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TRADE AND ECONOMIC LINKS IN THE TRANSITION PHASE: THE WEST BANK AND GAZA STRIP

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PREFACE

After some three decades of warfare and hostility, two of the major parties to the Arab-Israeli conflict have taken dramatic steps along the road to an overall Middle East peace. A peace treaty negotiated between Egypt and Israel at the diplomatic level is, of necessity, largely political in nature, with related security questions resolved as part of the implementation process. Ultimately, however, such political and military considerations merely provide the basis and the near-term stability in the environment during which the conditions for long-term peace and stabilization can be achieved.

In virtually every international situation, the fundamental basis of long-term stability lies in the economic incentives for the parties to maintain such a situation. Thus, in the Middle East, it is highly likely that, over time, the trade, economic links, development programs, and other mutually beneficial aspects of a settlement will do more to ensure its ongoing success than any other factor. Crucial in this regard will be the economic links which develop between the territories occupied by Israel since June 1967 in the Gaza Strip and Jordanian West Bank areas, with Israel, Egypt, Jordan, and the rest of the world.

With such a view, the present research looks toward the impact of a peace settlement on Israel, Egypt, Syria, Jordan, and Lebanon from the standpoint of the trade and economic links which are expected to develop with the West Bank and Gaza in support of PRM 39 study requirements. The analysis here is focused on expected developments during the five-year transition phase and beyond, considering such potential changes in trade linkages and barriers to trade as well as the effects of changes in direction and volume of trade on local production, productivity, employment, and income.

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1.1 The Political and Economic Context Since June 1967

Since the inception of Arab-Israeli hostilities in May 1948, efforts by the United States and other powers have focused on achieving an end to the conflict, and the conclusion of a comprehensive settlement accord. Negotiations conducted at various points since 1948 have led to a series of truces between Israel and the major Arab confrontation states, including the 1949 Armistice Accords signed at Rhodes and, most recently, a series of disengagement accords concluded following the 1973 October War.[1]

In large part, these truces, interim agreements, and partial accords have focused on the immediate problem of terminating hostilities and setting disengagement frontiers. Most of these agreements, negotiated through third-party intermediaries, have at best looked toward political negotiations which would then lead to a comprehensive settlement.[2]

While efforts to achieve a political settlement have been under way since the 1973 war, it has only been since the beginning of the Sadat-Begin initiative in 1977 that the parties have moved decisively toward achieving this objective. Although the bulk of the discussions have thus far centered on key political and military issues, there is an assumption on the

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[1] These include the 1974 Sinai-I and 1975 Sinai-II accords between Egypt and Israel, and the 1974 Syrian-Israeli disengagement agreement.

[2] There appears to have been at least a tacit agreement on the part of the confrontation states, as well as the United States, that the priorities in achieving a viable settlement include termination of ongoing hostilities, disengagement of Arab and Israeli forces on a near-term basis, stabilization of the regional military situation to prevent the outbreak of further hostilities, resolution of critical political and military issues between the parties, and, finally, the implementation of a comprehensive settlement accord which would provide the basis for long-term regional stability. See R. D. McLaurin, Mohammed Mughisuddin and Abraham R. Wagner, *Foreign Policy Making in the Middle East* (New York: Praeger Publishers, 1977).

part of all concerned that, over the long term, economic incentives will provide the key to any settlement's effectiveness.

It is useful to note that over the years the nature of the Arab-Israeli conflict has changed dramatically, largely as a result of the capture by Israel of the West Bank (including East Jerusalem), Gaza Strip and Golan Heights areas during the June 1967 War.[3] Had the major Arab confrontation states been willing to enter into a peace agreement with Israel on the basis of the frontiers then existing, there is little doubt that such an agreement would have received overwhelming support in the Israeli Parliament, the *Knesset*.[4]

With the exception of areas in East Jerusalem annexed by Israel, the status quo has consisted of deferring any Israeli decision about the political future of the West Bank and Gaza which is, in essence, what the framework emerging from the Camp David Summit proposes for the transition phase of five years to continue. Israeli government policy (including economic and defense policy as well) with respect to these territories has been based on three essential assumptions:

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[3]Israeli usage continues to refer to these areas as "administered territories" while common usage in the United States and elsewhere has been to refer to them as the "occupied territories." As used in the present report, the term "territories" includes those areas captured by Israel in the June 1967 War including the West Bank, areas of East Jerusalem occupied and annexed by Israel since 1967, and the Gaza Strip. The Golan Heights, also occupied since 1967, are not included in the terms of reference for the study and have been excluded. It is also important to note that data for East Jerusalem has not been included in the analysis since published figures have excluded it from the West Bank figures and are not readily available for re-inclusion in published figures for the West Bank.

[4]These frontiers were essentially the 1949 Armistice lines, although agreement could likely have been reached on the basis of the 1947 partition plan as well. For a concise review of the political setting, see Larry L. Fabian, "Prologue: The Political Setting," in Brian Van Arkadie, *Benefits and Burdens: A Report on the West Bank and Gaza Strip Economies Since 1967* (New York: Carnegie Endowment for International Peace, 1977).

- that Israel would not formally annex the territories (with the exception of East Jerusalem);
- that Israel would not withdraw from them, absent an overall Arab-Israeli peace settlement; and
- Israel would not allow them to become a net economic burden.

The implications of these assumptions are considered at somewhat greater length below.

Economic Integration

From 1948 through June 1967, Arab-Israeli hostilities created a situation whereby Israel was economically isolated from the rest of the Middle East.[5] Prior to June 1967, the economy of the West Bank was linked to the Arab world through Jordan, and that of the Gaza Strip, administered by but not treated as part of Egypt, through the Egyptian economy.

Military occupation by the Israeli Defense Forces (IDF) following the 1967 Six-Day War provided the opportunity for Israel to "break the seal" on the economic boycott and implement a new type of economic coexistence with the West Bank, Gaza, Jordan, and Egypt. The economic implications of this occupation were fairly clear. First, Israel could not treat the territories as an integral part of the Israeli economy. Second, as the administering authority, Israel was forced to deal with the economic requirements of the territories in some fashion and could not be indifferent to the welfare of their inhabitants. Third, the revenues provided by the territories (either directly or indirectly) would necessarily limit the scope of Israeli economic activity in these areas.

On balance, it was these considerations, rather than any overall or master economic plan for the territories, which determined the level of

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[5] Not included in this analysis is unreported smuggling, which has been an essential part of the Gaza economy at least since the time of the Crusades. Additional "unreported" links between Israel and the Arab world, largely through Lebanon, have existed since May 1948 and were considerably expanded following the Israeli "Litani Operation" in March 1978.

Israeli public investment in them as well as their economic development and the development of trade and economic links during the 1967-1978 period. The developments which did take place were characterized by economic improvisation. While this fell short of the "maximum integration" sought by some in the Israeli leadership, it did provide for the creation of highly significant economic connections within a remarkably short time.

As a practical matter, the territories required markets for their agricultural produce, the foundation of the economies in both the West Bank and Gaza. A net agricultural exporter itself, Israel permitted the West Bank to continue serving its traditional markets in Jordan through an "open-bridges" policy across the Jordan River. Gaza produce, never a major factor in Egyptian markets, was transferred to Israel and sold through Israeli marketing channels.

A rapidly expanding Israeli economy provided employment opportunities for a considerable number of West Bank and Gaza workers in unskilled and semi-skilled occupations. Here Israeli policies and the short distances involved permitted Gaza and West Bank inhabitants to commute to jobs in Israel on a daily basis, providing an essential and growing economic link.

1.2 Evolution of Economic Links with Israel and the Arab World

The close of the June 1967 Six-Day War and Israel's decision not to withdraw from territories occupied during the course of hostilities, as it had following the 1956 Sinai Campaign, forced Israel to come to grips with a number of practical problems concerning the territories. Differing points of view within the ruling Labor Alignment as to what should be done with these areas soon arose. The debate included both the issues of administering the newly occupied areas in the West Bank, Gaza Strip, and Golan Heights as well as the broader questions of using these territories as bargaining leverage with the Arab confrontation states in the search for a comprehensive settlement, and a partial annexation of land, particularly in the West Bank, to Israel itself.

Despite a failure on the part of the Israeli governing authorities to achieve a final resolution of the broader problem, the implementation of military rule brought a number of operational decisions which greatly facilitated the development of economic links in a decade of considerable political uncertainty.

Public and Municipal Services

Within a matter of days following the cessation of hostilities in June 1967, the Israeli military administration took its first measures to restore vital links with the West Bank and Gaza areas, cut since the Israeli War of Independence in May 1948. These included interconnection of water, electric, telephone, telegraph, postal, and other municipal services. Transportation, largely provided by the bus cooperative (*Egged*), was extended into the newly occupied territories, while parallel services continued to be provided by the West Bank bus services.

Barriers between East and West Jerusalem, erected in the 1948 war, sealing Israel from the West Bank, were removed by the Israeli military administration shortly after the cease-fire. Within hours, Israeli shoppers were purchasing West Bank agricultural products in East Jerusalem, while the first Arab and Palestinian workers took up positions on Israeli construction projects. Israeli-funded road works and other construction projects within the West Bank and Gaza provided employment for an increasing number of the territories' residents, while an economic boom in Israel itself provided yet additional employment opportunities, illustrated in Figure 1.1 below.

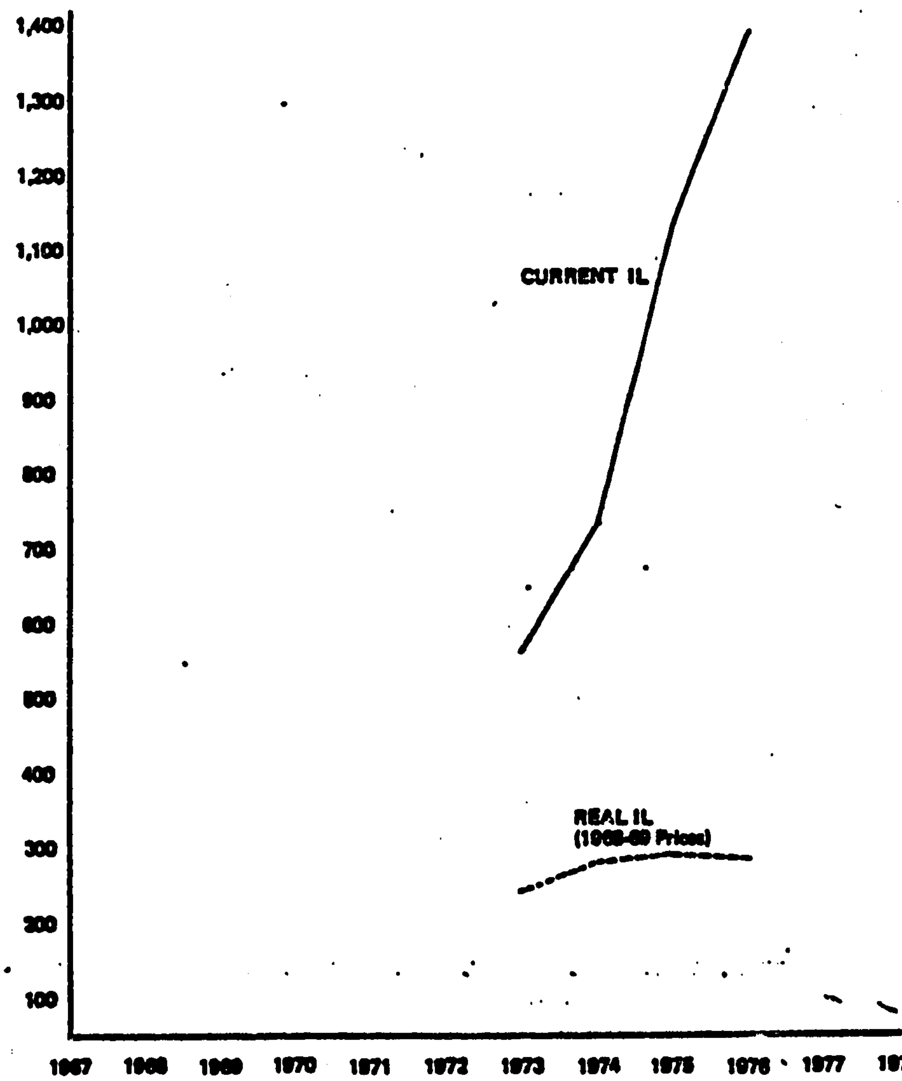
Opening of traditional links with Jordan, via the Allenby and Abdullah bridges over the Jordan River by the Israeli military authorities in tacit cooperation with Jordan, permitted the transfer of West Bank produce and articles manufactured in the West Bank (such as handicraft items and cigarettes).[6]

[6] Many of these items were labelled "Made on the West Bank" and re-exported to other Arab states despite the economic boycott of Israel.

FIGURE 1.1

EARNINGS OF WEST BANK AND GAZA RESIDENTS WORKING IN ISRAEL: 1967-1978

(millions of Israeli pounds)[a]



[a]Conversion of current IL to real IL has been made on the Israeli Consumer Price Index with a base of 1968-69 = 100.

Source: Central Bureau of Statistics (Israel), *Statistical Abstract of Israel* (U), No. 26 (1975), Tables XXVII/12,22,23.

Land Acquisition

Despite the fact that Israel's Labor leadership first viewed the territories as "bargaining chips" from the outset of the occupation era, it is clear that "security arrangements became inextricably mixed with religious and economic motives."[7] Israel placed East Jerusalem under the auspices of Israeli law by special legislation passed at the end of 1967 in deference to popular pressure based on religious grounds. This act had the net effect of annexing Jerusalem's Old City to Israel.

Following the *de facto* change in the legal status of Jerusalem, Israel authorized the establishment of a limited number of settlements on the West Bank and other occupied areas such as the Rafiah Salient in northern Sinai, and on the Syrian Golan Heights, and justified on religious, economic, and security grounds. From 1967 to 1977, succeeding Israeli governments have implemented what came to be known as "Oral Law," a non-written agreement between key Israeli leaders on Israeli presence in the administered territories, based on the so-called Allon Plan and containing the following key points:[8]

- "permanent Israeli presence on the Golan Heights";
- "holding a line from el-Arish on the Mediterranean to Ras Muhammed on the Red Sea";
- "holding Sharm el-Sheikh and a land link to Eilat";
- "a security zone around Jerusalem, in the Latrun Bridge and south of Bethlehem"; and

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[7] Ann Lesch, "Israeli Settlements in the Occupied Territories," *Journal of Palestine Studies,* III, No. 1 (Autumn 1977), p. 26.

[8] Formulated by former Israeli Foreign Minister Yigal Allon, this plan was never implemented as such but was proposed some two months following the June 1967 War and provided the basis for Israeli discussions for a decade.

- "a security border at the Jordan River cutting the populous heartland of the West Bank off from military support from the East."[9]

Israeli land acquisition has been criticized in part as being accomplished through extra-legal means, with significant areas acquired by Israel formerly belonging to the Hashemite kingdom of Jordan, including urban, agricultural, and forested areas as well as 300,000 dunams of desert. State-owned land acquired by the Israeli administration through 1972 amounted to 1,030,214 dunams, with title being vested in the Israel Lands Authority (ILA).[10] An additional 328,789 dunams of absentees' and abandoned properties were acquired in the same period, while in Gaza 119,244 dunams, out of a total of 362,923 dunams, were acquired.[11]

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[9]John Ruedy, "Israeli Land Acquisition in Occupied Territory, 1967-1977," *Israeli Settlements in Occupied Territories,* hearings before the Subcommittees on International Organizations and Europe and the Middle East, Committee on International Relations, House of Representatives, 95th Congress, First Session (Washington: U.S. Government Printing Office, 1977), p. 178.

[10]The acquisition of public land is generally recognized as a legal act by an occupying power. This does not, however, always mean that the public land in question is unproductive, unused, or uninhabited. With regard to land formerly belonging to the public domain on the West Bank, Paul Quering, program director of the Menninite Central Committee in Jerusalem, testified before three House of Representatives subcommittees, stating: "It is granted that a large portion of the land which was taken over by the settlement authority, in the establishment of any of the number of settlements, was used in the public domain before. That should not imply that the land was unused or that it was vacant, or that it was a wasteland . . . in many cases, that land was actively farmed or was used as grazing area by adjacent villagers . . . it had been used for generations by villagers, and this continues to be the case with many Palestinian villages today." *Israeli Settlements in the Occupied Territories,* p. 70.

