport, retail trade, tourism, and public services. Apart from tourism, the other activities do not help reduce the trade deficit.

Holding in mind these drawbacks, any immediate effort undertaken to improve the functioning of the Palestinian economic system should be directed towards sustaining labour-intensive sectors and expand the industrial base. The trade regime with Israel should be part of the picture and must take into account the fundamental and basic needs of the Palestinian economy, which will otherwise remain closely dependent on the Israeli economy, and would therefore have to rely on continuous foreign support.

SECTION IV – TRADE RELATIONS: THE SCOPE FOR AN ASYMMETRIC FREE TRADE AREA

Several research works have investigated the possible final economic status between Israel and a future Palestinian State. Among them the most detailed and extensive one is that provided by the World Bank (WB) in July 2002. Current economic relations are regulated by the Paris Protocol (PP), which consisted in a Modified Customs Union (MCU) but has never been completely implemented. In the 2002 report, the World Bank suggests a different regime, the Non Discriminatory Trade Policy (NDTP) as a potential alternative to the MCU: trade relations between Israel and Palestine would in principle be regulated by the Most Favoured Nation (MFN) type of rules, and the World Trade Organization (WTO). The study makes no explicit reference to special arrangements with respect to the mutual trade of Israel and Palestine.

Most of the analysis on final economic agreements points to a FTA as the most appropriate arrangement between the two economies (Peres Center 2004, p.11), while World Bank 2002 suggests NDTP as the best way to increase Palestinian GDP and to improve exports and

²⁹ The combined analysis of data from UNCTAD 2004 (p.8) and World Bank 2002 (p.41) shows that manufacturing activities within the industrial sector are currently larger than those related to construction, though by a small margin of 3 percent points of employment in WBG.

³⁰ A similar problem seems to exist in other economies of the region, most notably Lebanon and Jordan.

productivity. The latter document comes from a high status institution with a specialised economic team and, above all, it is extremely well documented. Moreover, the report provides extensive simulations of the relevant economic magnitudes for five different trade regime scenarios³¹, three of them being a clear improvement in the present conditions and also in the conditions prevailing during the period of the Paris Protocol (1994-2000) before the start of Al-Aqsa Intifada (World Bank 2002 p.90)³². The WB report concludes that a NDTP is superior to both an Improved Customs Union, with full application of the PP, and an FTA with Israel (World Bank 2002 p.86).

It seems interesting to concentrate the discussion on two of the possible trade arrangements, NDTP and FTA, and try to see to what extent there is a real opposition between the two. It is our impression that when some economic considerations about the two economies are brought into the picture (see Section II) it becomes apparent that the possible final status economic arrangements between Israel and Palestine could incorporate elements belonging to both trade regimes. In fact, a FTA should take into account the preoccupations of the World Bank study and should thus be 'asymmetric' in such a way as to provide for an *ad hoc* and favourable environment for the Palestinian economy to protect its industries, at least for a limited number of years.

In its Economic Road Map, the Aix Group recommends a FTA regime, while being rather explicit in recognising the differences between the two economies. In fact, "as a developing economy, the Palestinian state would be granted by Israel the option to temporarily protect some sectors on an MFN basis" (Aix Group 2004, p.16); notice that MFN rules are nothing else but NDTP³³. In the following page we read that "the FTA regime should allow for a degree of asymmetry - whereby for a certain period Palestine can implant certain trade restrictions on imports from Israel (...).The purpose of this would be to stimulate Palestinian economic growth and domestic employment, as was the case with the 1975 agreement between Israel and the EEC" (ibid. p.17)³⁴.

Two elements must be considered:

1. the close links of WBG with the Israeli economy which cannot be easily and substantially modified in the medium-term, and this is what suggests a FTA instead of the Modified Customs Union of the Paris Protocol;
2. the fact that Palestine is a lower middle income economy with a very weak production base, and this theoretically as well as practically, requires specific adaptations of the FTA regime, irrespective of the issue of the rules of origin. This adaptation must acknowledge a North-South dichotomy as the starting point and therefore the need to formulate economic agreements accordingly.

