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## **Economic Co-operation as a Means of Maintaining Palestinian-Israeli Peace: A Conceptual Framework**

### **I. Introduction**

The post-World War II history has witnessed four full-scale, conventional wars between Arabs and Israelis (Müftüler and Sayan) none of them leading to an indisputable victory in the sense of enabling one of the parties to totally impose its will on the other. During the whole period, the major issues have remained unresolved despite substantial losses of human lives and economic welfare. While regional by nature, the conflicts in the Middle East have also been a cause for global concern not only because of the threat they presented to the oil fields in the region, but also because of the risk of escalation into a nuclear war during the Cold War era (1). In the aftermath of the Gulf Crisis which followed the end of Cold War, and with the support of the international community, the parties have come to realize that peace (talks) deserved a chance.

Having stalled for so long after 1978 Camp David Accords and signing of the peace treaty between Egypt and Israel in 1979, the Middle East peace process gained momentum after the Madrid Conference in October 1991. It is argued in the present paper that for the Middle East peace process not to lose this momentum and to make the achievements towards peace to date sustainable, economic cooperation in the region must be promoted to the greatest extent possible, and without wasting any time. The purpose of this paper is to develop a conceptual framework to justify the validity of this argument and to discuss the potential role that economic cooperation can play in helping the ongoing reconstruction and development effort in the region, especially in West Bank and Gaza.

The plan of the paper is as follows. The next section presents a brief survey of the literature on economics of peace. Section 3 looks at economic cooperation as a

means of maintaining peace. In Section 4, the role that the contributions by international community to the peace effort in West Bank and Gaza is discussed. Finally, Section 5 summarizes the conclusions.

## **2. Peace vs Animosity: Potential Benefits of Peace in the Literature**

The economics of peace can be studied within different analytical frameworks and using different tools. An economic historian, for example, can present historical evidence that economic cooperation following peace leads to increased prosperity for the nations. The best example in this context is provided by the cooperation between two of the World War II enemies, France and Germany, in founding the European Coal and Steel Community (ECSC) after the war. The ECSC laying the ground for the establishment of European Economic Community (EEC) that was later transformed into European Union, has contributed substantially to the well-being of former enemies through economic cooperation. Even without reference to economic history, establishment of peace between belligerent nations can be defended on economic grounds as an arrangement that would eventually lead to efficiency and welfare gains for the parties involved. To identify the sources of these gains, this section briefly surveys the literature viewing peace in the Middle East as such an arrangement.

Numerous studies in the literature on economics of peace in the Middle East have focused on these welfare and efficiency gains that would have accrued to nations under (counterfactual) peace scenarios. Based on comparisons of peace and animosity scenarios, these studies have attempted to measure these gains as resulting from reduced defense expenditures or from implementation of economic cooperation opportunities missed by hostile nations. A permanent cessation of hostilities has been shown to be likely to create various sources for welfare gains as compared to continuing animosity.

One such source is the ability to buy a higher level of national security at a lower cost.

Such a relaxation of the nations' "budget constraint" is just like an exogenous improvement in the economy's technology shifting the production possibilities frontier outward, and releasing the resources that can alternatively be used to increase not only present consumption but also the future consumption --had they (at least, partially) been used to increase the productive capacity of the economy through investment (Fischer, Rodrik and Tuma --for a discussion on this idea in the context of Middle East peace, see. El-Naggar and El-Erian). Given typically high shares of defense expenditures in national incomes of the Middle Eastern countries (2), the potential for benefits from reduced spending on national security is large and can be measured in reference to the increase in growth rates of nations that put an end to animosities between them.