[11]Absentee land has been defined as property belonging to persons not present in the West Bank at the time of a post-1967 war Israeli census. In a number of cases, owners had fled the area prior to the outbreak of hostilities. Land belonging to persons fleeing the West Bank as a result of the 1967 war is classified as abandoned. Land acquisition has not been limited to state-owned, absentee, and abandoned property, with some efforts being made to acquire privately-owned land as well. "Palestinian (continued)

For the most part, Israel, a signatory of the Geneva Conventions, has allowed the West Bank and Gaza to be administered according to the systems in force prior to occupation. Thus the West Bank has continued to be administered under Jordanian law since 1967 except where such law conflicts with important Israeli policies. Jordanian law regarding the sale of land is one important case in point. Any Arab West Bank resident who sells land to an Israeli is subject to military trial for a capital offense.

Although significant amounts of the privately-owned Arab land acquired by Israel have been through confiscation, thousands of dunams have been bought by the Jewish National Fund (*Karen Kayemet Liyisrael*) with the approval of the military government, and by Israeli companies and individuals using a variety of legal procedures to avoid the Jordanian law.

> Purchases are carried out by means of granting the purchaser an irrevocable power of attorney, and by postponing the registration of transfer until such a time as the land is annexed to Israel, (or until) a permit can be obtained from the military government, or (until) acquisition of land by private individuals is legalized.[12]

Since the purchase is only recognized upon registration, the original landowner remains holder of record title until the land-acquisition restrictions are lifted by Jordan. In addition, the Israeli government has frequently utilized intermediaries in the course of purchases, with such transactions not being publicly recorded. Figures on such transactions are not currently available from the Israel Lands Authority nor the military government.

Composition of Trade

Despite the post-1967 war problems with military rule, land dealings, and various political and security matters, the volume of trade between Israel and the administered territories on the West Bank and Gaza has been

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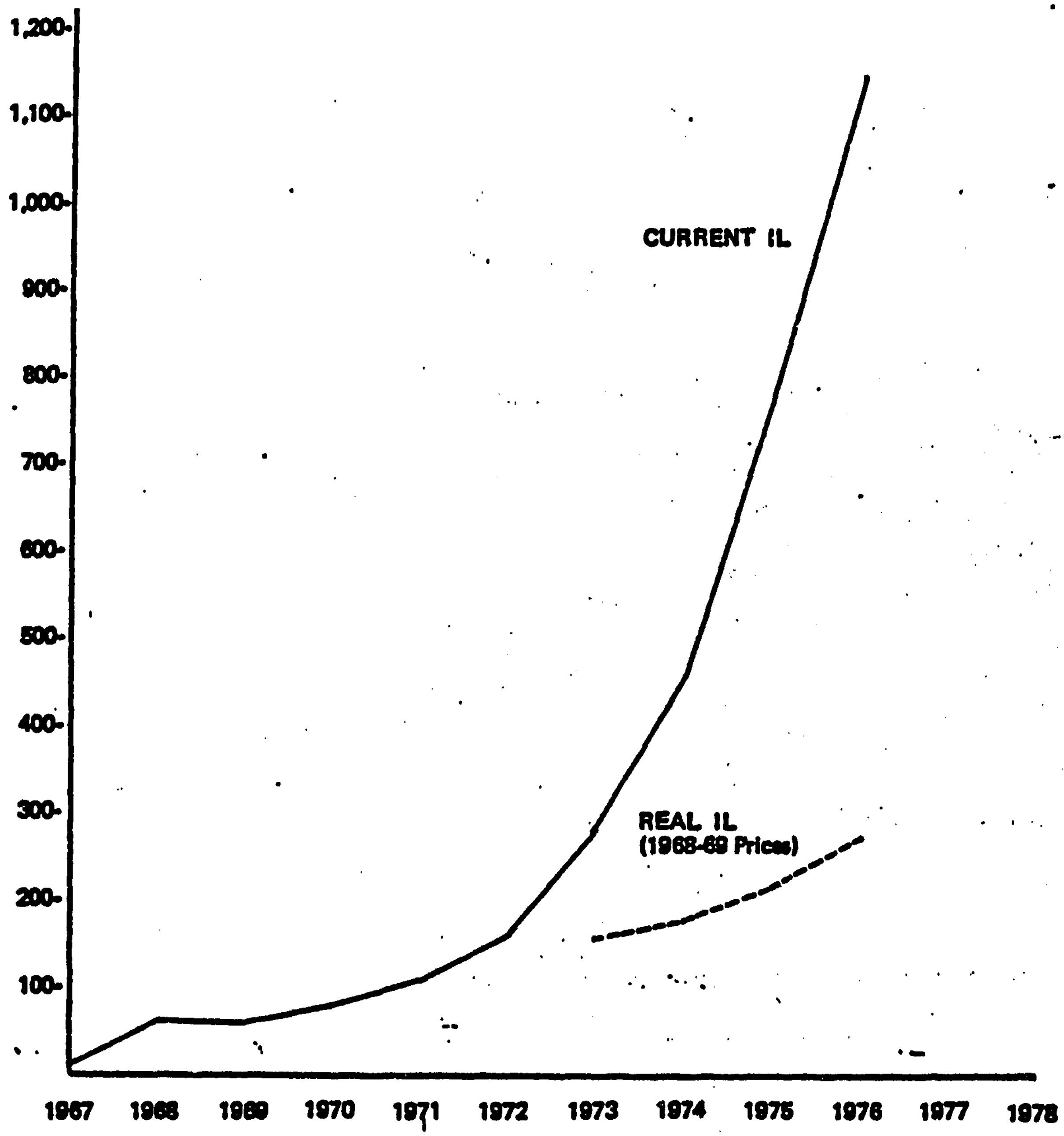
Emigration and Israeli Land Expropriation in the Occupied Territories," *Journal of Palestine Studies,* III, No. 1 (Autumn 1973), p. 112.

[12] *Israeli Settlements in the Occupied Territories,* pp. 44-45.

FIGURE 1.2

VALUE OF EXPORTS FROM WEST BANK AND GAZA TO ISRAEL: 1967-1978

(millions of Israeli pounds)[b]



[b]Conversion of current IL to real IL has been made on the Israeli Consumer Price Index with a base 1968-69 = 100.

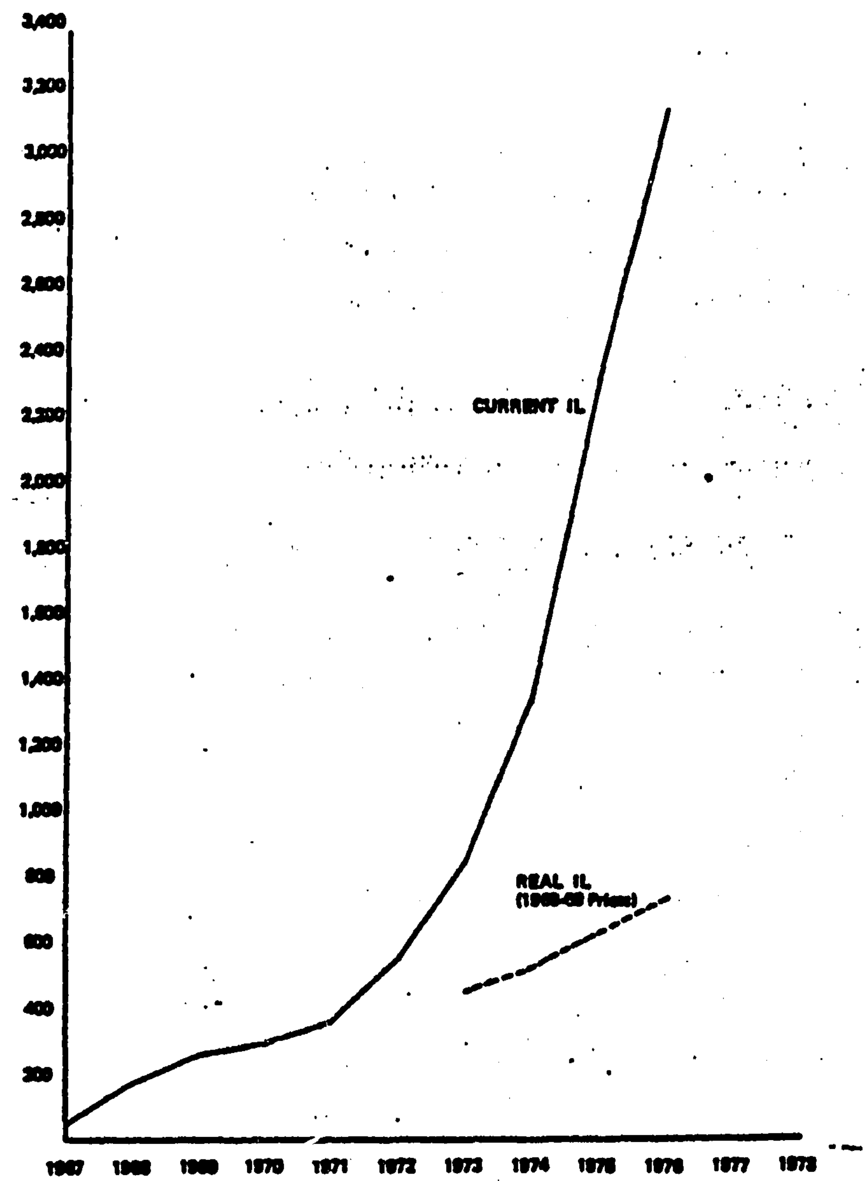
Source: *Statistical Abstract of Israel*, Tables XXVII/11,12.

FIGURE 1.3

VALUE OF IMPORTS FROM ISRAEL TO WEST BANK AND GAZA:

1967-1978

(millions of Israeli pounds)[c]



[c]Conversion of current IL to real IL has been made on the Israeli Consumer Price Index with a base 1968-69 = 100.

Source: *Statistical Abstract of Israel,* Tables XXVII/11,12.

increasing dramatically, as illustrated in Figures 1.2 and 1.3. While the Israeli presence in the West Bank and Gaza in the aftermath of the 1967 Six-Day War served to "break the seal" between Israel and the Arab Middle East, at least on a *de facto* basis in economic terms, a number of practical, if not political, constraints were now placed on the links between the administered territories and the rest of the Arab world. With the exception of the open bridges across the Jordan River, transport and communications between the territories and the Arab states were largely impossible.

The Israeli military government has permitted the export of agricultural produce and manufactured items out of the West Bank through Jordan, and on to other Arab markets via Jordan. The growth in this trade, as illustrated in Figure 1.4, has been substantial in current terms but has not increased significantly in real terms of this trade. Growth has largely been in the export sector, consisting of citrus, vegetables and manufactured food products. Imports from Jordan to the territories, consisting largely of manufactured goods, has increased marginally in current terms and declined in both current and real terms since 1975.

Reliable data on trade with other nations cannot be obtained. Although some limited caravan traffic has continued between the Gaza and Egypt across the Sinai, as it has for centuries, the actual trade volume is not economically significant.

While these figures and the associated statistical tabulations portray the nature of this trade growth in the aggregate, there is considerable difficulty in presenting the disaggregate composition of this trade, the precise institutions by which such trade takes place, and the exact nature of the evolution that can be anticipated in the transition phase.[13]

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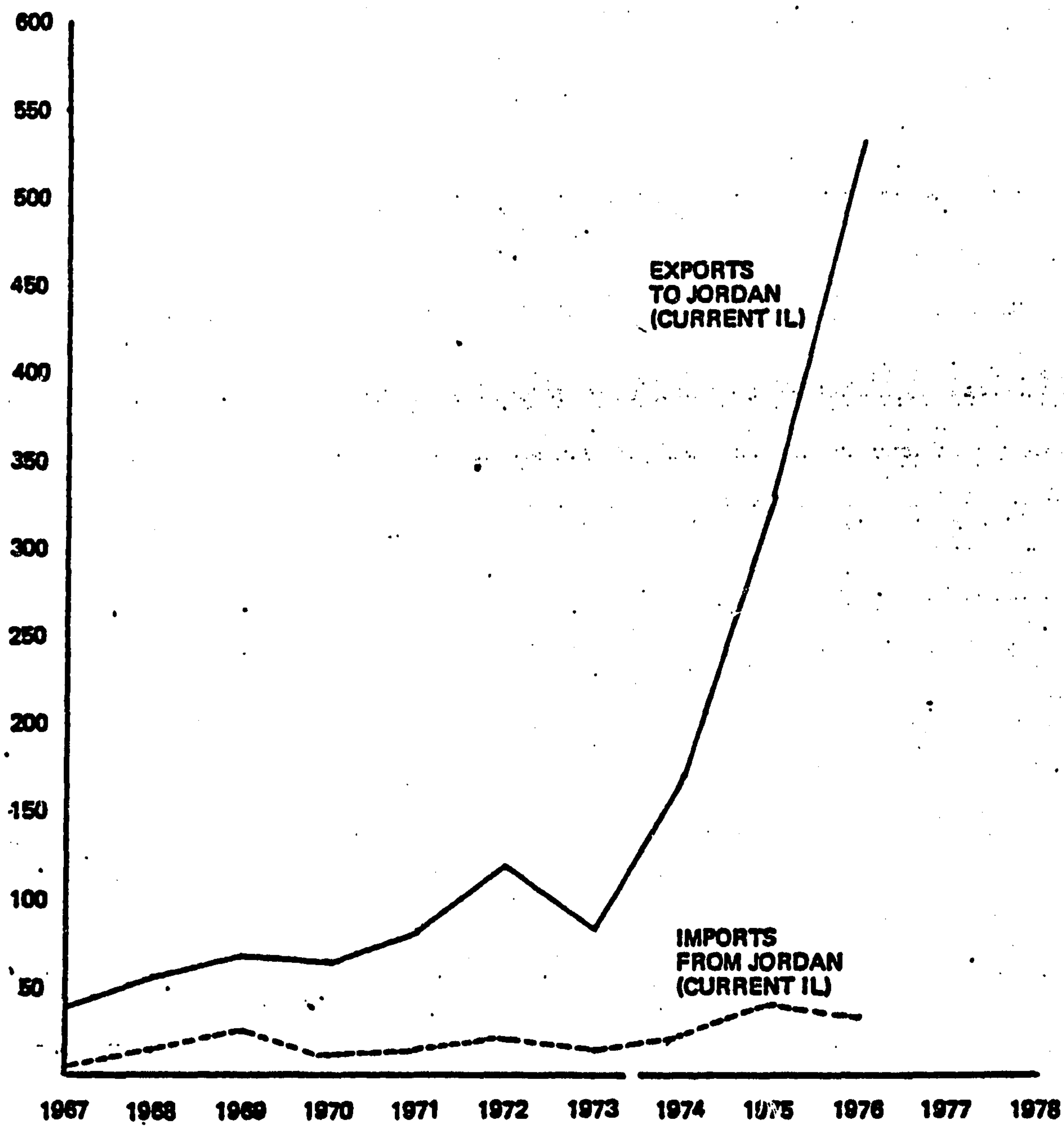
[13] In most cases, disaggregate data are not published or are not available. Many of the institutions and arrangements are, necessarily, ad hoc and can only be defined by conjecture or inference. While a detailed and thorough analysis may, in fact, be possible, it could only be successfully completed within the scope of a far more extensive effort.

FIGURE 1.4

VALUE OF WEST BANK AND GAZA TRADE WITH JORDAN:

1967-1978

(millions of Israeli pounds)[d]



[d]Conversion of current IL to real IL has been made on the Israeli Consumer Price Index with a base of 1968-69 = 100.

Source: *Statistical Abstract of Israel*, Table XXVII/11.