I) NORTH-SOUTH FREE TRADE AREAS

There is a vast body of economic theory according to which free trade is good for growth and development, under both conditions of perfect and monopolistic competition. Each country should experience an increase in welfare mainly due to an inter-sectoral reallocation of resources. Things are more complex and even in most basic models developing countries do not necessarily gain from trade liberalisation; this for several reasons, among which:

³¹ The assumptions underlying each scenario are in World Bank 2002 pp. 81-83. The five scenarios are also contrasted in two opposite cases: a High-Case where there is a strong economic dividend out of a peace agreement, and a Low-Case scenario where rising transactions costs hinder the Palestinian economy (see ibid, pp 93-4).

³² A valuable contribution by the Peres Centre for Peace summarises the findings and indications of some of these options, though there is no detailed mentioning of the World Bank 2002 report.

³³ Temporary protection and modifications even to the MFN standard may be necessary for a developing country, particularly a lower middle income economy such as WBG, to grow fast. Notice that this does not imply closing the country to foreign trade, but rather opt for a selective, guided, integration into the world economy, as the Asian Miracles have by now abundantly shown (see for instance Wade 1990 and UNCTAD 1996).

³⁴The views presented in this paper are in by no means to be ascribed to the Aix Group, of which one of the authors is a member.

1. the smaller economy may be an importer of subsidised exports, particularly equipment and machinery, from rich countries: if subsidies were eliminated, the developing country would pay more for her imports;
2. trade liberalisation affects relative prices and some country may end up with worsened terms of trade;
3. often the reduction of external tariffs implies a considerable fall in budget revenue for a developing country³⁵.

If multilateral Free trade is generally regarded as the long-term ideal-type of economic arrangements, two issues are becoming part and parcel of today's debate on trade: first, the role that regional integration and agreements can play; second, the need to have special trade arrangements for the poorest and weakest economies. There is growing recognition for the fact that when there are asymmetric initial economic conditions among countries, these differences must be acknowledged in their trade relations and may ask for modifications - at least temporarily - of the general thrust towards free trade.

In recent years there have been several initiatives which have focused on the need to proceed with policies designed to strengthen the production and export structure of developing countries. Most of these policies are intended to serve Least Developed Countries (LDCs), particularly Africa. Two general principles seem to motivate most of these initiatives:

- richest economies must favour access to their markets for the products of the weaker countries;
- the latter need some time to diversify their output and export structure and, hence, to implement free trade regulations at a slow pace.

We can mention four initiatives:

- a) the World Trade Organization applies special accession rules for low income economies, based on principles which allow for the preservation of the *Special and Differential Treatment*, in order to allow poor countries to gradually change their economic structure, and differentiate their export base (Maxwell and Engel 2003, p.8);
- b) the EU has proposed specific policies towards the poorest countries, such as *Everything but Arms (EBA)* of 2001, granting free access to her markets for many of the products of LDCs. Another important initiative is the *Cotonou Partnership Agreement* of June 2000, ratified in April 2003;
- c) the United States have launched the *African Growth and Opportunity Act (AGOA)* to favour imports from the poorest countries of Sub-Saharan Africa;
- d) in 2005, quota restrictions in textiles and clothing have been removed for WTO members, a fact which could generate problems to some producers, mainly in Africa, despite their duty-free advantage to EU markets *vis à vis* the Asian competitors. The EU is in fact considering modifying the *Generalised System of Preferences* and easing the rules of origin, including regional cumulation, in order to help poorest countries - which are also the weakest producers of textile.

These are just few examples illustrating the latest changes in the vision of free trade, which take into account the different income per capita levels across different countries and regions. Unfortunately, even if based on noble principles, some of these policies are still difficult to implement, while other ones have not been put into effect at all. In general terms, many developing countries are still incapable of immediately gaining from trade liberalisation in Europe³⁶.