A comparison of economic growth implications of animosity and peace scenarios (the latter characterized mainly by a reduction in defense expenditures) for the countries in the region can be found in Ben-Shahar. Bahiri presents the results from a similar exercise comparing the implications of a forced unity between West Bank and Gaza and Israel -- corresponding pretty much to the continuation of the pre-1993 situation-- to those of a peaceful separation as foreseen by the Declaration of Principles. A common feature of both studies is that the figures subject to comparison are for the base year and the terminal year which happened to be chosen as a decade from the base year (3). Even though income, and hence welfare gains reported can be considered large, both studies fail to give any information about the dynamic growth patterns during the decades under consideration. Any discussion on the predictive powers of the studies aside, this common lack of information about the growth patterns in time emerges as a serious flaw as explained in the next section.

Another source of benefits is the reduction in the investment risk brought about by peace with the declining likelihood of hostilities. As a result, an increase in both the domestic investment and foreign capital inflow may be expected (Fischer, Rodrik and Tuma; Clawson). Last but not least, peace makes economic cooperation possible among the previously belligerent nations. In the area of international trade, commodity flows will increase once boycotts and deliberate restriction practices have

fact, this is pretty much consistent with the conclusion reached by Ben-Shahar and by Bahiri in their independent works cited in the previous section (8).

Broadly the same idea, but this time not without reference to the growth patterns in time, can be observed in Figures 1 and 2 taken from Fishelson. Although not based on precise simulation exercises using actual data, the figures elegantly summarize the broad trends in which peace --with and without cooperation-- may increase economic well-being as measured by GNP per capita. Fishelson states that "the actual gradients differ for various countries, but the sense of the curves is identical for all. The differentials in slopes are largest for the confrontation states, but are positive for all." (p. 109). The distinction between the figures reflects that between the optimistic and realistic views as Fishelson calls them. Figure 1, corresponding to the optimistic view, foresees no time lag in adjusting the post-peace environment and hence the immediate large differential between the slopes corresponding to two peace scenarios and that corresponding to the "no peace" scenario. The realistic view by Fishelson is reflected in Figure 2 where the slopes do not differ much until after the post-peace adjustment period has passed, but the rate of growth of GNP per capita under "no peace" may exceed those under peace scenarios by then.

Since the figures are not drawn to scale, it is impossible to judge the length of this adjustment period (9). Drawing these figures to scale would have required a dynamic simulation exercise into the future, as in Ben-Shahar and in Bahiri where there unfortunately is no allowance for such an adjustment period --and no information about the growth patterns even without such an allowance. Then again, given the difficulty in predicting such growth patterns accurately --even without the problems concerning availability of reliable data for West Bank and Gaza-- Fishelson's approach is hard to blame. In fact, all three studies can be viewed as constructive efforts promoting peace over animosity from an economic perspective.

Now, a more fundamental question: could even the scenario called realistic by Fishelson be too optimistic? Anyone willing to play the Devil's Advocate can ask whether the growth rate under either peace scenario may turn negative (a possibility

come to an end. Free trade and voluntary customs union agreements will lead to mutual welfare benefits (4). Even when trade creating effects of peace are left out of consideration, there is a large potential for gains through trade diversion in the region (Raban) and trade creation is likely to follow a peaceful arrangement in the region (Kleiman). Economic cooperation in other areas than merchandise trade, such as tourism or water and infrastructure, has also been shown to imply potential gains (5).

### **3. Economic Cooperation as a Means of Maintaining Peace**

It must be recognized that, despite the existence of a vast literature in the area, economic rationalization of the advantages of peace is likely to have had little effect, if any, in convincing the national political leaders to take the steps they have recently taken towards establishment of peace in the Middle East. In other words, given the deep, historical roots of the conflicts in the region and their complex, international dimensions (6), other factors than a --perhaps, sudden-- realization of the benefits of economic cooperation seem to have played a more important role in convincing the national leadership of the nations actively involved in the Middle East peace process (7). With this recognition in mind, it becomes more appropriate to view economic cooperation as a means of maintaining the recent achievements towards peace, rather than as the motivation behind these achievements. This is precisely the reason why the promotion of economic cooperation in the region is needed as soon as and to the greatest extent possible.