Historically, the composition of the trade from the West Bank and Gaza to Israel has consisted of agricultural products, principally vegetables and citrus fruit, which have been used in Israel or re-exported through Israel to markets in Western Europe. Increasingly, semi-finished manufactured goods have become a part of the exports to Israel, with raw materials supplied to West Bank and Gaza workshops and the semi-finished goods returned to Israel for finishing, labelling and distribution. Indeed, much of this trade has developed along the lines of piecework in Taiwan and Hong Kong.

Trade between the West Bank and, to a lesser extent, Gaza with Jordan has also centered on the same types of agricultural products exported to and through Israel, although there is less evidence of trade in the area of manufactured goods of the type described above. Some finished goods are exported to and through Jordan to the rest of the Arab world, generally in the area of wood handicraft items (particularly olivewood carvings and souvenirs) which are labelled "Made in the West Bank." Reliable estimates on the extent of such exports are unavailable.

For Israel, exports to the territories have consisted increasingly of manufactured and other consumer goods as well as some raw materials for construction. In large part a function of the economic fact that workers in the territories earn substantial wages in Israel, in Israeli pounds, it is inevitable that these Israeli pounds ultimately be used in Israel to purchase goods and services, either by the original wage-earners or successive transferees.

While it is fairly evident that these purchases run the full gamut of goods available in Israel, both manufactured in Israel and imported from Europe, the United States, Japan and other nations, figures on the distribution of such goods are unavailable as well.

Mentioned above was the fact that Israel has also been exporting raw materials to workshops in the West Bank and Gaza, particularly in the textile area, which are then re-imported from the territories to Israel for final finishing. In addition, there is an increasing pattern of subcontract repair of durable goods by workshops in the territories, including such items as motor vehicles, refrigerators and others. When rebuilt, these items are re-exported to Israel, either to their original shippers or Israeli distributors.

Precisely why these trade and investment patterns, as detailed in far greater length in Part II below, have developed is a difficult and complex topic, requiring an extensive research and analytical effort. For present purposes, however, it is sufficient to understand that, on balance, the territories have, at least economically, tended to act as districts within Israel since their capture, and economic forces have permitted trade to develop where these territories held a comparative advantage; that is, low wage rates, labor surplus, and availability of arable land. How such patterns can be expected to develop in the transition phase depends on some major economic assumptions, and is considered in detail in Part IV below.

Trade Mechanisms

Unfortunately, even though a considerable amount of trade is taking place with the territories and some reasonable aggregate data are available on the extent of this trade, the amount of authoritative or definitive information on how this trade is conducted is highly limited. Here it is essential to bear in mind that these mechanisms have evolved to avoid or evade legal restrictions and taxes imposed by Israel and Jordan, and thus little formal information is available which is of use. Indeed, most of the mechanisms are informal ones, with the paperwork being limited or entirely ad hoc.

In some areas, the types of arrangements are "common knowledge" or conjecture, with little or no official authentication. For example, in the trucking industry it is known that deals are frequently made between trucking firms in the territories and Israel for the transport and sale of cargos, with the commissions being split by the firms. Presumably, these are most often cash transfers, with no bills of lading, and the parties are seeking to avoid income taxation as much as anything else.

More generally, it is clear that this trade is, to some major extent, conducted on a cash basis utilizing Israeli pounds, Jordanian dinar, gold, U.S. dollars, and a variety of other "hard" currencies. In other cases, actual bills of lading and bank transfers are utilized, although, even in such cases, the banks involved have been reluctant to report the nature and scope of these trades.

In addition to the incentive to avoid income taxation, a value-added tax (VAT) imposed by the military governor provides yet another incentive to keep such trade on a cash basis and unreported to the authorities. Thus, to a major extent, taxation as much as anything else has pushed a good deal of the territories into the "gray" market.[14]

Competition and Alternate Sources

With respect to imports by the territories, the aggregate data reveal that some 25 percent of the imports to the territories come from Israel, with the balance coming from the Arab world, the United States, Europe, and other nations. In general, such imports consist of consumer goods, durables and non-durables, raw materials, and agricultural products not grown locally. While precise data are lacking, it is estimated that the competition is among alternate sources primarily in Western Europe and secondarily among the U.S. and Japan, and other nations a distant third.

There is much less difficulty with respect to exports from the territories since these are fairly well specialized and concentrated in the areas of agricultural produce and semi-finished manufactured goods. As detailed in Table 2.10 (page 39), the two principal export markets for fruit and vegetables grown in the territories are Israel and Jordan, with an undefined portion of the produce exports to Israel re-exported to markets in Western Europe. To a considerable extent, Israeli exports of fruit (principally citrus) to European markets have varied, depending on seasonal and market

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[14]Currencies in use in banks in the West Bank and Gaza include the Israeli pound, at least 55 million Jordanian dinar (mostly on the West Bank), Egyptian pounds (in limited amounts, mostly in Gaza), U.S. dollars, gold, and a variety of "hard" Western currencies in limited amounts. The Bank of Israel, Israeli commercial banks, and their branches in the territories will clear all of these currencies.

factors in Europe. Were the territories to achieve an independent status, they would likely be able to compete in European markets with Israel to some extent, possibly increasing their market share.[15]

The extent to which fruit and vegetables exported to Jordan may be re-exported, either to the Arab world or Europe, is largely unknown, but is estimated to be a relatively insignificant factor. Further, it is unlikely that this would become a significant factor in either of the two scenarios considered for the transition phase and beyond.

As indicated above, the balance of exports from the territories consists of semi-finished manufactured goods returned to Israel for final finishing and distribution. Specific figures of any reliability are not currently available on the level and scope of this industry. The final category of exports consists of finished goods, largely handicraft and souvenir items, which are exported to Jordan for further distribution. Because of the boycott of Israel by the Arab world, such export activities have kept a low profile, and hence data which might otherwise be available cannot readily be obtained.

Prospects for Change

What changes can be anticipated in the composition, nature, and extent of trade with the territories depends heavily on the type of scenario which evolves during the transition phase and the economic assumptions which are associated with each of the alternatives. These scenarios, the economic assumptions, and their implications for trade in the transition phase and beyond are considered in detail in Part III below.

The most significant finding of the analysis, however, is that while, under current conditions, Israel supplies over 90 percent of goods and services imported by the territories, this figure could drop dramatically in the transition period. Jordan and the rest of the world, which now supply some

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[15]Offsetting this effect in the current situation is the advantage which the territories now have by utilizing Israeli marketing and distribution networks, and any premium which the "Jaffa" labels give in these markets.

10 percent of these imports, could supply up to 25 percent by 1983, which is a dramatic change in the pattern of trade. While Israel clearly dominates the trade pattern with the territories now, they will be "opened up" to a significant extent under anything approaching a cooperative scenario.

II. ECONOMIC LINKAGES
DURING THE TRANSITION PHASE AND BEYOND

2.1 Overview of Fundamental Conditions

Had an Arab-Israeli conflict not existed, and under conditions of peace and open boundaries, Israel, the West Bank, the Gaza Strip, Jordan, Lebanon, and perhaps other countries in the Middle East region could have constituted an integrated economic entity functioning in a way similar to the Common Market in Europe. The fact that this is not the case suggests that, before any prediction regarding future trade and economic links can be made, it is essential to understand the nature of the links today and what constitute the major barriers to achieving a more integrated and linked system of economies.

It is clear that, as for the period extending from May 1948 to June 1967, the non-existence of links between Israel, the West Bank, and the Gaza Strip was a simple outcome of the state of belligerence which prevailed in the region following the declaration of Israeli independence.[1] Thus the interesting period to study is the period of Israeli military occupation, 1967 to 1978, which would suggest what are the vital factors operating in the region today and will, no doubt, operate there during the transition period as well.

The most notable facts regarding the links between Israel, the West Bank, the Gaza Strip, and Jordan can be summarized as follows:

- During the occupation period, a large number of Arab residents of the West Bank and Gaza found employment in Israel. In many cases, jobs simply were not available in the territories, and wages in

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[1]See Brian Van Arkadie, *Benefits and Burdens: A Report on the West Bank and Gaza Strip Economies Since 1967* (New York: Carnegie Endowment for International Peace, 1977).

Israel were some three times as high as those prevailing in the territories, increasing at a 13-percent annual rate.

- Associated with this employment in Israel, a growing level of imports from Israel to the territories was recorded.[2]

- Very minor Israeli economic activity took place in the administered territories and, apart from the settlements, no significant activity can be recorded.

- Significant economic ties were maintained between the West Bank and Jordan and extensive official trade has been maintained.

These trends are illustrated in Tables 2.1 and 2.2. Thus the trade with Jordan is modest, where imports from Jordan are negligible while exports to Jordan are rising rapidly.

It is clear that extensive amounts of goods and services move across the frontiers of the territories and a large number of workers cross from the territories into Israel. A negligible amount of joint business activities does, however, take place, with little private Israeli capital invested in the territories and no Arab capital invested in Israel. Furthermore, the growth process in the territories involves very little direct economic activity of outside resources, entrepreneurs, or venture capital. The growth process itself does not seem to be influenced by a clear economic plan and supported by any specific public actions.

This economic picture is a unique outcome of the special circumstances of the Middle East and any future developments must take into account the factors which shaped the above developments. Before proceeding with the analysis of the nature of linkages, it is important to review the legal basis of economic activity as it relates to the potential for future developments.

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[2]Here both the payment of wages to territories' residents in Israel, lower prices in Israel, and the availability of many goods in Israel contributed to this flow. As an accounting matter, payment of these wages in Israeli pounds ultimately led to their being spent in Israel for export items.

TABLE 2.1

TERRITORIES' TRADE WITH ISRAEL:

1974-1976

(millions of Israeli pounds)[a]

	Exports From Territories To Israel				Imports Of Territories From Israel				Net Labor Earnings Of Territories In Israel	
	Agricultural Products		Industrial Products		Agricultural Products		Industrial Products			
	Current IL	Real IL	Current IL	Real IL	Current IL	Real IL	Current IL	Real IL	Current IL	Real IL
1974	81.9	28.2	372.0	145.0	199.8	68.8	1135.9	442.8	736.9	28.3
1975	114.1	26.0	664.0	180.7	353.2	80.6	2000.0	544.4	1137.9	28.9
1976	184.5	37.3	961.1	227.7	473.4	95.7	2649.4	627.7	1386.3	28.3

[a]Conversion of current IL to real IL has been made on the Israeli Consumer Price Index with a base 1968-69 = 100.

Source: AAC computations, based on data from *Statistical Abstract of Israel* (1977), Tables XXVII/10,11,12.

Following the June 1967 War, the area of East Jerusalem was annexed to Israel and all economic activity in Jerusalem has been taking place subject to the laws of Israel. This means that any resident of these areas can establish property rights anywhere in Jerusalem. This is not the case in the other territories.

In holding the legal position that the territories are administered and not annexed, Israel agreed to allow the Jordanian law to apply in the West Bank and Egyptian law to apply in the Gaza Strip. In both territories, Jordan and Egypt promptly enacted legislation establishing the death penalty to anybody who sold land to an Israeli citizen. Similarly, the Israeli law does not permit acquisition of land by Israeli citizens without a special permit by the military governor. There are some very exceptional cases where the military governor permitted private land sales for special purposes, and in these cases an official registration of these private transfers

TABLE 2.2

TERRITORIES' TRADE WITH JORDAN:

1974-1976

(millions of Israeli pounds)[b]

	Exports From Territories To Jordan				*Imports Of Territories From Jordan*			
	Agricultural Products		*Industrial Products*		*Agricultural Products*		*Industrial Products*	
	Current IL	*Real IL*	*Current IL*	*Real IL*	*Current IL*	*Real IL*	*Current IL*	*Real IL*
1974	84.8	29.2	85.0	33.1	2.4	.8	18.6	7.3
1975	176.1	40.2	149.9	40.8	1.0	.2	31.4	8.5
1976	291.1	58.8	244.5	57.9	1.5	.3	28.8	6.8

[b]Conversion of current IL to real IL has been made on the Israeli Consumer Price Index with a base 1968-69 = 100.

Source: AAC computations, based on data from *Statistical Abstract of Israel* (1977), Tables XXVII/10,11,12.

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of title did take place but are regarded as illegal by the Jordanian or Egyptian laws. These abnormalities have generally been avoided, and whenever some land was needed by the military authorities for whatever public purpose, the land was publicly expropriated and market value was paid to the owners as compensation. Most of the land that was expropriated for the purpose of military bases or settlements was public land, with the technical owners being the Jordanian or Egyptian government.

These legal facts of life reflect both the opposition of the citizens of the territories and the governments of Israel to massive purchases of land by Israeli citizens in the territories. It also reflects a rather hostile economic environment, not only to land purchases by Israeli citizens but to any economic activity involving Israeli interests which would require the establishment of any property rights and legal protection of these rights. This means that even if some method like renting or leasing of real estate could have been found to overcome the issue of owning real estate, the general economic climate set much too high a risk premium on direct private Israeli investments in the territories.

Thus, with the impossibility of acquiring real estate and faced with a very risky domestic environment, little Israeli private capital had the incentive to move into the territories. We may note that if the profit rate were high enough, Israeli firms would have used indirect methods of investment (if possible) and would have taken the risks which these would have entailed. This process did not take place and two factors prevented it from occurring: First, there is Arab capital, both from local sources and also from the rest of the Arab world, that has been invested and thereby prevents the rates of return from being so high as to attract Israeli investment. For Israeli investors, rates of return in the territories can be approximated at 25 percent for the 1967-78 period, compared with rates on the order of 50 percent in Israel for risk capital, in current Israeli pounds. In addition, investments by Israelis in the territories lack the protection of either the military governor or the State of Israel, adding considerably to the risk factor. Second, the Jordanian, Egyptian, and Israeli laws do not permit the acquisition of any property rights by Israelis in the administered territories, and this precludes the formation of any partnership, corporate entities, and any other organization that would involve Israeli capital indirectly.

The situation is completely symmetric with respect to investments of citizens of the territories in Israel, thus precluding the establishment of any significant economic ventures that would cross the territorial boundaries in any direction.

It should be absolutely clear that any prediction of future links between the territories and Israel or the rest of the Arab world depends, to a crucial degree, upon the maintenance or modification of legal structure discussed here. In the scenarios discussed in Part III, we take up this issue explicitly.

2.2 Evolution of Trade Links and Institutions

The evolution of trade and economic links between the West Bank, Gaza Strip, and other parts of the Middle East following the June 1967 Six-Day War provides the basis for an assessment of the types of further development which are likely to take place in the five-year transition phase and beyond. Here it is essential to understand that this development will, to a major extent, be governed by both the formal institutions, such as customs unions and restrictions, as well as the informal agreements and arrangements among the parties.

Trade in the Post-1967 Era

Since the trade links which evolved in the 1967-78 period between the West Bank, Gaza, and Israel were based on Israeli military administration and a desire on the part of many in the Israeli leadership to see economic links develop, few, if any, formal restraints on trade were imposed. The territories were viewed as part of Israel for some economic purposes, so no customs duties, surcharges or other restrictions were imposed on the import of goods from the territories to Israel or from Israel to the territories. To some extent, this made the territories subject to the same international boycott restrictions which Israel itself faced over the decade, although the limited scope of trade between the territories and states other than Israel and Jordan has made this a generally insignificant problem thus far.

Even during the period of Israeli military administration, Jordan has attempted to maintain the concept that the West Bank was still an integral part of that nation. Consequently, Jordan has not imposed duties or other restraints on the trade between the West Bank and Jordan on the east bank of the river.

This has had the net impact of creating an ad hoc customs union or free trade zone between Israel, the West Bank, and Gaza. Much of the analysis in the present report is based on the implicit assumption of free trade within the region during the transition phase and beyond.

Middle East Free Trade Area

One of the most innovative proposals offered for the post-settlement economic development of Israel, the occupied territories, and the Arab confrontation states has been the formal establishment of a Middle East Free Trade Area.[3] Under such a plan, a MEFTA Zone would be established and supervised by an international authority and operated under United Nations auspices.