The richest countries could, and should, be more generous in terms of trade agreements with Southern countries; the idea that the latter need to undergo a process of structural change in their economies seems to be more and more accepted. There is by now a wide recognition that, in

³⁵ See more on this in Vaggi and Missaglia 2004.

³⁶ However, imports from EBA countries into EU have increased by almost 9% since enforcement of the treaty.

specific cases, free trade needs to be asymmetric and should be implemented in a gradual and differentiated way for different groups of countries.

These considerations are highly relevant to the final status economic arrangements between Israel and Palestine and in particular for the type of Free Trade Area to be designed. Before moving to analyse the future trade agreements between the two parts in question, we want to make some further considerations on two famous Free Trade Areas: the European Union Association Agreements with partner countries in the Mediterranean Basin, and the North American Free Trade Area (NAFTA). Both experiences represent examples of North-South trade.

1) EU Association Agreements with MENA countries

Ten countries have joined the EU in May 2004. This is an important achievement, but other countries still await at the borders: to the East, in the Balkans, and to the South of the Mediterranean Basin. The EU must undertake coherent economic strategies towards these countries; they will not become full members in the near future, but they cannot simply be left out in the cold. Here trade liberalisation might help and indeed it could prove a powerful instrument for growth³⁷. The European Union is steering itself towards the stipulation of bilateral agreements of free trade with Mediterranean countries, following the indications introduced by the Barcelona Conference in November 1995, where a wish was expressed to set up a large area of free trade in the Mediterranean by the year 2010³⁸.

The EU has a trade surplus with Mediterranean countries of almost 10 billion euros; moreover, many of these countries export more than 50% towards EU markets. The success of free trade policies in the Mediterranean highly depends on the concrete features of the Association Agreements and on the timing of the integration process itself. Unfortunately, the way in which the agreements are designed, mainly asking for liberalisation of industrial exports of EU to the Mediterranean, are likely to produce more damages than benefits to MENA partners. As early as 1996, the IMF warned that "the European exporters will benefit from the progressive lowering of commercial barriers in Mediterranean countries" (International Monetary Fund, *IMF Survey*, 1996, p.368)³⁹. In the short-term, the EU trade surplus with the Mediterranean countries could eventually increase, but the lowering of tariff rates in the Mediterranean countries will involve a significant loss of fiscal revenue for recipient countries (ibid.)⁴⁰.

Given the above considerations, MENA countries should not necessarily liberalise their trade at the same time and in the same way as the EU. It is important that they be accorded access to European markets, but without temporary protection of their fragile manufacturing sectors they will incur even larger trade deficits. Trade liberalisation is not a once and for all accomplishment; it must be seen as a sequence of events⁴¹.

³⁷ An example of extremely fast 'trade re-orientation' and of the enormous power of attraction which a large economic area has on her smaller neighbours comes from some countries of Central and Eastern Europe, where in just four years, from 1988 to 1992, the EU has replaced the former USSR as the most important commercial partner (Vaggi 1999).

³⁸ An extensive analysis of this issue can be found in Joffé 1999.

³⁹ A detailed analysis and a strong criticism of the way in which these Association Agreements between EU and some MENA countries are structured at present can be found also in Mold 2004.

⁴⁰ Europe already plays the role of the large market for exports for countries of the region such as Egypt, with the exceptions of Jordan and Lebanon, with the United States playing a smaller role from this point of view.

⁴¹ The so called "sequencing of liberalisation" was a major issue in the late eighties with respect to countries of the former Soviet Union; some MENA countries, and certainly WBG, are in even weaker conditions than most of the former Soviet Union countries were in 1988.

2) North American Free Trade Area (NAFTA)

NAFTA represents an *ad hoc* Free Trade Area, with special provisions evidently designed for Mexico and having in mind some specific manufacturing activities⁴². Moreover, geographical proximity helped to conceive a very specific type of Foreign Direct Investments (FDI)-production-assembly-sales linkages between the Northern and Southern sides of Rio Grande which goes under the name of *maquilla*.