#### **3.1. The Conceptual Framework**

The discussion in the preceding section indicated two possible sources for potential welfare gains other than the economic cooperation: The reduction in military spending giving rise to an expansion of production possibilities, and an expected rise in investment spending due to the reduction in associated risks. Within this framework, therefore, the political settlement of conflicts alone may lead to welfare gains, i.e., without the economic cooperation, through growth in national incomes. In

after May 18 when the transfer of authority was completed. Unfortunately, however, this new era of self-rule opened with a crisis in West Bank and Gaza.

The difficulties that started in the early 1980s deepened after 1987. Despite the recovery in 1992 induced by expectations of peace, 1993 was a year with severe recession (Diwan and Walton) (11). While a detailed discussion of the reasons behind the crisis is beyond the scope of this paper, the fundamental reason is worth noting: the loss of income from employment abroad after the Gulf crisis. There is consensus in the literature that these workers' remittances have been the major means of sustaining growth in the past (see, for example, Diwan and Walton; Nashashibi and Kanaan). Economic cooperation in other in such areas as tourism or water and infrastructure, or through international trade ("exporting goods rather than workers") can help create alternative domestic employment opportunities for the Palestinian workers displaced after the Gulf crisis but in the short run, alternative employment opportunities will be limited.

The left hand side of Figure 3 below gives some idea about the magnitude of the crisis in Gaza economy (12). Given that the curve for peace with economic cooperation may initially (i.e., during the adjustment period) turn downward even when the curve representing the trend without peace is upward sloping under what Fishelson calls the realistic scenario (Figure 2), the actual contraction trend observed after 1992 in Gaza economy may especially be alarming for it could imply a faster decline in per capita disposable income under peace with economic cooperation scenario. The right hand side of Figure 3 accounts for this possibility (13). Even though the economic cooperation after peace is bound to increase the rate of growth of disposable income eventually, this will take time. But the political support for the peace effort among Palestinians may wither away before the end of the adjustment period and undermine all achievements towards peace up to date. As stated in Ben-Shahar, Fishelson and Hirsch (p. 1), "War unites nations; peace, in contrast, is not a flag to which all rally in unison."

already allowed for the "peace and economic cooperation" scenario in Figure 2) with a higher slope (in absolute value) and for extended periods. As far as the situation in West Bank and Gaza is considered, this may be a serious possibility in the absence of immediate foreign aid that could jump start the economy that has been having difficulties since the early 1980s.

In addressing this issue with special reference to the situation in West Bank and Gaza, the curves in Figures 1 and 2 must be modified accordingly. This task is undertaken in the next sub-section by using per capita disposable income as the criterion for what Fishelson calls economic well-being. The reason for use of disposable income rather than GNP per capita in the figure is twofold. First, it is a direct determinant of consumption and hence, a better measure of welfare, and second, information about its pre-1993 trend is available.

### **3.2. Use of the Conceptual Framework as a Tool for Addressing the Situation in West Bank and Gaza**

Although the participants lacked any power to agree on or veto proposed solutions, Madrid Conference served its purpose by laying the ground and providing a framework for further talks. Within this framework, two separate channels were opened to carry out talks after the initial conference: The bilateral track and the multilateral track. As a result of peace talks conducted as part of the bilateral track for about two years, a joint Israeli-Palestinian Declaration of Principles (DOP) was signed in Washington, D.C. by the two parties on September 13, 1993 (10). The Interim Self-Government Arrangements in DOP allowed for an immediate self-rule in Jericho and Gaza Strip and started a process called early empowerment for Palestinians in the rest of West Bank. The arrangements have been agreed to lead to permanent status after five years (Israel Ministry of Foreign Affairs).

The Cairo Agreement signed on May 4, 1994 started the actual process for transfer of authority to Palestinians in Jericho and Gaza. The experience of Palestinians towards creation of their own state can therefore be taken to have actually begun

representatives from the rest of the international community, were meant to provide a forum for negotiations on the key issues of concern to the entire region: water, environment, arms control, refugees and cooperation for regional economic development (Israeli Ministry of Foreign Affairs).