A free trade area would, presumably, facilitate the development of trade and economic links as well as flows of development capital to the West Bank and Gaza areas from a broad range of potential investors. Such investments are considered at greater length in Section 2.5. This would have the additional effect of providing employment for Palestinian refugees in the areas of construction, tourism, manufacturing, and agriculture. A free trade area would enable such workers to live comfortably under relatively moderate wage scales, purchasing their requirements duty-free. Assuming that the self-governing authority in the West Bank and Gaza does not maintain a military and, consequently, bear the related defense costs, taxes on local residents should be minimal.

Under the MEFTA proposal, an international free trade buffer zone (MEFTA Zone) on both sides of the international Egypt-Israel border, with an extention in a strip along the Gulf of Aqaba, would be established. *If successful,* Israel would be obligated to apply the MEFTA principles to a settlement of the Palestinian and Golan issues, including the establishment of an independent, non-militarized Palestinian state (like Costa Rica) on the West Bank and in the Gaza Strip.

The Israeli West Bank settlements would remain, but they would become free trade, agricultural, tourist, commercial, and manufacturing sites of the international trade sector over which the Palestinian state would have no

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[3] As indicated above, the West Bank has experienced considerable success by labelling manufactured products "Made in the West Bank" and re-exporting them through Jordan. See S. C. Yuter, "Bridging the Egypt-Israel Negotiating Gap," *Ripon Forum,* Vol. XIV, No. 6 (July/August 1978).

jurisdiction. The Sinai settlements in the MEFTA Zone would also remain as part of the free trade sites allocated to Israel. International police would have exclusive jurisdiction over the MEFTA Zone and the international trade areas in the Palestinian state.

The northern end of the MEFTA Zone adjacent to the Gaza region would include a deep-water port, an international airport, and an electric power-desalination plant to provide ample electric power and fresh water.

The plant would be located on the coastline between Yamit and the international border. It would be powered by Saudi gas sold at production cost, and delivered to the Jordanian border at Aqaba-Elath via a Saudi-constructed pipeline; and from there to the plant via a U.S.-constructed underground pipeline in the MEFTA Zone. The U.S. would also construct a parallel pipeline to supply desalinated water, not only for industry and agriculture but to the cities of Elath and Aqaba (in equal amounts in return for the transit rights) and to the MEFTA Aqaba Strip to expand tourisms; also, an underground power line paralleling the water pipeline. The production cost of the fresh water would be low enough to assure its profitable use for irrigation.

The Israelis would provide an unrestricted transit easement from the West Bank region to the northern MEFTA Zone for a limited access thruway to connect the West Bank and Gaza regions. This would give Jordan unrestricted access to the seaport in the MEFTA Zone via the West Bank region.

The MEFTA Zone would be supervised by an international MEFTA Supervisory Authority (MSA) consisting of Egypt, Israel, and the Inter-Governmental Maritime Consultative Organization (IMCO), a U.N. specialized agency, based in London, having the objective of removing hindrances to trade.

2.3 Flows of Capital and Entrepreneurial Talent

Investment and Intrepreneurial Links

We have noted previously that the legal restrictions on real estate purchases could have been overcome by a complex system of long-term leasing. Although not totally similar, there are examples of situations where non-resident landowners have granted such leases for various commercial purposes, including Hawaii, where major commercial tracts are on 99-year leases, and Palm Springs, California, where over half of the commercial and residential development has been on land leased from local Indian tribes for long terms. The essential point is that, in the case of the territories, the real estate restrictions, either *de facto* or *de jure,* were supplemented by a legal system that makes it virtually impossible to develop business enterprises across the territorial frontiers. More specifically,

- in order to make a contract, register a corporation, or operate a partnership, an Israeli individual or corporation must appeal to a Jordanian or Egyptian court, and this is forbidden by both courts. The state registrars of corporations are in Amman and Cairo, where Israeli firms cannot even reach these authorities.

- no citizen of the occupied territories can by himself or jointly with an Israeli firm establish a partnership or a corporate entity to be registered in Israel and be protected by Israeli law.

Thus, both in the territories and in Israel, there is no legal basis for any investment and economic activity of territorial enterprises in Israel or Israeli enterprises in the territories. As noted earlier, the amount of trade between the territories and Israel is great, but this is accomplished because of the following reasons:

- Movement of workers into Israel is not illegal under the above arrangements, and when territorial residents work in Israel they are even partly protected by local union rights.[4]

- There are special joint ventures between territorial and non-territorial residents and these are the commercial ventures moving

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[4]Although the evidence is somewhat conflicting on the extent of these rights, it is clear that Arab workers are the subject of collective bargaining agreements negotiated on their behalf by the *Histradrut* (Israeli General Federation of Labor). Whether *Histradrut* dues are collected in all cases or full rights of *Histradrut* membership afforded to residents of the territories remains open to dispute within Israel.

the extensive trade between the territories, Israel, and Jordan and Egypt. On the Jordanian and Egyptian sides, there are no problems of setting up the legalities of trade. On the Israeli side, the traders on both sides work out their payments via the branches of the Israeli banks which operate in the territories. These branches are mostly operated by territorial residents, and they are needed since all three currencies circulate in the territories: principally the Israeli pound and, to a lesser extent, the Jordanian dinar and the Egyptian pound. There are many joint ventures of Israeli residents and territorial residents that do not

- land values in Israel have been increasing rapidly and are much higher than in the territories;
- wage rates in the territories are lower than in Israel, and Israeli business enterprises do not locate where the wages are low but, rather, the workers travel to Israel to seek gainful employment;
- lack of Arab investments in Israel and of Israeli investments in the territories.

Leaving aside the political aspects of the Israeli settlements in the territories, these settlements do have the economic property of inducing further links among the various economies in the region. This follows from the basic links between Israel and the settlements; and the potential growth of economic interdependence between the settlements in the territories is not likely to remain agricultural in nature, mostly because of the limited amount of fertile land available in the territories and the inability of the settlers to maintain adequate standards of living, based on this limited amount of land. Thus an extensive Israeli settlement program is ultimately bound to become industrial in scope. Such industrial development could take place either within a rural set of communities or within a completely urban context. An industrial society will need capital, skilled labor, efficient transportation and communication, and efficient supply of materials. Thus, if the Israeli settlement program continues, we are likely to see, during the transition period and beyond, a growing interaction between the territories and Israel even if no changes are made in the legal climate discussed above and no reduction in the economic risks of investments occur.

Sections 2.1 and 2.3 above are intended to show what are the most important limiting factors in the development of further economic links between the territories and the neighboring areas. In Part III of this report we attempt to indicate the kind of economic developments which may take place in the transition period and beyond. We strongly assert that the kind of economic links which will occur depend upon changes of the political and legal constraints discussed so far. The two scenarios which we develop differ essentially in the degree by which these restrictions are, in fact, changed. If some of these restrictions are removed, then the development of economic links will depend upon the nature of the economies at hand, their resources, their investment opportunities, their financial institutions, and their political organization. These we must evaluate now.

Investment Opportunities and Capital Requirements

In spite of the severe economic, political, and military constraints, the economies of the West Bank and Gaza territories have become more and more linked to the economies of Israel and, to a lesser extent, Jordan in the period since 1967. The analysis has, however, been largely limited to links in the form of increased specialization of the labor force: an increasing number of West Bank and Gaza residents employed in Israel, using their income to purchase goods and services imported from Israel. We have already seen some of the initial effects this has had on employment in the agriculture and industry sectors of the territories. The present section examines in greater detail two additional aspects of the growing economic links between the West Bank and Gaza economies and those of Israel and Jordan:

- due to the rising wage rates and competition of imports, the traditional sectors of agriculture and light industries have been concentrating on those activities in which they have relative advantage and increasing their output by capital deepening while decreasing the labor/output ratios; and
- a growing fraction of local output becomes sensitive to market conditions in Israel, Jordan, and other export markets.

To examine these two points, recall first our observation that the growing employment of territorial residents in Israel has been associated with an actual decline of employment in agriculture and a nearly constant rate of employment in industry. A more precise picture is illustrated in Table 2.3, where the decline in agricultural employment occurs both in the West Bank and Gaza.

TABLE 2.3

DOMESTIC DISTRIBUTION OF EMPLOYMENT IN THE TERRITORIES BY SECTOR: 1971-1975

	West Bank					Gaza Strip				
	1971	*1972*	*1973*	*1974*	*1975*	*1971*	*1972*	*1973*	*1974*	*1975*
Agriculture	40.2%	38.0%	34.2%	37.9%	34.6%	31.1%	24.8%	25.7%	24.8%	26.3%
Industry	14.7	14.6	16.4	15.1	15.8	12.2	12.6	12.7	12.2	12.0
Construction	6.1	7.2	7.6	7.0	8.4	4.6	4.1	3.9	4.1	5.1
Services and others	39.0	40.2	41.8	40.0	41.2	52.1	58.5	57.7	58.9	56.6
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Total domestic employment: thousands	91.2%	90.3%	87.8%	95.0%	91.9%	51.5%	46.0%	45.6%	46.7%	46.7%

Source: AAC calculations based on data in *Statistical Abstract of Israel.*

What is unusual in the economies of the territories is the fact that the rapid decline in agriculture employment is associated with a slow rise in all other sectors: some rises in manufacturing, services and construction. This remarkable "balance" in the development can only be explained by the existence of Israel as a large source of supply which then allows all the domestic industries in the territories to grow in accord with their relative advantage.

This same conclusion can be drawn from an examination of the specific crops produced by the agricultural sector of the territories, as indicated in Table 2.4. It is clear from Table 2.4 that the most rapid growth occurred in field crops, vegetables, citrus, and other fruit because of the growing markets for these products in Jordan, Israel, and overseas.

Looking at the destination of agriculture output of the West Bank and Gaza given in Table 2.5, it is clear that Jordan buys a large fraction of the output of fruit (particularly citrus) produced by the West Bank and

TABLE 2.4

TERRITORIES' OUTPUT OF SELECTED AGRICULTURAL PRODUCTS: 1967-1976

(thousands of tons)

	West Bank				Gaza Strip			
	1967/8	*1973/4*	*1974/5*	*1975/6*	*1967/8*	*1973/4*	*1974/5*	*1975/6*
Field crops	23.5	63.9	38.3	34.9	—	—	—	—
Vegetables	60.0	138.5	139.9	147.3	31.8	37.9	46.0	48.0
Melons	36.0	4.2	3.6	4.5	12.5	6.1	4.7	3.0
Olives	28.0	110.0	10.0	50.0	—	—	—	—
Citrus	30.0	61.5	63.8	74.1	91.0	207.0	201.4	243.7
Other fruit[c]	47.9	71.0	78.1	76.6	19.0	26.5	25.2	20.9
Meat	10.3	22.0	20.3	22.4	1.7	3.4	3.7	4.4
Milk	30.3	44.7	46.0	41.5	2.8	11.7	12.9	12.8
Eggs (millions)	25.0	38.0	38.0	38.0	10.0	30.0	32.0	32.4

[c]"Other fruit" in Gaza includes Olives.

Source: *Statistical Abstract of Israel* (1977), Table XXVII/26.

Gaza, but almost no vegetables. Israel and overseas markets buy both fruit and vegetables in the territories, with the vegetables going to Israel and the fruit (particularly citrus) going to overseas markets, primarily in Europe. Note the great specialization of the Gaza agricultural economy in exporting citrus.

The general conclusion here is the growing concentration of the agriculture sector on cash crops and fruit, all of which depend upon outside markets and are heavily capital-intensive. The growing links between the territories and outside markets, particularly in Israel, can be seen from the pattern of industrial development. Table 2.6 demonstrates the growth patterns of key sectors in recent years.

TABLE 2.5

DESTINATION OF AGRICULTURAL OUTPUT: 1971/2-1975/6

(percent of total volume)

	Origin							
	West Bank				Gaza Strip			
	Fruit		Vegetables		Fruit		Vegetables	
Destination	1971/2	1975/6	1971/2	1975/6	1971/2	1975/6	1971/2	1975/6
West Bank	61.0%	70.5%	79.7%	79.6%	17.2%	10.0%	87.2%	82.3%
Gaza Strip	.7	4.2	.7	.4	11.0	2.5	10.1	7.3
Jordan	32.0	24.3	9.3	7.3	18.2	53.4	—	—
Israel and overseas	6.3	1.0	10.3	12.7	53.6	34.1	2.7	10.4
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: AAC computations, based on data from *Statistical Abstract of Israel* (1973), Tables XXVI/28,29, and (1977), Tables XXVII/27,28.

Without, for the moment, entering into detailed analysis of Table 2.6, it is important to note the striking imbalance of the growth of different sectors. This imbalance stands in sharp contrast to the appearance of balance in the aggregate data. The facts are that industries which have import competitors or insufficient relative domestic advantage have grown slowly. These include, for example, the food and beverage industries as well as wood products in Gaza or basic metals and equipment in the West Bank. The really rapidly growing industries are the light industries and textiles. These have excellent domestic markets and a growing potential of markets in Israel. This arises from the fact that most of these industries are based on semi-skilled workers whose relative availability is greater in the West Bank and Gaza. Furthermore, the products produced are simple in nature and require unsophisticated technology. The reader who is familiar with the development of Korea and Taiwan will note some similarity of conditions in these far-eastern economies and the economic structure of the administered

TABLE 2.6

INDICES OF INDUSTRIAL EMPLOYMENT IN THE TERRITORIES

(index numbers, 1969 = 100)

	West Bank					*Gaza Strip*				
	1969	*1973*	*1974*	*1975*	*1976*	*1969*	*1973*	*1974*	*1975*	*1976*
Food and beverages	100	87	93	93	91	100	90	89	100	107
Textiles and clothing	100	150	160	162	132	100	158	150	144	152
Wood products	100	118	139	166	137	100	100	99	107	129
Light industries (paper, rubber, plastics, chemicals, oil products, misc.)	100	131	132	143	132	100	192	205	213	218
Basic metals and equipment	100	115	128	132	124	100	148	144	168	191

Source: *Statistical Abstract of Israel* (1977), Table XXX.

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territories of the Middle East. The essential characteristics of the industrial potential of the territories can be summarized as follows:

- The agricultural base of the economies provides the potential for further capital investments and concentration on specialized products. The hills of the West Bank are suitable for the production of fruit and the Jordan Valley has some potential for agricultural development, particularly for winter crops.[5] The

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[5]The rocky corridor to Jerusalem, for example, is being utilized for intense agricultural production. See, for example, the increase in production in Table 2.4.

Gaza Strip has some additional potential for developing citrus crops. Any of these developments will require irrigation projects, capital investments, and major development of outside markets. It then follows that future economic development of these areas will require further links with outside sources.

- The relatively low wages coupled with rising skill and education levels suggest that future industrial developments are likely to occur in those industries which are sensitive to such conditions: textiles, clothing, light manufacturing, crafts based on leather or plastic, various electrical instruments which require simple assembly lines, etc. Such industrial development will require deeper ties of the territories with sources of finance and marketing. This means that, in considering the transition period and beyond, the rising ties of the territories with Israel or other areas depend upon the arrangements which will enable the utilization of the above conditions.

- An especially interesting industry is tourism. Obviously, Jerusalem is a major tourist attraction, but there are many parts of the territories (e.g., Bethlehem and Hebron) which are very attractive to tourists, both local and overseas. Consider the "Hotel Bed-Nights" and "Rooms Available" in the West Bank during the recent period. The reader may note that, up until 1973, tourism was developing fairly rapidly and included both local and overseas tourists. Yet, after 1973, when the terrorist activities began to rise, tourism in the West Bank began falling although it continued to develop rather rapidly in Israel. This example demonstrates the potential evolution of joint economic activity in the territories, Israel, Jordan, and other regional centers like Egypt. Such potential could materialize during the transition period and beyond only if cooperative actions are taken and if the political and military environments permit.

2.4 Labor Flows and Future Labor Force Composition

The population of the West Bank and Gaza territories has one of the highest natural growth rates in the world. Table 2.7 provides a general view, demonstrating that the net growth rate of the population (net of death and immigration) has been over 2 percent except for 1975-1976.

On the other hand, three other basic economic forces are operating in the territories which will become highly significant during the transition period and beyond. The first of these factors, illustrated in Table 2.8, is the rapidly rising level of education in these territories.