In many ways NAFTA has been a successful strategy if we look at the composition of Mexican exports from 1982 to 2000, manufactures replacing fuel as the major export item (Martelli 2003). However, there are several negative elements in NAFTA: namely, low technological content of the *maquilla* products and low value-added. Mexican exports to the US are growing at the expenses of productivity: economic growth has been limited to the Northern provinces of Mexico and even there value-added in manufactures increased significantly lesser than overall export⁴³. Moreover, net exports have not improved during the last twenty years: the overall growth of the economy has not been particularly robust since 1994 and the trade balance is still in deficit (ibid.).

Export diversification and an increase in the share of manufacturing are a necessary condition for a sustainable process of economic growth, but probably not a sufficient one. In the case of Mexico, in fact, increase in the share of manufacturing exports has not led to major backward and forward production linkages within the overall economy.

II) WHY AN ASYMMETRIC FREE TRADE AREA BETWEEN ISRAEL AND PALESTINE?

The lessons arising from the EU Association Agreements and NAFTA could be extremely relevant to design future economic relations between Israel and Palestine.

Notwithstanding the peculiar political conditions of the area, the present economic relationships between Israel and WBG resemble in many ways those existing among two regions, a rich one and a poor one, within a country. Incomes per head are different; there are independent statistical sources and data; and, above all, there is a distinct citizenship. But at the same time there are:

- a *spurious* customs union;
- a *spurious* monetary union - the NIS is widely used in WBG for day-to-day transactions⁴⁴;
- an interconnected and segmented labour market;
- a peculiar *fiscal transfer system* - under the Paris Protocol the duties and taxes on the external trade of WBG are levied by Israel and then transferred to the Palestinian National Authority (PNA)⁴⁵.

All these links have been established and are currently managed unilaterally by Israel, and not by consensus between the two parties. The Paris Protocol provided for a Joint Economic Committee which was supposed to co-ordinate the activities between the two sides, but this committee has never acted properly (World Bank 2002, pp. 8-9)⁴⁶. Thus, WBG economic dependence on Israel rests on three major grounds:

1. the fiscal transfer system of external trade taxes;

⁴² The Brady Plan of 1989 can be seen as the financial side of the US strategy to support the Mexican economy, while NAFTA is the commercial side (see Vaggi 1999 and UNCTAD 2002).

⁴³ In South Korea both net exports and the value added of manufacturing have constantly risen from 1976 to 2001 (Martelli 2003, p. 22-23). On economic growth in South East Asia and the fundamental role of ad hoc policies in it see also Rodrik 2003, mimeo.

⁴⁴ On the monetary arrangements between Israel and Palestine see Cobham 2004, Cobham and Kanafani 2004.

⁴⁵ The 'fiscal transfer system' is a typical mechanism in operation inside a sovereign and independent country, but it is also at work within the EU (see Vaggi 1999).

⁴⁶ The emphasis on the common sharing of economic decision is a key point in the proposal of the Aix Group.

2. the labour market and its 'closures', to the point that variations in Palestinian GNI are sometimes calculated according to the days of closures;
3. trade relations, with 76 percent of imports coming from Israel and 96 percent of exports going in the same direction (World Bank 2002, p.16, and UNCTAD 2004, p.7).

It goes to the credit of two Israeli scholars (Arnon and Weinblatt 2001) to have first indicated the need for clear economic borders and an independent and sovereign economic policy: the two economies should retreat from the Paris Protocol and *spurious* Customs Union in which they have been involved in the past and shift to a looser type of link, as it is that implicit in a FTA. On the other hand, given the strong interdependence that links Israel and Palestine at present, it is unlikely that there will be complete economic separation between the two economies in the near future; Israel will continue to be Palestine's biggest trade partner, whatever the trade regime adopted (World Bank 2002, pp.85-ff.)