Following the inclusion of multilateral track in the Madrid Framework, concrete steps towards development of solutions for problems in West Bank and Gaza were taken at the Donors' Conference that met in Washington, D.C. on October 1, 1993. By committing more than 2 billion dollars in the form of concessional loans/grants and loan guarantees over the interim period of self rule (Table 1), the conference participants reflected their belief that unless broad segments of the Palestinian population experience rapid social and economic improvement, the political support for the peace efforts may fade leading to incalculable consequences. In the conference, the donors also established an Ad Hoc Liaison Committee to help coordinate the assistance with the World Bank as the secretariat. Moreover, the World Bank was requested to provide a framework for effective use of the committed funds. After setting aside \$ 50 million from its profits into a special trust fund for Gaza to help finance priority rehabilitation projects, the World Bank also established a \$ 35 million trust fund for technical assistance in program and project preparation and institution building. After obtaining the approval and support of the donors in December 1993 Consultative Group meeting in Paris that followed the dispatching of World Bank missions to West Bank and Gaza in October and December 1993, the Emergency Assistance Program (EAP) was developed in collaboration with the Palestinian side (World Bank). The cost summary for the EAP is given in Table 2.



While this line of reasoning may appear extremely pessimistic, it points to a very serious possibility about which the international community is seriously concerned. Fortunately, this concern itself is what makes the future look not so bleak. This issue is discussed in the next section.

#### **4. International Support for Peace**

The PNA is now in charge of running all aspects of civilian life in Gaza and Jericho including domestic security and has to assume the responsibility of building the necessary institutions (14). While performing these duties, it must also take the economies of West Bank and Gaza out of the stagnation and lead the way to an autonomous growth path. The major challenge that the PNA now faces is the need to achieve all these goals without jeopardizing political stability since political unrest in West Bank and Gaza may destroy the peace efforts. Although it may not be the only one, a major precondition for political stability to be maintained is to take concrete steps towards alleviation of poverty and increasing per capita consumption as soon as possible. Once this is achieved, the remaining challenge is to make welfare gains sustainable. This section discusses the role of the support provided by international community to Palestinians in meeting these challenges.

However, slow it could be to reach the areas where it is most needed (15), the inflow of foreign aid could give the jump start for sustainable economic growth. The international community has already shown an awareness of the importance of the sustainable growth in maintenance of peace. Reflecting this awareness were the steps taken at the Madrid Conference. While the bilateral track channel opened at the conference aimed achievement of peace, the inclusion of the multilateral track alongside the bilateral track in the Madrid Framework can be viewed as a reflection of the recognition that, once established, sustainability of peace requires binding of nations through mutually beneficial economic relations. Multilateral track negotiations that opened in January 1992 in Moscow were designed to deal with those problems whose solution would, in a sense, shape the future of the region by helping make peace sustainable. The talks to be attended by regional delegations as well as