The implication of this rising educational level is that the skills level of the manpower base in the territories will also be rising dramatically, which could lead to economic development in the territories themselves or a drain of skilled workers into labor markets outside the territories. A major factor in determining whether or not these workers can be retained

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TABLE 2.7

POPULATION AND GROWTH RATES IN THE TERRITORIES

Year	*Population (thousands)*	*Natural Increase (thousands)*	*Net Percent Growth Rate*	
			West Bank	*Gaza*
1969	957.4	21.5	2.3%	1.8%
1973	1043.4	29.0	2.7	3.6
1974	1070.1	31.3	2.4	2.8
1975	1083.3	32.4	.5	2.4
1976	1099.9	35.1	.9	2.5

Source: *Statistical Abstract of Israel* (1977), Table XXVII/1.

TABLE 2.8

RISING EDUCATION LEVEL IN THE TERRITORIES: 1968-1976

Year	Total Population Aged 0-14 (thousands)	Total Population In School (thousands)	Percent In School
1968	460.8	222.2	48.2%
1970	470.4	283.4	60.2
1973	497.9	321.8	64.6
1974	509.1	331.3	65.1
1975	514.5	343.7	66.6
1976	520.1	367.6	70.7

Source: *Statistical Abstract of Israel* (1977), Tables XXVII/2,40.

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will be the availability of development capital, considered in Section 2.5 below.

The second factor is of ongoing importance: the relatively slow rate of domestic industrialization in the territories coupled with a rapid decline in agricultural employment, summarized in Table 2.9. This table shows that, in spite of the rapid growth of the population, total domestic employment is falling and the relative share of employment in agriculture is also falling. These two phenomena can be explained by the increasing percentage of territorial residents who have found employment in Israel, and the transformation of agriculture in the territories from a labor-intensive form to one more advanced and capital-intensive. This can be seen as well from a comparison of agricultural production, which has been sharply increasing at

TABLE 2.9

COMPOSITION OF DOMESTIC EMPLOYMENT IN THE TERRITORIES: 1970-1976

Year	*Domestic Employment (thousands)*	*Percent Employed In Agriculture*	*Percent Employed In Industry*
1970	152.7	38.7%	13.8%
1971	142.7	36.8	13.8
1972	136.3	33.5	13.9
1973	133.4	31.3	15.1
1974	141.3	33.8	14.0
1975	138.6	31.8	14.5
1976	140.9	31.4	14.4

Source: *Statistical Abstract of Israel* (1977), Table XXVII/23.

the same time agricultural employment has been falling off. Closely associated with the latter has been a rapid mechanization of agriculture in the territories, due largely to Arab investment and concentration in other capital-intensive subsectors of the territorial economies. At the same time, manufacturing employment has been rising, but only slowly due to the relatively slow growth of this sector. Again, this growth is linked to capital investment by non-resident Arabs, which has been limited. These non-resident Arabs include investors from the OAPEC countries as well as some traditional Lebanese and Syrian investors who have made investments in the territories both for political reasons and as a speculation which would yield high returns under settlement conditions.

The third and most distinct factor involved is the rapid rate by which the workers of the territories are becoming linked to the economy of Israel. Table 2.10 shows that the fraction of the territories' labor force employed in Israel has risen from 11.9 percent in 1970 to 31.5 percent in 1976. This extreme development is a unique outcome of the restricting forces, discussed above in Sections 2.1 and 2.3, which were imposed by the political forces operating in the region. Had these restrictions not been enforced, undoubtedly the links between Israel and the territories would have led to extensive capital investments in the economy of the territories, and this would have established the demand for domestic employment in the territories. With these restrictions in force, the rapidly rising wage rates in Israel have been attracting a rising number of workers from the territories. Note that this process is associated with a very intensive process of capital deepening economic specialization in the territories, leading to a very

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TABLE 2.10

THE RISING EMPLOYMENT LINK BETWEEN ISRAEL AND THE TERRITORIES: 1970-1976

Year	*Territories' Workers Employed Domestically (thousands)*	*Territories' Workers Employed In Israel (thousands)*	*Percent Employed In Israel*
1970	152.7	20.6	11.9%
1971	142.7	33.8	19.2
1972	136.3	52.4	27.8
1973	133.4	61.3	31.5
1974	141.3	68.7	32.7
1975	138.6	66.3	32.4
1976	140.9	64.8	31.5

Source: *Statistical Abstract of Israel* (1977), Table XXVII/22.

impressive growth of Gross Domestic Product in the economy, as shown in Table 2.11. The table indicates that, from 1968 to 1976, Gross Domestic Product (GDP) increased by 127.9 percent in the West Bank and by 90.1 percent in the Gaza Strip, and all this when total employment in the domestic economy *declined* by about 11 percent!

When attempting to draw conclusions from all these factors to the way economic links are going to operate in the future, it is clear that one should be very aware of how any of these predictions are sensitive to the

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TABLE 2.11

REAL GROSS DOMESTIC PRODUCT

(millions of 1968 Israeli pounds)

Year	*West Bank*	*Annual Growth Rate*	*Gaza Strip*	*Annual Growth Rate*
1968	333	--	131	--
1969	377	13.2%	138	5.3%
1970	411	9.0	167	21.0
1971	471	14.6	189	13.2
1972	578	22.7	195	3.2
1973	527	-9.7	206	5.6
1974	688	30.6	213	3.4
1975	650	-5.8	227	6.6
1976	759	16.7	249	9.7

Source: *Statistical Abstract of Israel* (1977), Table XXVII/6.

restrictions discussed in Sections 2.1 and 2.3. Yet there are a few important conclusions to be drawn:

- The very rapid growth rate of the population will continue and the size of the population will reach, by 1983, the range of 1.3 million.
- The rapid growth of the wage rate will continue to take place due to the real growth in Israel, leading to a decline in the rate of employment in the traditional industries of the territories and generating a large, excess supply of labor in these sections.
- The rising supply of labor is likely to be more educated and more skilled than the current labor force.
- In order to absorb this growing labor force, either a massive rate of domestic capital investment will need to take place or the continuation of the trend of employment in Israel will occur.
- Since the domestic industry is highly specialized, a growing industrialization of the territories will necessitate a rapid growth of exports and foreign trade. Thus, under either of the two scenarios explored in Part III below, the territories will need to increase their links and level of trade with the outside world.

2.5 Banking, Currency and Financial Institutions

Prior to 1967, commercial banks operating in the West Bank and the Gaza Strip were either Arab banks or branches of the British Bank of the Middle East. In the West Bank, the Jordanian dinar was the chief currency; in Gaza, the Egyptian pound.

The Israeli military government closed all commercial banks at the outset of the occupation, although several months later the banks were given permission to reopen. None did, however, due to the failure of negotiations between Israel and the banking authorities to establish principles of operation. Two of the major issues have been the control of branches in the West

Bank by headquarters in Amman, and the reopening of branches in East Jerusalem. Israel finds both of these points unacceptable.[6]

From 1967 to the present, the only banks operating in the West Bank have been branches of the Bank of Israel, which has replaced only slightly the role of the pre-war banking institutions. The Bank of Israel itself estimates that its West Bank deposits account for only 4 percent of the West Bank's national product, as opposed to the 29 percent held by the British and Arab banks in 1966.[7] West Bank residents are reluctant to place deposits in Israeli banks for three general reasons:

(1) traditional and political feelings;
(2) the strength of the Jordanian dinar relative to the Israeli pound;
(3) the reluctance of the Israeli banks to make loans to the occupied territories, due to investors' reluctance to invest in an area with an uncertain political future.

The Israeli pound and the Jordanian dinar circulate alongside each other in the West Bank, although the Israelis had considered eliminating the dinar from the territory. The continued circulation of the dinar "facilitated both the recovery of business activity within the West Bank and the restoration of trade across the River Jordan."[8] From 1967 to the present, West Bankers have shown a strong preference for the Jordanian dinar over the Israeli pound. Since the Jordanian dinar is a stable, hard currency (it is a member of the sterling bloc of currencies) and the Israeli

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[6]Brian Van Arkadie, *Benefits and Burdens: A Report on the West Bank and Gaza Strip Economies Since 1967* (New York: Carnegie Endowment for International Peace, 1977), p. 102. Mr. Van Arkadie also states that "detailed accounts of the negotiations and the precise terms of the disagreement are not publicly available."

[7]Arie Bergman, *Economic Growth in the Administered Areas, 1968-73* (Jerusalem: Bank of Israel Research Department, 1975), p. 95.

[8]Van Arkadie, *Benefits and Burdens*, p. 104.

pound has a continuing record of depreciation, illustrated in Table 2.12, the preference for dinars is sound on a purely economic basis.

TABLE 2.12

CONSUMER PRICES AND VALUE OF THE ISRAELI POUND: 1967-1978

Year	Consumer Price Index (% Change From Prior Year)	Exchange Rate Of The Israeli Pound (IL per U.S. $)	
		Official Rate	Black Market
1967	+ 1.6	3.00	3.50
1968	+ 2.1	3.00	3.69
1969	+ 2.5	3.00	3.90
1970	+ 6.1	3.00	3.85
1971	+12.0	3.50	3.98
1972	+12.9	4.20	4.41
1973	+20.0	4.20	4.50
1974	+39.7	6.00	6.26
1975	+47.6	7.10	11.00
1976	+32.0	8.77	11.00
1977		15.15	—[e]
1978[d]		18.86	—[e]

[d] As of November 1978.

[e] Official statistics on black market rates prohibited. Estimated at 20.00 for November 1978.

Source: Central Bureau of Statistics (Israel), *Statistical Abstract of Israel* (U), No. 26 (1975), Table X/1. Also, The Economic Intelligence Unit (London), *Quarterly Economic Review of Israel*, No. 1 (1976), Nos. 1 and 2 (1977).

The popularity of the Jordanian dinar and the small deposits placed in the Bank of Israel suggest that most Palestinians in the territories keep their savings in the form of cash or bank it outside Israel and the territories. "Transactions are facilitated by the moneychangers who operate on a much larger scale than would be likely if the banking system were fully operative."[9] The moneychangers are usually indigenous West Bankers whose operations have "involved some serious costs for the Israeli monetary authorities."[10] In fact, there have been recent official efforts to control the moneychangers.

Currency is probably the largest means of payment, most of which is in the form of dinars. West Bank residents tend to hold only as many Israeli pounds as necessary to meet immediate needs for transactions with Israelis.[11] The Israeli Government does, however, offer a favorable exchange rate for dinars to exporters to Israel, to gain access to the stronger Jordanian dinar.

Despite the fact that the West Bank and Gaza economies have become increasingly interrelated with the Israeli economy, the territories, particularly the West Bank, have not become assimilated into the Israeli monetary system. West Bank residents have benefitted from continued access to the Jordanian dinar due to its strength in relation to Israeli currency; and have enjoyed monetary autonomy due to the limited penetration of Israeli banks, the continued circulation of the dinar, and the fact that financial links remain with Amman.[12]

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[9] Vivian A. Bull, *The West Bank: Is it Viable?* (Lexington: Lexington Books, 1975), p. 60. Vivian Bull states that during archaeological expeditions in 1968 and 1970, she had to offer a bonus to workers to accept Israeli money. The Israeli currency was then taken to moneychangers and converted on the spot.

[10] Van Arkadie, *Benefits and Burdens,* p. 104.

[11] Bull, *The West Bank,* pp. 60-61.

[12] Van Arkadie, *Benefits and Burdens,* p. 106.

Risk Capital

Turning to the specific issues of the transition phase and beyond, no major economic development can take place without satisfactory financial institutions through which risk capital and credit can be made available. We have already seen in Sections 2.1 and 2.3 that the legal foundations of the territories make it impossible for Israeli risk capital to be invested in the West Bank. Moreover, the law does not provide protection for any joint ventures between citizens of Israel and residents of the territories. Thus, as it stands, the only source of risk capital are the territories themselves and the rest of the Arab world. There are some indications of individual and family transfers from the rest of the Arab world to the territories. However, the possible movement of risk capital from and into the territories appears to be more difficult to establish. The evidence in Table 2.13 seems to suggest that in the early 1970s risk capital was leaving the territories to the rest of the Arab world at a fairly extensive rate. Some evidence exists that West Bank capital was used to purchase land in Amman.[13]

It appears that this process may have been reversed after 1973. Thus, as the economic climate in the territories has improved, some limited although not insignificant amounts of outside capital have moved into their economies and might be viewed as a reflection of the trend to increase the economic links of the territories with the rest of the Arab world. It may be speculated that part of the rise in capital movement into the territories may be a manifestation of the general, post-1973 economic climate in the Arab world, reflecting the availability of a great deal of risk capital due to oil income. It can only be speculated what the sources of this capital may be, and no reliable information is presently available to clarify this matter.

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[13]This evidence consists largely of press accounts in the Jordanian media of Palestinians living in the West Bank and Gaza speculating in real estate in Amman, driving up land prices there.

TABLE 2.13

NET CAPITAL TRANSFERS INTO THE TERRITORIES:

1968-1976

(millions of current Israeli pounds)

	West Bank		Gaza Strip
1968 (combined)		-41.7	
1960 (combined)		-61.4	
1970	- 39.3		- 54.0
1971	- 79.1		- 50.7
1972	- 56.3		- 71.9
1973	25.6		32.0
1974	149.0		83.4
1975	245.6		160.0
1976	167.4		-179.5

Source: *Statistical Abstract of Israel* (1977), Table XXVIII/10.

Given the profitability of investment opportunities in the West Bank and Gaza and the availability of risk capital both in Israel and in the Arab world, we expect that during the transition period further movements of such capital into the territories will continue. This flow could dramatically increase if any of the legal restrictions discussed in Sections 2.1 and 2.3 were relaxed. For example, the extension of Israeli legal protection (land registration, etc.) to such investments will naturally reduce the individual risk so that, even if the territories revert to Arab ownership, the individual capital is given protection. The position of the Israeli government is that a condition for a settlement of the status of the territories is to allow Israeli citizens to buy land and establish business enterprises in the West Bank and Gaza. Given the conditions analyzed here, we conclude that if the position of the Israeli Government is upheld during the transition period and beyond, the flow of risk capital and entrepreneurial activities into the territories will rise by a very significant proportion.

Credit and Banking

Banking in the territories is in a most peculiar and unsatisfactory state. As indicated above, the pre-1967 Arab and British banks that operated in the territories were closed after 1967 and never reopened. The reasons for their closure are not completely known, but it is clear that two of their conditions for the continuation of service were not acceptable to Israel. The first insisted that the branches in the territories would continue to report to their central offices in Amman and Cairo. The second was their demand for continued operations in East Jerusalem under the same legal status as in the territories. Following the closure of the banks, Israel allowed its own commerical banks to open branches in the territories, but these have not gained the position of the previous banks. The banks have enabled the payment mechanism for labor services and commodity trades with Israel, but play no part in the trade with Jordan. It appears that these banks contribute little to domestic trade and most of it is carried out in cash; also, a great deal of the personal liquid assets are held in cash. Due to the failure of the commercial banks to develop a reliable financial system, the money-exchange dealers have played an important part in the financial operations of the territories.

It is rather peculiar that the situation with credit is different than the legal condition of ownership of land or business enterprises. The law does not prohibit an Israeli citizen from receiving credit in an Arab bank in the West Bank or Gaza, and a resident of the territories may obtain credit in a private bank in Tel Aviv. No reliable information is available for us to make an evaluation of the extent of such activities, although we think they are neglibile at the present moment. None of the banks currently conducting business in the territories issue the type of fiscal or economic reporting common to the Bank of Israel, Israeli commercial banks, and many Arab banks as well. Again, this may, in part, be due to a desire on the part of such banks to maintain a low profile with respect to trade activities. We do, however, know that it is possible for territorial residents to obtain credit at Israeli commercial banks, particularly with the authorization of the military governor, although most such transactions are closely guarded and not reported.

Our main conclusion here is that the financial machinery for expansion of financial links between the territories and the rest of the world is virtually nonexistent and will require a complete reconstruction if such financial services are needed in the period ahead.