Given the small territory and the strong contiguity of the two economies, a FTA seems to be the most realistic arrangement: it will ensure future harmonization in trade and purchase taxes, and help limiting smuggling and favour joint industrial parks and productive initiatives, which are extremely sensitive to the trade tax system.⁴⁷ According to the World Bank study of 2002, a FTA carries some disadvantages with respect to a NDTP in terms of the lower impact on GDP and export growth (World Bank 2002, pp.27-ff. and pp.87-ff.) and higher administrative costs linked to the need to assess rules of origin. The lower competitiveness of the Palestinian economy in a FTA with respect to NDTP derives from higher domestic wages, because of workers flowing to Israel and higher input prices from Israel. These are indeed relevant observations and justify the need for *ad hoc* arrangements in the FTA that would prevent, or at least limit, negative outcomes arising to the Palestinian economy. An Asymmetric Free Trade Area (AFTA) could fulfil this purpose.

We have seen that there are other *de facto* examples in which different levels of income per capita account for differentiated rules in trade agreements. Explicit recognition of differing initial conditions and asymmetries allows for a better formulation of trade agreements, and might eventually ensure their efficient continuity over time⁴⁸. In our view, an AFTA between Israel and Palestine should include three main elements: two of them are related to trade, one to industrial policy.

1) Trade concessions

The FTA should be accompanied by temporary concessions in favour of Palestine to protect some sectors of her economy; otherwise the larger and more productive Israeli economy would simply prevent the smaller one to develop an autonomous productive capacity. This implies drawing a list of goods, mainly on the side of imported inputs, where Palestine can look for best prices, independently of the FTA. This agreement need not be detrimental to Israel; exports to WBG are only 6-7 percent of total Israeli exports, and much less in terms of value-added, since most of them are transit trade (World Bank 2002, p.107)⁴⁹. These recommendations include some expenditure in infrastructures, both at the borders and at governmental level. Notice that these costs, added to those specifically linked to the administration of the rules of origin, are among the reasons that led some authors to state the superiority of a NDTP with respect to a FTA (World Bank 2002, p.89; Dessus and Ruppert Bulmer 2004, p.24). These costs are albeit unavoidable if an independent Palestinian State has to come into existence: an Administration capable of handling different trade agreements and of managing border trade is an essential element of any country's economic viability.

⁴⁷ On these issues see the work of the Aix Group 2004.

⁴⁸ One of the major problems with the Paris Protocol was the fact that it was a kind of incomplete contract (Arnon and Weinblatt 2000).

⁴⁹ According to UNCTAD 2004, only 2 percent of total Israeli exports go to WBG; while WBG trade with Israel is 60 percent (UNCTAD 2004, p.7).

2) Palestinian trade with neighbouring countries

A FTA with Israel should be accompanied by trade agreements with other partners in order to help Palestine reduce her economic dependence on the former, and to diversify her export markets. Thus, there should be a set of different FTAs. In North-South models, partners' diversification means reducing the dependence of the Southern country on the economic cycle of the Northern one. In the case of Palestine, economic independence from Israel should mean export-markets diversification and direct external trade with chosen trading partners, without having to pass through Israel and thus having full economic control of her borders. Moreover, in the case of WBG, agreements with the EU and the Arab countries already exist, and Palestine needs to take advantage of the proximity with countries with similar economies, such as Jordan, Lebanon, and Egypt. Notice that Israel could benefit from other FTAs by increasing her exports to other countries, for instance in the Arab world, through trade with Palestine, and this could justify special treatment to favour the Palestinian economy inside the FTA with Israel. The 'hub and spokes' effect could arise, with Israel being economically well placed to play the 'hub' role and thus able to take advantage of any trade agreement, even indirect ones. For this reason, the external trade of Palestine has to be closely supervised by the government, particularly in the initial phase of its full economic independence.