**Table 2: Emergency Assistance Program: Cost Summary**

million Dollars

| <b>Public Investments</b>           | <b>Y e a r s</b> |             |             | <b>A r e a</b> |             |              |
|-------------------------------------|------------------|-------------|-------------|----------------|-------------|--------------|
|                                     | <b>1994</b>      | <b>1995</b> | <b>1996</b> | <b>WB</b>      | <b>Gaza</b> | <b>Total</b> |
| Transportation                      | 19               | 28          | 26          | 27             | 46          | 73           |
| Water and wastewater                | 22               | 39          | 50          | 44             | 67          | 111          |
| Solid waste                         | 13               | 18          | 26          | 25             | 32          | 57           |
| Power                               | 33               | 38          | 37          | 32             | 76          | 108          |
| Municipalities                      | 17               | 31          | 36          | 32             | 52          | 84           |
| Housing                             | 10               | 10          | 10          | 25             | 5           | 30           |
| Telecommunications *                | 13               | 0           | 0           | 5              | 8           | 13           |
| Education                           | 27               | 25          | 28          | 35             | 45          | 80           |
| Health                              | 8                | 7           | 3           | 6              | 12          | 18           |
| Agriculture                         | 5                | 10          | 11          | 3              | 23          | 26           |
| <b>Subtotal</b>                     | <b>167</b>       | <b>206</b>  | <b>227</b>  | <b>234</b>     | <b>366</b>  | <b>600</b>   |
| <b>Private Sector Support</b>       |                  |             |             |                |             |              |
| Telecommunications                  | 15               | 35          | 50          | 50             | 50          | 100          |
| Housing                             | 10               | 25          | 45          | 30             | 50          | 80           |
| Agriculture                         | 1                | 7           | 12          | 5              | 15          | 20           |
| Industry                            | 24               | 33          | 43          | 40             | 60          | 100          |
| <b>Subtotal</b>                     | <b>50</b>        | <b>100</b>  | <b>150</b>  | <b>125</b>     | <b>175</b>  | <b>300</b>   |
| <b>Start-up expenditure support</b> |                  |             |             |                |             |              |
| Central adm. start-up               | 108              | 0           | 0           | 50             | 58          | 108          |
| Incremental support to NGO's        | 50               | 40          | 27          | 50             | 67          | 117          |
| <b>Subtotal</b>                     | <b>158</b>       | <b>40</b>   | <b>27</b>   | <b>100</b>     | <b>125</b>  | <b>225</b>   |
| <b>Technical assistance</b>         |                  |             |             |                |             |              |
| Inst. building and training         | 8                | 12          | 7           | 11             | 16          | 27           |
| Policy studies                      | 2                | 6           | 3           | 5              | 6           | 11           |
| Project prep. and implement.        | 7                | 12          | 11          | 14             | 15          | 29           |
| Feasibility studies                 | 1                | 3           | 4           | 3              | 5           | 8            |
| <b>Subtotal</b>                     | <b>18</b>        | <b>33</b>   | <b>25</b>   | <b>33</b>      | <b>42</b>   | <b>75</b>    |
| <b>Total</b>                        | <b>393</b>       | <b>379</b>  | <b>428</b>  | <b>492</b>     | <b>708</b>  | <b>1200</b>  |

Source: Garg and El-Khoury, p.8.

\* Most of the investment in the telecommunications is assumed to be coming from private sources.

The EAP will help relax the major constraints upon growth in West Bank and Gaza through institution building and improved infrastructure. By helping the Palestinians establish an administrative system of their own, EAP will save potential investors from

**Table 1: Foreign Aid Pledges for the Interim Period of Self Rule, 1994-98**  
(million Dollars)

|              | Grants/<br>Concessional<br>Loans | Loan<br>Guarantees | Total         |
|--------------|----------------------------------|--------------------|---------------|
| EU           | 300.0                            | 300.0              | 600.0         |
| US           | 375.0                            | 125.0              | 500.0         |
| Japan        | (*)                              | (*)                | 195.0         |
| Norway       | 150.0                            |                    | 150.0         |
| S. Arabia    | 100.0                            |                    | 100.0         |
| Italy        | 77.0                             |                    | 77.0          |
| Israel       | 25.0                             | 50.0               | 75.0          |
| Germany      | 61.5                             |                    | 61.5          |
| Turkey       | 2.0                              | 50.0               | 52.0          |
| World Bank   | 50.0                             |                    | 50.0          |
| Denmark      | 40.0                             |                    | 40.0          |
| Switzerland  | 40.0                             |                    | 40.0          |
| Sweden       | 32.5                             |                    | 32.5          |
| Arab Fund    | 30.0                             |                    | 30.0          |
| UAE          | 25.0                             |                    | 25.0          |
| Algeria      | 10.0                             |                    | 10.0          |
| Australia    | 10.0                             |                    | 10.0          |
| Spain        | 10.0                             |                    | 10.0          |
| UNDP         | 8.7                              |                    | 8.7           |
| Austria      | 7.0                              |                    | 7.0           |
| Canada       | 7.0                              |                    | 7.0           |
| Finland      | 6.0                              |                    | 6.0           |
| Indonesia    | 5.0                              |                    | 5.0           |
| Ireland      | 5.0                              |                    | 5.0           |
| UNWRA        | 2.0                              |                    | 2.0           |
| Iceland      | 1.3                              |                    | 1.3           |
| India        | 1.0                              |                    | 1.0           |
| <b>TOTAL</b> | <b>1381.0</b>                    | <b>525.0</b>       | <b>2101.6</b> |