Currency

As noted earlier, the legal state of affairs in the territories is rather unique since all three currencies — Israeli, Jordanian, and Egyptian — circulate there to some degree with an active market to establish the exchange rate among them.[14] Prior to November 1977, when Israel abolished foreign currency controls, the exchange rates among the three currencies were established in rather thin markets. Since the opening of markets in foreign currency in Israel, the markets for all three currencies in U.S. dollars are extensive so that the exchange rates are more stable.

The fact that the territories accept three currencies does not seem, by itself, to cause any great difficulty. Moreover, given that the territories trade with all three countries, the presence of three currencies does not represent any limiting factor on increasing the economic links with any one of the three countries. We shall see in the next section that the lack of a separate territorial currency simply means that the territories cannot follow an independent economic policy. To make this point a bit clearer, the reader may note, for example, that the territories

[14] In Gaza, the Israeli pound circulates generally, with U.S. dollars, gold, and various "hard" European currencies also used to some limited extent. Some limited numbers of Egyptian pounds are also in use and are cleared by Israeli banks. In the West Bank, both the Israeli pound and Jordanian dinar circulate widely, with U.S. dollars and other "hard" currencies accepted as well.

cannot determine the money supply or the inflation rate in their economies: The money supplies are determined in Jerusalem, Amman, and Cairo, resulting in territorial residents experiencing three different inflation rates. Given the institutional arrangements that exist, there is little that can be done without a major change in the status of the territories.

2.6 Development of Links in Essential Infrastructure

To further link the West Bank and Gaza to their neighboring countries, it is necessary that the basic infrastructure for such links be in place. Let us briefly review the state of affairs with the intent of evaluating whether any major limitations exist in this area.

Transportation System

The basic highway system of the West Bank runs in the north-south direction and only three secondary roads go in the east-west direction. The main east-west highway is the one connecting Jerusalem and Tel Aviv, and this highway is, indeed, a major route for the movement of commodities traded between the West Bank and Israel. In the direction of Jordan, the main highway connecting Jerusalem and Amman is a good roadway. Other roadways and bridges connecting the West Bank to Jordan and Syria are not operative, but could open if an agreement were reached. Thus, in principle, the system at this time is not geared for an extensive pattern of trade and commodity movements in an east-west direction. If additional economic links evolve, then a more intricate system of highways from the West Bank to Israel will need to be constructed and more highways and bridges over the Jordan River will need to be opened and developed.

Neither rail nor air transports are viable alternatives for the region of the West Bank, since it is mostly a mountainous region and, if needed, residents could use the Israeli rail service which runs in a north-south direction very close to the Green Line (the old, pre-1967 border).

The Gaza Strip is so close to the Israeli network of highways, rail system, and air transport that, from the economic viewpoint, the Gaza Strip has no transportation problems with Israel. Furthermore, the Gaza Strip is very close to Ashdod, the southern Mediterranean port of Israel, and thus all export shipments can travel via Israel without any difficulty.

A more complicated problem exists when considering the transportation network between the Gaza Strip and the West Bank, Jordan and Egypt. In relation to Egypt, the distance is very great since the centers of population are west of the Suez Canal. In relation to Jordan and the West Bank, there is no open, direct road from Gaza to the West Bank; goods need to travel via the transportation network of Israel. Thus, if future links between the Gaza Strip and the West Bank expand, a more efficient transport system linking them will need to be constructed.

Postal and Communication Links

The problem of establishing postal and communication links in the Middle East would be the easiest one to solve. We feel that, apart from the capital investments needed to acquire and install additional communications equipment, telephone exchanges, etc., the present situation represents a minor limitation on future links.

Israel and the Arab states are all signatories to the Universal Postal Union Convention (1868), and there is little to inhibit the delivery of mail to and from the territories. Mail service to the territories has been handled with considerable efficiency by Israel and Jordan in the 1967-78 period, and mail from the territories to Israel, the Arab world, and beyond has been expedited as well, using third parties where necessary. As a peace agreement takes effect and further transport links develop, it can be expected that postal service will continue and possibly improve in speed of delivery, at a lower cost.

Soon after the capture of the territories by Israel in June 1967, commercial telephone service was extended from Israel to the territories and subsequently upgraded to a "direct dial" basis where equipment permitted. This was, in part, due to the military utilization of commercial telephone systems, but also due, in part, to a desire on the part of Israel to integrate these areas into the Israeli economy to the fullest extent possible. Telephone and telex service between the territories and the rest of the Arab world, particularly Jordan and Egypt, has been possible from time to time, political factors and equipment permitting. Indeed, in the wake of the November 1977 Sadat-Begin initiative, telecommunications between Israel and Egypt via Rome were opened up for the first time.

As members of the international telecommunications conventions, it is anticipated that service will improve during the transition phase, dependent largely on the availability of modern switching equipment and the installation of long distance links, via microwave or satellite. The territories are part of the international direct dialing system, where equipment permits, and it is expected that such equipment will become more widespread during the coming decade, particularly as the costs of such equipment decrease due to the increasing use of computerized switching equipment.

Power Grids

At the moment, each municipality in the West Bank and Gaza has its own power system. In Jerusalem, the Jordanian Power Company has not been integrated into the Israeli Electric Company and is operating rather independently in East Jerusalem. This situation is in sharp contrast with Israel, which has a very modern and fully integrated power grid. Israel has extensive plans to develop nuclear reactors that will join the grid early in the 1980s. Also, it appears that the plans to transport water from the Mediterranean Sea to the Dead Sea will entail very large power stations and power lines, which will probably cross the West Bank. Moreover, the plan to raise the level of the Dead Sea will entail flooding some areas in Jordan and the West Bank, and this is likely to lead to some regional discussions on these issues. There is little doubt in our mind that the future economic development of the West Bank and the Gaza Strip will raise their demand for power and thus would, sooner or later, raise the possibility of integrating the entire power grid of Israel and the territories. Although this will not raise great technical difficulties, it may raise some political difficulties. This is so since, as stated above, the local power sources are controlled by the municipalities of the West Bank and Gaza. Now, depending upon their degree of political autonomy during the transition period, they may not wish to depend upon sources of power in Israel. Thus the linkage of power grids may turn, during the transition period, into a political issue which may have important symbolic value. It is thus conceivable that during the transition period, and perhaps beyond as well, the process of industrialization and economic development in the West Bank and Gaza may induce major investments in power-generating stations which may ultimately put each territory on a completely integrated and independent power grid but with no connection to either Jordan or Israel.

2.7 Optimal Policies for Trade and Stabilization

In evaluating the future evolution of economic links of the territories with Israel and the Arab world, it is necessary to take into account the effects of any fiscal or monetary policies followed in the territories. We note first that, for the moment, it appears naive to raise this question since the territories clearly have no currency of their own, no central bank, no governmental taxing ability, and no power to restrict foreign trade. Yet it is important to keep in mind that Israel has agreed to yield the civilian government to local authorities and, during the transition period and beyond, local residents may gain more independence or further political links with Jordan. This might enable the territories to follow independent economic policy, resulting in either slowing down or accelerating their links with one country or another. Thus our discussion here is purely speculative and should be viewed as background material only.

If the Status Quo Is Maintained

Local authorities have, today, limited taxing ability which is carried out via the military governor. The office of the military governor has also been enforcing tax laws thusly, collecting income taxes, property taxes, gasoline taxes, and the recently introduced value-added tax (VAT). When the military government is withdrawn, it is likely that a local authority to enforce the tax laws will be established. If tax revenues will be re-channeled back to the municipalities, then the change of government operations will not change the neutrality of the current policy with respect to expanding economic links. This is reinforced by the fact that, under the present arrangements, there is no locally independent currency or central bank; thus the governing body will have little if any effect on the money supply and the rate of expansion of the economy. This means that any stabilization (or destabilization) policies followed in Israel, Jordan or Egypt will overflow into the territories to the extent of their links with that country.

If New Governmental Body Gains Taxing Power

Different tax laws will have profound implications to future links with one country or another. For example, if the territories impose a heavy tax on labor income earned in Israel, then the incentive to work in Israel will be reduced. But a more subtle tax could have differential effect. For example, if heavy import duties are imposed on imports of industrial goods, then such taxes will differentiate against imports from Israel, which sends mostly industrial goods to the territories.

Taxing authority may enable the territories to impose taxes against foreign enterprises and thus reduce their links with the rest of the world. As is the case with any other sovereign entity, the ability to impose duties, tariffs, and other constraints on the economic activities of foreigners provides a considerable degree of leverage. In the case of the territories, this power could be used to limit foreign involvement and control-evolving trade links, thus controlling the nature of economic development. As indicated elsewhere, the non-imposition of such taxes could be used to promote the opposite effect, encouraging the development of trade links and foreign economic involvement.

We bring these examples to indicate that, in our opinion, such issues will appear in the negotiations during the transition period and it is important to keep in mind the deeper and long-run implications of each possible economic move.

If a Central Bank and an Independent Currency Are Established

We have already indicated that, without control over the money supply, the territories cannot control the rate of their economic growth and thus the extent and nature of their interdependence with their neighbors. Thus the act of establishing a separate central bank and currency can have deep implications for the nature of economic links in the Middle East beyond the period of transition.

A government in the territories that may elect for limiting or reducing trade and economic links may consequently elect to impose taxes on imported commodities. It may also slow the growth rate of the economy by controlling the money supply and thus engaging in a deflationary policy with high interest rates.

Alternatively, a government that may not fear increasing the economic ties with the rest of the region may attempt to maintain a policy of sustained growth with an expansion of the money supply in accordance with a somewhat full employment policy. Obviously, these two possible policies or courses of action would have very different consequences for the evolution of the economy of the territories.

The Likely Development

The present analysis suggests that the territories, Jordan, and Israel have already established a set of such intimate links that they all stand to sustain large short-term losses from breaking down these ties. Given the nature of the political forces at hand, we believe that whatever the political power and taxing ability given to the local authorities in the territories, the basic principles that will be used during the transition period are:

- No independent currency and central bank will be established.
- No taxes will be imposed which will have direct or indirect discriminatory force with respect to economic links with any country in the region.

- Tax revenues will be used to improve social services and basic infrastructure in the territories. These will tend to improve capital productivity and further attract private capital.

Development of Trade Patterns

The evolution of economic links as presented here has been a subject of a regional controversy over the meaning and desirability of the development process. Israel has been pointing out the extremely high, and sustained, rates of growth of both the GNP and GDP experienced by the territories since 1967. This view suggests that, with only limited Israeli intervention, economic forces of specialization and trade developed links have been beneficial to the territories and Israel.

The opposite view, held by many Palestinians, holds that economic growth and an improved standard of living are not the issue. They maintain that by exposing the territories to competition of Israeli products, without protection of the domestic industry in the territories, the development of the territories was limited, and made the territories into an Israeli "colony" specializing only in some products in which they can compete with Israel. At the same time, the territories were sending a growing fraction of the able-bodied labor force to work for low wages in Israel. According to this view, the process is one benefitting only Israel since it prevents the development of a balanced, viable, national economy in the territories.

Since our objective in the present analysis is not to evaluate the desirability of any given process and its contribution to the national aspiration of one group or another, the issue is important only to the extent that it is related to the explanation of the forces operating in the economies under consideration. With this in mind, we may note that the observed economic facts were a natural consequence of the conditions which were analyzed earlier.

In economic forms, opening the borders between Israel and the territories simply set free competitive, economic factors which tended to make the territories develop as regions within a larger economic system. In the same way that the north of Israel concentrated on developing along the lines of its relative advantage, so did the West Bank and the Gaza Strip. The peculiar areas of specialization and the specific direction of movement of labor and commodities were determined by the special political-legal restrictions placed on this regional development.

The outcome of such a process with these restrictions is exactly what one would expect: a massive movement of labor to areas of higher wages, selective development of the domestic economy in the territories, and massive trade in commodities. Israel became the largest market for exported goods from the territories, and the West Bank and Gaza became the second largest (after the U.S.) market for Israeli exports. The deficit in the balance of payments between the territories and Israel is simply an outcome of the income earned by the residents of the territories who work in Israel. It would be in error to think of the growing exports of Israel into the territories as a form of market domination by Israel. Rather, it is a simple outcome of the earnings of the territories from labor services sold to Israel which generated the income used to bring the imports from Israel.

To what extent this process will continue throughout the transition phase and beyond remains subject to two major political uncertainties. If, on the one hand, any settlement accord permits Israel to effectively annex the territories, it is clear that the processes described above will continue largely unabated. On the other hand, if such a settlement provides for the establishment of a sovereign Palestinian state, it is unlikely that these trends will continue as before.

Rather than speculate about the political environment which will accompany a settlement, it is more useful to consider the relevant economic parameters in terms of two scenarios representing the alternative limits of the environment which is expected to emerge over the five-year transition phase.[15] The scenarios, the assumptions behind them, and the alternative economic implications for trade patterns and developments of the territories are considered in Part III below.

[15] For an analysis of the political context and uncertainties, see Avigdor Haselkorn, *Uncertainties of Political Cooperation and the Durability of Economic Links in the Transition Phase* TR-9902/78 (Marina del Rey: Analytical Assessments Corp., November 1978).

III. THE NATURE OF EVOLVING TRADE AND ECONOMIC LINKS

3.1 Assumptions About the Economic Environment

The most important observation which we have stressed throughout this research is the fact that any future evolution of the patterns of trade, investments, and output depends crucially upon political and, indirectly, legal developments during the same period. During the past nine years, the governments of Israel and the residents of the territories sought to avoid direct Israeli investments in the West Bank and Gaza. As a result, the pattern of output, investment, and trade favored the movement of workers from the territories into Israeli labor markets. Associated with this trend has been a reduction in the domestic rate of employment in the territories and a rapid rise of imports from Israel into the territories. At the same time, the territories proceeded to develop those domestic crops and industrial products in which they had relative advantage. This entire pattern resulted in a very rapid rise in per capita income in the territories but a relatively slower rate of *domestic* product. Had the parties elected a different political and legal arrangement, the resulting structure of links would have been different, indeed.

To analyze the pattern of trade and economic linkages anticipated for the five-year transition phase and beyond, we have analyzed two alternative scenarios: a "Cooperative" vs. continuation of the "Status Quo" scenario. The two scenarios represent somewhat polar sets of political and economic forecasts. As a matter of subjective judgment, we believe that the political and legal developments which will, in fact, take place as a result of the settlement process are probably in between the two hypothetical scenarios developed here. Considering two sets of political assumptions, however, provides a form of intrinsic sensitivity analysis since it allows a clearer perspective of how the political assumptions change the economic forecasts.

The Cooperative Scenario

The first major scenario represents the outcome of agreements concluded among the parties, to move the entire region toward an integrated economic system like the Common Market in Europe. The main parties to this cooperation will be Israel, Jordan, and the territories. Such cooperation would not necessarily imply a resolution of all the open political problems, and it would not necessarily be achieved during the transition period itself.[1] Under such a scenario, the following political-economic circumstances can be expected:

- Removal of limitations in purchases of land and establishment of economic enterprises in Israel, Jordan, and the territories by the parties involved: Israelis, Jordanians, territorial residents, and foreign investors.
- Discontinuation of support by Egypt, Jordan, Saudi Arabia, and local residents for any act of terror against economic enterprises and movement of workers and/or commodities across the regional boundaries.
- Special legal protection and encouragement of foreign investors who will be offered essentially a politically safe economic environment.
- Customs agreements that may include a few additional Middle Eastern countries.
- Cooperative attitude toward taxation; rapid development of social services and public infrastructure.

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[1] It is, of course, unlikely that a Middle Eastern common market could be achieved within the five-year transition period. A realistic view of the optimistic possibility looks something like Western Europe after the Kennedy round of trade negotiations and prior to the establishment of the Common Market.

- Israeli agreement to the expansion of trade and economic ties between the territories and the rest of the Arab world.