Palestine is already part of the Greater Arab Free Trade Area (GAFTA), proposed by the Arab League at the end of the 1990s (Zarrouk and Zallio 2000, pp.7-8), at least in principle, since at the moment she has no direct borders with other Arab countries. During the last ten years several intra-MENA FTAs have been established (*ibid.*)⁵⁰, a fact which might have led to some confusion, particularly for what concern rules of origin. Conditions on inputs are usually set as a percentage of the overall value-added: for instance in GAFTA, preferential rules of origin require that at least 40% of the value-added be produced in the partner country⁵¹. In a FTA which includes two countries at different levels of income and with very different export bases, the need for asymmetric considerations is also strictly linked to the problem of rules of origin. Because of the different factor endowments of the two economies, the country with a wider and more diversified pool of factors is in sharp advantage in satisfying the input requirements necessary to receive the duty-entry benefits of the preferential rules of origin provided by the FTA. In the ambit of a FTA, the situation can be asymmetric not only because of different factor endowments, but also because of different technological capabilities and the different extents of economic integration into the world economy of the two countries entering the FTA.

In all cases, a 'hub and spoke' effect could emerge; that is to say, firms could invest in the richer and more diversified economy, where they can find both factors and technology sufficient to fulfil the rules of origin required to have preferential access to the market of the less advanced country. Notice that since 1993 Israel has liberalised its trade policy and has entered several FTAs (World Bank 2002, pp.17-8, 25) and it is undoubtedly more technologically advanced than WBG, particularly in the sense of being capable of producing more inputs and capital goods. Hence, the Palestinian economy needs to be 'temporarily protected'; otherwise its trade dependence on Israel will increase.

3) Industrial policy

The above considerations have clear implications for some autonomy in the industrial policy of Palestine and in her bilateral relations with Israel: the 'infant industries argument' suits well the

⁵⁰ However, intra Middle East trade is still very low (Askari et al. 2003).

⁵¹ In GAFTA there is the so called 'cumulation of origin rule' which allows for 40% of value-added to be produced inside the GAFTA countries and does not in each of them separately (see Zarrouk and Zallio 2000, p.14). This cumulation principle would be more difficult to apply among very different economies. More on this issue can be found in Hirsch 1998.

Palestinian economy, manufacturing needing to be fostered and initially supported with appropriate industrial policies.

In the World Bank 2002 scenarios, productivity increases derive mainly from trade openness; thus, Total Factor Productivity (TFP) is a function of the share of exports (Dessus and Ruppert Bulmer 2004, p.21-22), and this explains the greater performance of a NDTP *vis à vis* a FTA; all the more so if a FTA implies more Palestinians going to Israel for work and thus higher domestic wages than in the NDTP scenarios (*ibid.*). Simply stated, reducing the number of people working in Israel, as in NDTP, should increase the downward pressure on wages in WBG⁵² and, coupled with trade openness, should produce an increase in the export share of real GDP and further stimulate foreign and domestic investments; this in turn should trigger exogenous technical progress and increase productivity.

However, linking productivity growth to trade openness, as in World Bank simulations, gives sensitive measures. This scenario contains several elements of truth, but other important elements are missing: it is a 'thriving supply-side tale' based on only one static comparative advantage for WBG, namely low wages. If technical progress is entirely exogenous, all dynamic considerations which are usually linked to endogenous technical progress are ignored: in a dynamic scenario, productivity and TFP increases would also depend on the growth rate of industry, and in particular of manufacturing, because part of the technical progress is embodied. Together with competitiveness in foreign trade, capital accumulation in the dynamic sectors is an essential element contributing to long-term profitability, as World Bank studies extensively suggest.

In economies such as WBG, with a weak production base and a history of low productivity increases and low investment ratios in high value-added sectors, both private and public investments must be supported, at least at the beginning, by appropriate and *ad hoc* policies which could ensure a high rate of return and sustain accumulation. These considerations bring to the forefront issues such as the composition of output, export diversification, and the emergence of significant forward and backward linkages. An independent *industrial policy* should be designed to support specific sectors and could adopt measures that have already proved effective in other areas⁵³: gradual liberalisation and outward trade orientation; policies designed to favour the long-run export capacity of an economy through subsidies for the most dynamic sectors; and special economic zones with clear fiscal advantages, both for domestic and foreign investors. With these kinds of policies, Palestine would simply replicate the strategies already adopted by Israel and other neighbouring countries.