(\*) For Japan, only the total contribution is noted, pending their decision on the mix of grants and loans. (Source: Blair 1994a, p.5)

Note: For information on the distribution of the funds committed by the EU, see, for example, EC, passim.

curves associated with peace scenarios in Figures 1 through 3 may not be observed immediately --justifying the identical vertical intercepts that Fishelson used. If this is indeed the case, then, the risks concerning political stability in West Bank and Gaza will be notably high and the future of peace in the area will be jeopardized as our discussion of Figure 3 indicated.

Two points can be raised to counter this argument. First, once started, infrastructure projects will immediately increase current public expenditures through payments at the implementation stage. The use of Palestinian inputs, including employment of local workers in construction, at this stage will increase local disposable income quickly. In fact, there is already an awareness concerning the need to maximize local inputs in the implementation of various projects under the EAP (Garg and El-Khoury). Secondly, the foreign aid to West Bank and Gaza also includes allowances for current expenditures especially in the area of institution building. Creation of the local police force, for example, has already started generating incomes for more than 5 thousand people. The first Palestinian budget prepared by PEC DAR puts 268 million dollars for recurrent expenditures including the salaries for more than 20 thousand civil servants (Blair 1994a).

So, contributions from the international community can be expected to immediately shift the schedules representing the growth paths for disposable income under both peace scenarios in Figure 3. This would also justify using a common vertical intercept for peace scenarios that is higher than the vertical intercept for the schedule for no peace scenario. Moreover, once the economy reaches an autonomous and sustainable growth path, the schedule for the peace scenario with economic cooperation can be expected to lie consistently above the schedule for the peace scenario without economic cooperation, which will itself lie above the path for no peace. The main message of this discussion is that foreign aid is extremely important in jump starting the economy especially in the case of West Bank and Gaza where the economy was in a downturn when the September 13 agreement was signed.

having to go through restrictive regulations that were in effect under Israeli rule and help increase capital investment (16). Also, the improvement of infrastructure will not only expand income generation capacity of the economy but also will better living conditions.

Since economic development has so far been constrained by, among other things, an under-provision of public goods including water, sanitation, roads and power supply (Diwan and Walton; Müftüler and Sayan), the international efforts are likely to make a substantial contribution to the sustainability of economic development. Other than these medium to long-run benefits, the increase in current spending for reconstruction will increase the disposable income and hence personal consumption in the short-run. In fact, the main objective of the EAP is given as "to provide tangible benefits to the Palestinian population quickly, equitably, and efficiently, while laying the foundation for sustainable development over the long term" (Garg and El-Khoury, p.7).

## **5. Conclusion**

In the light of the discussion in Section 4, foreign aid in general is expected to shift the curves for peace scenarios in Figures 2 and 3 upward. In fact, this is a possibility not allowed for by Fishelson in his figures reproduced as Figures 1 and 2 here: By assuming that the vertical intercepts for the curves of all three scenarios would be identical, Fishelson ignores the possibility of upward shifts in each of the curves representing peace (with or without economic cooperation) scenarios that will result from the inflow of foreign aid. This treatment may be defended on the following grounds. Since it takes time to complete infrastructure projects, the direct, expansionary impact of improvements in infrastructure on existing domestic production capacity can not be observed immediately.