The Status Quo Scenario

The second alternative represents a continuation and perhaps an intensification of the tension between Israel, the residents of the territories in the West Bank and Gaza, the PLO, Jordan, and Syria. The additional autonomy gained by the territories under the Camp David accords may be exploited by the extreme elements in the territories to intensify their struggle against Arab work in Israel and against the developing trade between Israel and the territories, such as pressure on traders not to proceed with transactions, etc. Thus we can describe the scenario at hand in the following way:

- Continuation of the present legal system preventing the establishment of property rights by Israeli citizens in the territories and by territorial residents in Israel.
- Continuation of PLO terrorist activities against workers employed in Israel and against individuals involved with the growing trade with Israel.
- Due to the political climate involved, the economic environment will be risky for investors (foreign and domestic alike), discouraging foreign investments, thus limiting the flow of capital and new technology from the Arab world and overseas into the territories.
- Limited ability of local authorities to tax and develop a vital fiscal system. This will result in a slow growth of social services and public infrastructure.
- The conditions of Status Quo will intensify the security problems of Israel and thus it is to be expected that countermeasures will be taken to prevent the PLO and Jordanian influences from developing

beyond their present levels. This will probably entail further settlements in the territories.

The Likely Middle Ground

Between these rather extreme alternatives, used to define the ends of the possible political and economic spectrum, lies the less well-defined middle ground where future trade and economic links will develop. As indicated above, it is probably too much to expect a formal, Common-Market-type arrangement in the first five years of the transition, although the informal and tacit beginnings of such an arrangement are likely to emerge. As more of the political problems are removed, and "normalization" of relations progresses, such a formal trade union will become increasingly possible.

Similarly, it cannot be expected that the effects of regional terrorism, economic boycotts, and other antagonisms will subside immediately. At best it can be expected that, over the course of the transition phase, these effects will diminish as plans for Palestinian autonomy are implemented. Whether or not such autonomy will provide the basis for increased extremism, as indicated in the second scenario, remains open to question. Here one would expect that moderate elements in the Arab world have a considerable incentive to restrain extremist elements.

It is also unlikely that tax and fiscal systems will evolve in any sophisticated fashion in the near term. Over the five years, it is possible that such systems, as well as social services and public infrastructure, could reach levels currently being experienced in Western Europe. Even this estimate, however, tends toward the optimistic side and implicitly assumes the availability of substantial funds from the OAPEC states to finance such developments.

Since the uncertainties about what middle ground may prevail are so great, the analysis below continues along the polar lines suggested in the two alternative scenarios and develops a set of quantitative estimates for each. Presumably, what situation actually develops will lie between these two sets of estimates.

3.2 The Cooperative Scenario: Implications of Economic Links to the West Bank, Gaza

General Characterization of the Process

Although closer to the textbook development model, the Cooperative Scenario is difficult to describe quantitatively since little or no base-line data for this scenario exists for an analysis to proceed upon. Any projection which might be made is likely to be subject to substantial error, and for this reason it is difficult to make a precise evaluation of the scenario at hand.

Yet the difference between the outcomes of the Status Quo and the Cooperative scenarios could be so great that there is no difficulty establishing the key quantitative forces at work.

Based on the analysis in Part II, above, the fundamental economic forces that would operate under the Cooperative Scenario are:

(1) The territories have a relatively large reservoir of unskilled and semi-skilled workers and Israel has a great shortage of such workers. Moreover, the high cost of labor and the difficult labor-management relations in Israel will create an incentive for some Israeli enterprises to locate some of their plants in the territories. Thus we could visualize a gradual but sustained movement of capital from Israel to the territories, employing the surplus labor in the territories themselves rather than in Israel. The rising education and skill level of workers in the territories in the future will not slow down this incentive since the wage rates in the territories are likely to stay lower than in Israel for some years to come.

(2) A peaceful environment will reduce the risk factor of domestic investments all around and will make extensive quantities of capital available for investments. The sources of this capital will include both the domestic income of residents and resources from the rest of the Arab world. In addition, investments from the oil-producing countries are likely to be attracted to the area.

It is clear that the dramatic nature of the economic boom which may result is difficult to estimate.

(3) The discrepancy of rates of return to capital, land prices, and home values between Israel and the territories is very extensive. A unit of land on the Israeli side of the Green Line costs some 10 to 20 times what it may cost on the side of the territories. Furthermore, it is likely that a significant number of Israeli citizens will either wish to buy real estate or live in some parts of the territories. This "private" movement might be associated with a public policy aiding Israeli settlements in the territories. All such acts will further add to the economic momentum which might build up in the domestic economy of the territories.

(4) The reduction in the risk factor and the availability of capital will attract entrepreneurial talent from the territories, the Arab world, and Israel, thus providing the final vehicle for the gradual transformation of the domestic economies of the two territories.

Turning now to some specific projections, it is important to bear in mind that these are highly speculative projections based mostly upon our judgment and not on any complete, formal model. Our objective in presenting these projections is only to provide the reader with the quantitative basis of our thinking.

Quantitative Estimates

1. Population, Labor Force and Employment Under the Cooperative Scenario

The natural growth rate of the population in the administered territories is among the highest in the world, but the actual growth rate includes immigration, and this is influenced by economic factors. Consider the annual growth rates of the population in the territories as reported in Table 3.1.

The years of lowest growth rate were 1967-1968, following the 1967 Six-Day War, and the years 1975-1976, when the Israeli economy slowed down to essentially zero growth. The year 1972 was also a recession year in Israel

TABLE 3.1

ANNUAL GROWTH RATES OF THE POPULATION IN THE TERRITORIES: 1967-1976

(percent)

Year	*West Bank*	*Gaza Strip*
1967	-1.7%	-2.3%
1968	- .7	-6.6
1969	2.3	1.8
1970	1.5	1.5
1971	2.2	2.2
1972	1.9	2.0
1973	2.7	3.6
1974	2.4	2.8
1975	.5	2.4
1976	.9	2.5

Source: *Statistical Abstract of Israel* (1977), Table XXXVII/1.

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and it reflects itself in a lower growth rate of the territorial population. The point which we wish to stress is that the growth rate of the population in the territories is sensitive to the economic conditions of the territories, and these have depended upon the economic conditions in Israel. The Israeli economy, on the other hand, will continue to experience rather slow growth for the next year or two, gradually resuming growth in the early 1980s with the rest of the Western economies.

Thus, under the Status Quo Scenario, the economic conditions of the territories will exhibit relatively slow growth rates which will improve slowly as we move into the 1980s. Under the Cooperative Scenario we would expect a rapid rate of investment in the territories, thus enabling them to experience rapid growth even when Israel is experiencing rather slow growth rates. This will be considered at greater length below. For the moment, we note that the average annual growth rate of the population in the territories between 1970 and 1976 was 1.7 percent in the West Bank and 2.4 percent in the Gaza Strip, bringing the total growth rate to 2.0 percent. Under the Status Quo Scenario we project the average annual growth rate until 1983 at about 1.6 percent, and under the Cooperative Scenario it will be 2.2 percent. Thus our population assumptions are as shown in Table 3.2. Clearly, in such a short period the difference between 1229.2 and 1280.1 is not very large: Such a difference in the growth rate will make a significant impact in the longer run. The determining factor is to be found in the ability of the Israeli economy to absorb Arab workers. As we see from Table 2.6, the number of territorial workers in Israel increased from 20,600 in 1970 to 61,300 in 1973, but then went to 68,700 in 1974, 66,300 in 1975, and 64,800 in 1976. We think that the present slow growth rate of the Israeli economy is a temporary phenomenon which is familiar in many Western countries. We believe that a rapid growth rate will resume after 1980, when most European economies are expected to advance.

Turning now to the rest of our projections, let us note first the assumptions on which they are based:

- The growth rate of the population, as indicated earlier, is likely to be approximately 2.2 percent per year.

TABLE 3.2

POPULATION PROJECTIONS,

WEST BANK AND GAZA STRIP: 1976 AND 1983

(in thousands)

	Status Quo Scenario	*Cooperative Scenario*
1976	1099.9	1099.9
1983	1229.2	1280.1

- Total number of residents working in Israel will be held, by 1983, down to about 50,000 per year in spite of the growth of the labor force.
- There will be adequate capital and entrepreneurial resources to enable the domestic economy to grow at a rate which will ensure essential domestic full employment during the transition period.

Table 3.3 presents our best estimate of how the structure of the labor force will evolve under the Cooperative Scenario. Given the assumed growth rate of the population and the availability of capital, the high rate of investment in the domestic economy is estimated to generate sufficient jobs to enable a rapid increase in its employment. We think that:

TABLE 3.3

PROJECTIONS OF SOME KEY ECONOMIC VARIABLES: THE COOPERATIVE SCENARIO

	1976[a]	*1983*[b]	*Change Between 1976 and 1983*
Population (thousands)	1099.9	1280.1	16.4%
% of population employed	18.7	20.0	7.0
Total employment (thousands)	204.9	256.0	24.9
Employed in Israel (thousands)	64.8	50.0	-29.6
% employed in Israel	31.5	19.5	-61.5
Domestic employment (thousands)	140.9	206.0	46.2
% employed in domestic agriculture	31.4	27.0	-16.3
% employed in domestic industry	14.4	20.0	38.9
% employed in construction	8.2	12.0	46.3
% employed in services and others	46.0	41.0	-12.2

[a]Actual 1976 data.

[b]Analytical Assessments Corporation computations.

- Domestic agriculture will expand its employment moderately, thus the percentage employed in the sector will continue to decline.
- The two expanding sectors will be industry and construction, absorbing together some 19,360 new workers during the period through 1983.

2. Capital Requirements and GNP

We assume that the West Bank economy will grow under the present scenario at a 10-percent average annual rate and the Gaza Strip at 11 percent. This will yield the following GDP projections of Table 3.4. For the 1971-1976 period, we have estimated the average incremental capital/output ratio to be 3.3. On that basis, we arrive at the capital requirements implied by the projections in Table 3.5. Thus we calculate a total sum of 2,897 million pounds (equivalent to 1,346 million 1977 dollars) of investments. Including the estimated income from labor employed in Israel, we estimate the GNP of the territories to grow as shown in Table 3.6. Thus the proposed investment program will require a rate of gross investments over the five-year period which is about 1.23 times the terminal year GNP. This is a rapid rate of investment and, if the Cooperative Scenario takes place, the appropriate capital investments will be forthcoming most likely from Israel, the Arab world and overseas.

TABLE 3.4

PROJECTIONS OF GROSS DOMESTIC PRODUCT: 1976 AND 1983

(millions of 1968 Israeli pounds)

	1976	*1983*
GDP in West Bank	759	1,480
GDP in Gaza Strip	249	517
Total	1,008	1,997

TABLE 3.5

CAPITAL REQUIREMENTS: COOPERATIVE SCENARIO

(millions of 1968 Israeli pounds)

Year	*West Bank*	*Gaza Strip*	*Total*
1979	324	124	448
1980	391	137	528
1981	430	150	580
1982	473	165	638
1983	521	182	703
5-year total	2,139	758	2,897
(in 1977 dollars)	$994.2	$352.3	$1,346.46

Source: Analytical Assessments Corporation computations.

TABLE 3.6

PROJECTIONS OF GROSS NATIONAL PRODUCT: 1976 AND 1983

(millions of 1968 Israeli pounds)

	1976	*1983*	*Annual Growth Rate*
GNP in West Bank	949	1,668	11.9%
GNP in Gaza Strip	365	687	13.5%
	1,314	2,355	12.4%

3. *The Pattern of Trade*

It is difficult to make a reliable assessment of the pattern of economic trade in 1983, lacking any reliable information on potential sources of risk capital which will be invested in the territories during the transition phase. We can estimate the amount of capital needed to be invested, although we cannot predict where precisely it will come from. Due to these facts, we shall evaluate the pattern of trade in two steps. First, we shall review the qualitative forces at work and provide some basic reasoning for these. Second, we shall propose a certain set of quantitative assumptions and, on that basis, develop a numerical exercise which will illustrate the pattern of trade which might result. Such estimates provide a general order of magnitude of the flows involved.

1. Qualitative Evaluations

a. *Wage Rates*. The annual growth rate of GNP by 12 to 13 percent while population is rising at some 2.2 percent means that the per capita growth rate of income will rise by about 10 percent. Due to the extensive discrepancy in the wage rates between Israel and the territories, it is likely that territorial workers in Israel will experience a rate of increase of their wage rates which will exceed 10 percent. This will be amplified by the fact that, under the scenario at hand, the Israeli economy will need to compete for territorial workers due to the rising demand for labor in the domestic economies. For this reason, we assumed in our GNP calculations that the annual rate of increase of the wage rate received by the territorial workers will be 11 to 12 percent.

b. *Foreign Trade*. In 1976 the pattern of foreign trade of agricultural and industrial products in the territories was as follows:

Imports		*Exports*	
From Israel	90.3%	To Israel	63.3%
From Jordan	.9%	To Jordan	29.6%
From the rest of the world	8.8%	To the rest of the world	7.1%

with the excess of imports over exports in current 1976 Israeli pounds:

Excess from Israel	+1977.2
Excess from Jordan	- 505.3
Excess from the rest of the world	+ 175.0
	1646.9

The high rate of imports from Israel results partly from the amount of labor income earned in Israel, which amounted to 929.3 million pounds. Thus the essential factors operating here consist both of labor income in Israel and the surplus with Jordan together financing most of the deficit. The rest was financed by transfer payments (801.7 million in 1976) while capital movement was nil (see Table 2.12).

The Cooperative Scenario is likely to change the above picture. Imports from Israel will continue to be large, partly due to labor income earned in Israel which we assume to be generated by the 50,000 workers in Israel. Their income will rise from 929.3 million in 1976 to 1,544.2 million in 1983 (in 1976 prices) in spite of the decline in the total number of workers. However, we would expect that the change in environment will encourage imports from Jordan and the rest of the world. The pattern of trade is likely to become very complex as industrialization proceeds, due to the rising imports of raw material and expanding volume of exports of finished and semi-finished products. On the basis of the above, we would expect imports from Jordan and the rest of the world to rise drastically in importance while exports to the rest of the world may rise only moderately. The structure of export will probably change little.

c. *Finance*. The investment demand and the associated deficit in the balance of payment will be financed by three sources: labor income in Israel, transfer payments, and foreign investments. Some of the extensive amounts of capital required will need to be supplied from abroad, and we expect some of it to come from Israel and the West and some of it from the Arab world.

d. *Other Industries*. We expect agricultural production and foreign trade to maintain its current pattern, with slow improvements in productivity and reduction in the fraction of the labor force employed in it. A major improvement in tourism should make an additional contribution to the balance of payment.

e. *Time Frame*. Keeping in mind the nature of economic links in 1978, it should be clear that even if major changes occur under the Cooperative Scenario, they will take more than five years to make their way through the system. The estimates provided here are based on a five-year period with the full expectations of further developments beyond. We return to this point later.

f. *Free Trade Assumption*. The estimates in this chapter are based on the idea of establishing a "free trade" arrangement around the territories.

2. Some Quantitative Assumptions

In order to obtain a clear picture of the balance of trade in 1983, let us make the following assumptions which will be the basis for our numerical exercise to follow:

- The composition of total imports and exports *in relation to GNP* will remain the same as in 1976.
- The distribution of commodity export destinations remains the same as in 1976, while it moves toward higher exports of services to the rest of the world. (Tourism and other exported services rise to about 15 percent of all non-labor export services.)

- Imports of commodities and services from Israel fall from 90.3 percent to about 70 percent, while Jordan and the rest of the world rise to 5 percent and 25 percent, respectively.

On the basis of the above, we can now carry out the computation of our pattern-of-trade exercise. We repeat that this exercise is presented so that the order of magnitude of the various variables can be perceived. Obviously, we have selected the most likely parameters, in our estimation, but a more detailed analysis can be provided. The results appear in Table 3.7.

The main conclusions one can draw from the pattern presented above are as follows:

(a) Given the assumptions above, Israel will still be a large source of commodity imports but will have a growing excess purchase of services in the territories.

(b) The main change between 1976 and 1983 is the rising importance of the "rest of the world" in the trade of the territories. This means both the "rest of the Arab world" and the economies of the West.

(c) After taking into account the earnings from labor services exported to Israel, the territories will be running an annual deficit of 1.8 billion Israeli pounds (about $191 million in 1976 prices). This will need to be financed by transfer payments and net capital inflow.

The picture presented above hides the deep change in the composition of imports and exports. This will move toward increased fraction of imported raw materials and capital goods while, at the same time, lowering the fraction of agricultural exports and rising fraction of exports of finished and semi-finished manufactured goods.