UNCTAD asks for policies designed to support specific sectors of the economy that need to receive priority attention. These sectors include part of agriculture, manufacturing industries related to natural resources, and information technology (UNCTAD 2004, pp.12-13). Similarly to many other developing countries, the difficulty of Palestine is that of speeding up growth in some exporting and high-tech sectors, without leaving behind traditional ones and support of infrastructure. Industrial policies must also stimulate the network of small and medium-sized enterprises which are an important element of the WBG economy, but which also need appropriate support if they are to become stronger and more self-reliant in the medium to long-run.

Some type of industrial policy would be needed in the NDTP scenario as well. However, the AFTA with Israel has one main advantage over a NDTP: transaction costs are lower, and this is as an extremely important element to stimulate investment and production. As a matter of fact, Dessus and Ruppert-Bulmer (2004), although in favour of a NDTP, recognise that in a situation of high transaction costs, as it is the case now and was before the second Intifada, FTA leads to better results than a NDTP, all the more so if labour flows to Israel remain significant.

⁵² This would eliminate the 'Dutch disease' effect due to incomes accruing to WBG but not being generated there, which implies that in WBG wages tend to be higher than those of neighbouring Arab countries.

⁵³ The East Asian miracle is largely explained by a mixture of exposure to international competition and appropriate industrial and export promotion policies (see for instance UNCTAD 1996, and Rodrik 2003).

SECTION V: CONCLUSION

This paper provides some indications for a possible path that would lead the Palestinian economy from relief to development. Considerations on relief are highlighted in sections II and III, while section IV concentrates on long-run trade relations between the two countries here under study.

The relief measures cannot but be grounded on the conditions existing in the WBG economy and have to prove effective in the very short-run. Nevertheless, even in the short-run these initiatives must try to stimulate the economy to move away from its vast dependence on the Israeli one, particularly for what concern the labour market.

An Asymmetric Free Trade Area can serve the long-run growth of the Palestinian economy by taking into account existing socio-economic conditions: the close links existing between the two economies; the labour flows to Israel, all the more so if a peaceful situation emerges; and the need for Palestine to take advantage of the largest and more technologically developed Israeli economy. The relationships between the two countries should not resemble those now prevailing in NAFTA, with Palestine becoming a kind of assembly line for Israel.

Why should Israel accept this special FTA? In a situation of peace, Israel will in any case benefit from the development of the Palestinian economy and even from the latter's closer integration with other economies in the region. As a matter of fact, Israel is already a kind of North to Palestine, and potentially to neighbouring countries; the Israeli economy would thus play the 'hub' role in the region.

A final consideration concerns the role of high-income economies, which are often regarded as, and indeed are, 'donors'. We prefer to consider them as large consumption markets: North America, parts of Asia, and in particular the EU could potentially realize the *more trade-less aid* allegory if more generous Association Agreements with developing countries were generated. An increasing integration of the Palestinian economy with Arab neighbouring countries such as Jordan, Egypt, Syria, and Lebanon would lower the costs necessary to sustain, mainly through trade concessions by the EU, the economies of the region as well. Regional integration, in fact, is not opposed to multilateralism, or to the fact that a large market such as the EU has a dominant economic role in the region. Rather, regionalism should be seen as a way of reducing the costs currently borne by Israel and the EU alone. A Middle East Common Market coupled with export promotion outside the area - a kind of export-oriented regionalism - could ensure economic development in the area⁵⁴. Regional economic integration can be part of an overall strategy to give Southern trading partners the time they need to overcome limits in their commercial capacities and become 'less unequal' partners.

Political events have strongly influenced the economies of Israel and Palestine in latest decades. By the same token, however, a sustainable growth for the Palestinian economy should be seen as an essential pillar of long-lasting peace in the Middle East. This is an important conquest and *ad hoc* economic policies can help the Palestinian State undertake the process of structural change that is needed to attain economic viability.

⁵⁴ For the potential of a great free trade area in the Middle East under conditions of peace see Rosenberg 2003.

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