The Economic Gains and Losses

The analysis should have made it clear that the Cooperative Scenario entails some gradual changes in the economic gains of trade with the

TABLE 3.7

PATTERN OF TRADE IN TERRITORIES,

COOPERATIVE SCENARIO: 1983

(millions of 1976 Israeli pounds)

Commodity Trade:

Imports			*Exports*			*Net Imports*
From Israel	5,483	70%	To Israel	2,583	63%	2,900
From Jordan	392	5%	To Jordan	1,230	30%	- 838
From the rest of the world	1,958	25%	To the rest of the world	287	7%	1,671
	7,833	100%		4,100	100%	3,733

Services Traded (including labor services):

Imports			*Exports*			*Net Imports*
From Israel	1,240	70%	To Israel	2,701	74%	-1,461
From Jordan	89	5%	To Jordan	617	17%	- 528
From the rest of the world	443	25%	To the rest of the world	313	9%	130
	1,772	100%		3,631	100%	-1,859

Net aggregate excess of imports over exports -1,875

Source: Analytical Assessments Corporation computations.

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territories. Moreover, those gains or losses will continue to evolve in the long run beyond the five-year transition period. It is difficult to evaluate the long-run effects, but it is important to keep them in mind.

Israel: Compared to its current position, Israel will lose, under the Cooperative Scenario, some of its advantages in the territories. It will certainly lose some of its potential export markets. Also, due to the rising competition, the profit margins from exports to the territories will be reduced while at the same time the cost of purchased labor will continue to rise faster than it is rising today.

It is important to keep in mind that these are "short-term" losses and, ultimately, the long-run benefits of cooperation may be more important. It is difficult to evaluate the long-run vs. the short-run effects of the Cooperative Scenario. However, since the short- vs. long-term effects should be considered relative to the Status Quo Scenario, we shall return to this issue in the relevant later section. For the moment, we concentrate on short-term costs during the transition period.

In addition to these economic losses, one may add the following considerations:

- In order to maintain a strong position in the territories, Israel will need to finance a good portion of the 1.8- to 2.0-billion-pound deficit of the territories. This will mostly take the form of private investment.
- The higher rate of economic expansion will encourage a higher rate of population growth in the territories.
- The present scenario shows that Israeli manufacturers will be facing growing competition of products manufactured in the territories. This may have an influence on the profit margins of some domestic industries in Israel.

Jordan: It is clear that Jordan is the big gainer from the Cooperative Scenario. The territories will become a market for Jordanian products where no such market existed before. The large deficit in the balance of payments will represent the net annual investments of Jordan in the territories.

The rest of the world: In absolute terms, the trade with the rest of the world is the most dramatic change in the trade picture of the territories.

It is difficult to say which specific countries will be involved in this trade, but we have little doubt that a good portion of this will be the rest of the Arab world.

Without further elaborating on the gains and losses, it is clear that the Cooperative Scenario represents an economic short-term loss to Israel. If that scenario ever becomes a reality, the motivation for it must entail important political considerations. We may add that our analysis so far has focused on the first five years of the transition period. The process at hand will continue into the period beyond 1983 and that represents further potential economic loss to Israel.

We conclude that significant factors are operating to perpetuate the political and economic status quo in the territories, and for this reason we turn now to this alternative scenario.

3.3 The Status Quo Scenario: Implications of Economic Links to the West Bank, Gaza

General Characterization of the Process

The single most important economic force that will be operating under status quo conditions is the rapidly rising wage rate in Israel combined with a slow pace of domestic investments in the territories. The political environment assumed in the Status Quo Scenario will induce a very risky economic environment, making it legally impossible for Israeli enterprises to invest in the territories but, at the same time, keeping Arab and other foreign investments on a very modest level! In spite of this, the process does entail a very rapid rate of increase in the standard of living of the territorial residents, associated with rising interdependence of the territories with Israel. These ties will have three distinct features:

- o A rising fraction of the labor force will be working in Israel.
- o The domestic territorial economy will be growing relatively slowly.
- o The domestic territorial economy will deepen its specialization and further concentrate on the agricultural crops and industrial products in which the economy can compete with other regional imports.

This kind of development is a natural outcome of the fact that, given the conditions specified, economic forces will be at work which will make it optimal for the territories to concentrate on their relative advantage and purchase from other regions the products and services which are cheaper to import. This type of regional development maximizes the well being of the residents while intensifying their interdependence with other regions of the Israeli economy. We thus arrive at what may be viewed as a paradoxical conclusion: The high rate of political tension between Israel, the territories, the PLO, and other actors in the region will produce a risky economic environment which will only deepen the present links between Israel and the territories. This will tend both to increase the flow of labor and goods between the territories and Israel and to relatively slow down the rate of growth of the domestic economy of the territories.

The Long vs. Short Run

It is clear that during the past nine years both the territories and Israel have enjoyed dramatic economic gains from the economic links between them. It is our opinion that the potential gains from further links between them are still very great. This means that it is likely that if the Status Quo Scenario is played out during the transition period and beyond, major economic gains will accrue to both the West Bank and Gaza.

Yet it is important to keep in mind some long-term forces which will be operating and may demonstrate that, as time goes by, some important changes will need to take place. To understand this, note first that those among the residents of the territories who are employed in Israel tend to hold unskilled and semi-skilled jobs. On the other hand, as demonstrated earlier, the educational level of the labor force is rapidly rising, thus making a growing fraction of the labor force seek skilled jobs which may not be available in the economy of the territories either. This process will be associated with deep changes in the industrial composition of the Arab labor force working in Israel, as Table 3.8 demonstrates.

Table 3.8 shows that about half of the territorial labor force in Israel is employed in construction. But the table also shows a gradual rise

TABLE 3.8

EMPLOYED PERSONS BY SELECTED ECONOMIC SECTORS:
TERRITORIAL WORKERS WHO ARE EMPLOYED IN ISRAEL (1970-1976)

(percentages)

	Percent Employed In			
Year	*Agriculture*	*Industry*	*Construction*	*Other*
1970	24.4%	11.6%	54.3%	9.7%
1971	22.3	14.8	52.3	10.6
1972	23.1	17.1	49.5	10.3
1973	19.3	18.1	51.7	10.9
1974	19.1	17.5	52.5	10.9
1975	14.3	18.4	54.4	12.9
1976	15.4	19.7	50.3	14.6

Source: *Statistical Abstract of Israel* (1977), Table XXVII/22.

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in the level of employment in industry and services, combined with a rapid decline in agricultural employment. What should be kept in mind is that employment in industry and services tends, on the whole, to be more stable than that in construction and agriculture. With stability comes familiarity with other workers, unionization, and concern with status, fringe benefits, and salary. Since the labor force at hand will tend to become more educated, their employment in Israel is likely to be associated with greater frustration and sense of social deprivation. Moreover, some of these employees will probably demand improved conditions and fringe benefits, and intensify the demand for more permanence in employment and the right to live in Israel rather than to commute to it on a daily or weekly basis. All these developments will be taking place while the domestic economy in the territories will be creating semi-skilled and skilled jobs at a relatively slow pace, forcing the educated labor force to choose between immigration or unskilled and relatively low-paying jobs.

It is important to keep in mind that the discrepancy in living standards between Israel and the territories is high and the rapid industrialization of Israel causes the real wages in Israel to rise rapidly. In fact, the economic benefits which will accrue to the territorial residents are so great that the five-year transition phase is too short for the fundamental forces mentioned above to work their way out. It is possible that if the process we are discussing intensifies, some extreme elements in the territories may seize upon the growing frustration and anger and succeed in organizing, say, a "general strike" of some segment of the territorial workers employed in Israel. Although such an act may not achieve a great deal by itself and, from the economic viewpoint, may even harm the territories more than Israel, it is likely to raise important questions about the direction of economic developments under the status quo. Two Israeli options in the face of such potential developments are important to keep in mind since they may, in fact, be used during the transition period.

1. Allowing Skilled Workers from the Territories to Move to Israel

This will mean that the demands of the growing number of industrial workers from the territories will be met with an offer of residence in Israel, equal working conditions, fringe benefits, and industrial status.

2. Industrialization in the Territories

In essence, part of the problem will arise from insufficient job creation in the territories. Israel can encourage investments in the territories, offering potential investors the legal protection of Israeli law. Keeping in mind that the amount of available fertile land in the territories is limited, any major movement of Israelis into the territories will have to be urban and industrial in nature; otherwise, they will not provide an adequate standard of living to the settlers. But such an urban-industrial process will certainly have important spillover effects on the economy of the territories, generating the capital investments and the skilled jobs which will reduce the supply of labor to Israel proper.

We repeat our earlier subjective evaluation that, due to the great benefits of the links between Israel and the territories, we do not think that major problems will surface during the short-term transition period. Further, we are not sure if the cumulative, long-run process is operating against Israeli interests, but this is a subject far beyond the scope of this study. We now turn to some specific quantitative projections under the Status Quo Scenario.

Quantitative Estimates

1. Population, Labor Force and Employment Under the Status Quo Scenario

As indicated in Section 3.2, we shall assume, under the Status Quo Scenario, a population growth rate of 1.6 percent per year. Combining this with the rest of the assumptions we made in the Status Quo Scenario, we present, in Table 3.9, an assessment of how some of the key variables under consideration are likely to develop. As Table 3.9 indicates, we anticipate that the population will grow at an average annual rate of 1.6 percent, with the participation rate rising slowly to 20 percent of the population and thus employment rising from 204.9 thousand to 245.8 thousand workers. The most distinct change is still the number of workers employed in Israel, which we estimate to rise by up to 30 percent with domestic employment to rise by only 4.7 percent. Recall that, until recently, domestic employment in the territories was *falling* due to the rapid rise in employment in Israel. We think that under the present scenario this process will be *reversed,* and thus domestic employment will rise in the next five years. In the same manner, we think agricultural employment will continue to fall moderately and employment in industry (mining and manufacturing) will rise moderately. Throughout this process we shall have a significant rise in the domestic economy and a rapidly rising element in the national accounts will be the wage payments from Israel.

TABLE 3.9

PROJECTIONS OF KEY ECONOMIC VARIABLES:

STATUS QUO SCENARIO (1976 AND 1983)

	1976	*1983*	*Change Between 1976 and 1983*
Population (thousands)	1099.9	1229.2	11.8%
% of population employed	18.7%	20.0%	7.0%
Total employment (thousands)	204.9	245.8	20.0%
Domestic employment (thousands)	140.9	147.5	4.7%
Employed in Israel (thousands)	64.8	98.3	51.7%
% employed in Israel	31.5%	40.0%	27.0%
% employed in domestic agriculture	31.4%	29.0%	-8.3%
% employed in domestic industry	14.4%	16.0%	11.1%

2. *Living Standard and Domestic Production*

The essential characteristic of the process at hand is best seen from the fact that, during the 1968-1976 period, total Gross Domestic Product (GDP) in the West Bank grew at an approximate annual rate of 10.8 percent while the Gross National Product (GNP) grew at an approximate annual rate of 13.5 percent. The difference between the GNP and the GDP is "factor payments from abroad" which, in the case at hand, are mostly wage payments to residents working in Israel, and this factor grew during the same period at the annual rate of 34 percent. By 1975, the fraction of GNP earned abroad was 22.5 percent! This ratio eased a bit in 1976, but we think that under the present scenario it will continue to rise in the future.

The important fact that must be kept in mind is that the growing links between the territories and Israel will be associated with a rapidly rising standard of living, although the Gross Domestic Product will be rising relatively slowly. Our projections of the growth factors involved are presented in Table 3.10. The estimated growth rates represent an average over the early period of slow growth and over the later period where we expect the growth rates to pick up. Thus we expect both the GNP and the GDp to rise more slowly than in the 1971-1976 period and wages earned in Israel to continue to rise rapidly but, perhaps, to slow down somewhat in the Gaza Strip. To provide a summary, our Status Quo Scenario suggests the following pattern:

- Lower growth rates of population and output relative to the 1970s.
- Continued rise in income earned in Israel but a relatively slower growth rate of Gross Domestic Product (GDP).
- Continued rise in domestic wage rates, inducing increased specialization of both agriculture and industry in the territories. This

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TABLE 3.10
ACTUAL AND PROJECTED GROWTH RATES:
STATUS QUO SCENARIO
(percentages)

	Actual 1971-1976		*Projected 1976-1983*	
	West Bank	*Gaza Strip*	*West Bank*	*Gaza Strip*
Annual Growth of GDP	10.0%	5.7%	8.0%	5.0%
Annual Growth Rate of Wages Paid in Israel (Real)	8.6%	29.4%	9.0%	15.0%
Annual Growth Rate of GNP	10.0%	11.0%	8.2%	7.0%
Annual Growth Rate of Population			1.6%	2.2%

will cause modest decline in the fraction employed in agriculture and modest rise in the fraction employed in industry.

- Rising dependence of the territories on imports from Israel and overseas and export earnings from Jordan, Israel, and overseas.
- The territories will not provide an adequate environment for high-quality skilled labor and entrepreneurial talent. A good fraction of these talents is likely to move to other countries of the Arab world. This drain will be associated with rising domestic tension.

IV. CONCLUSIONS

The present research reviews both the economic forces likely to operate in the Middle East during the transition phase as well as their impact on the development of trade and economic links with the West Bank and Gaza. The main conclusions can now be summarized.

4.1 The Links with Israel

The economies of the territories have already developed strong links to the Israeli economy over the past decade, and these links will be difficult to change. Approximately one-third of the labor force of the West Bank and Gaza is employed in Israel, and some 90 percent of all exports of these territories go to Israel. Similarly, the territories have become the second largest trading partner of Israel. The economic forces at work are expected to be effective and, unless strong economic and political barriers are imposed, the process is likely to continue throughout the five-year transition phase and beyond.

4.2 The Economic Consequences of a Cooperative Scenario

It is clear that a cooperative scenario will call for a more independent development of the territories and growing economic links of the territories with Jordan, the rest of the Arab world, and overseas economies. Some of these developments will occur at the expense of Israeli interests. Furthermore, adding the cost of settling the refugees, the economic cost to Israel would be very extensive and the economic gains to Jordan equally significant. Although Jordan may experience economic benefits, it may not be able to join a cooperative peace effort due to conflicting internal forces. Putting these together, we arrive at the conclusion that economic considerations alone do not favor a cooperative peace process between Israel, Jordan, and the West Bankers. If economic cooperation does take place, the following could be expected:

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- The economies of the territories will develop rapidly, with a growing rate of investments in manufacturing, construction, and services. This more balanced development will provide a high level of demand for domestic labor, competing with Israeli demands for territorial labor. This will result in a gradual reduction in territorial workers employed in Israel.
- Domestic development will require significant capital investments amounting to some $1.5 billion, most of which are to be financed by domestic savings and Arab capital.
- Expansion of trade with Jordan and overseas markets will reduce the relative importance of Israel as a trading partner, but as of 1983 Israel will still remain the biggest partner of the territories.
- The standard of living in the territories will continue to rise at a rapid rate.

<u>4.3 The Implications of a Status Quo Scenario</u>

If a cooperative peace process does not take place, the basic economic forces currently at work are likely to intensify in the transition phase and beyond. This will entail the following considerations:

(1) The fraction of territorial labor force working in Israel will grow to some 40 percent, increasing the integration of the Arab labor force with the Israeli economy. This may represent a potential long-run problem for Israel, but such long-run considerations are unlikely to play a role within the period under consideration.

(2) The economies of the territories will continue to evolve like regional economies within a larger integrated economy, concentrating on their industries of relative advantage and with a relatively slow rate of domestic investments.

(3) Although experiencing a slow rate of domestic investment, the GDP, GNP, and overall standard of living in the territories will

rise rapidly due to the large demand for territorial workers and exports in Israel and the significantly higher wage rates in Israel.

(4) The pattern of trade will continue to be based on intimate links between Israel and the territories; the territories being the second biggest partner of Israel and Israel being, by far, the largest partner of the territories. Exports of specialty agricultural products from the territories to Jordan and overseas will expand, but will maintain a stable relative position.

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