While such improvements in infrastructure will also promote the creation of new capacity by private sector through physical investment, this is likely to take even longer for many sectors. This time dimension implies that the upward shifts in the

goods. Any costly self-sufficiency attempts to build relatively large power plants, for example, must be left out of consideration and opportunities for linking to the regional power grids must be searched instead. Whenever the scarcity of funds appears to prevent joint ventures in such areas as tourism, the build-operate and transfer scheme must be introduced as an alternative to finance capacity expansion. Although the Palestinian desire for autonomy and independence is understandable after so many years of suffering under Israeli occupation, this should not prevent the Palestinians from seeking economic cooperation because the way to real autonomy passes through cooperation.

## NOTES

- (1) In 1987, ex-soviet declared that it viewed the possession of an intermediate-range missile by Israel as a direct threat to itself and implied that the break up of a fifth Arab-Israeli war would immediately become a global confrontation. For more on this point and the implausibility of major political gains out of another military confrontation between Israel and Arab states, see. Ben-Shahar, Fishelson and Hirsch, Chapter 1.
- (2) In 1989, Turkey had the lowest of both the per capita (\$55) and the share in GNP (4.4 %) of military expenditures whereas Israel had the highest GNP share with 29.2 %, and Qatar had the highest military spending per capita with \$ 3.597. For the other countries in the region, GNP shares of military expenditures exceeding 9% were typical even before the Gulf Crisis (Fishelson). Since West Bank and Gaza have until recently been parts of a Greater Israel, it is impossible to speak of the share of defense expenditures in GNP for these areas. Nonetheless, the arguments about the ability to buy a higher level of national security at a lower cost under peace conditions would equally apply to these areas once the transition to statehood is completed.
- (3) Ben-Shahar takes 1982 and Bahiri uses 1985 as the base year. Terminal years used, therefore, are 1992 and 1995.

Before concluding the paper two warnings are in order. First, the lags between the time when funding commitments for various projects are made and the time these funds actually reach the region, has not been accounted for so far. When these lags are sufficiently long, the increase in disposable incomes may not be as quick and/or as large as required for political stability. So, utmost attention has to be paid to this issue in coordinating the distribution of aid. Secondly, it must be kept in mind that the main challenge before the PNA is to make the growth sustainable even after the flow of foreign aid comes to an end. In addition to the fixed duration of development aid that is already set at five years, i.e., during the interim period, budgetary assistance from abroad should not be relied on for extended periods. After the second year at the latest, such external support in the form of budgetary assistance is bound to decline as the need for support can only be justified on the grounds that the nature of initial period expenditures is exceptional.

A development strategy to sustain the growth without aid must therefore be developed. Given the size of domestic market, inward looking strategies based on import substitution and infant industry arguments are out of consideration. With the only option left, i.e., export-orientation, the short-run aim should be to diversify markets for exports in the region and in the rest of the world, to the extent access is possible to such markets. In the medium to long-run, increasing the volume of exports and a diversification of trade patterns are desirable. Since this would require an expansion of productive capacity, the priority areas for investment should be chosen in accordance with historical comparative advantages of Palestinians, with a view to reduce dependence of the economy on labor income from abroad through increased domestic employment in export sectors. In fact, given that production for domestic market is not so attractive to bring in capital from abroad (especially Palestinian capital), any capital inflow induced by reduced risk of investment can be expected to aim sectors producing exportables. So, such capital inflow must be encouraged as much as possible.

Like in the selection of trade strategy, self-sufficiency arguments must be left out of consideration whenever cooperation is possible for investment in provision of public

Ministry of Foreign Affairs). Not long after the first talks carried out in the bilateral track, two important milestones in the way toward peace were reached with the signing of the historical agreement between Israel and the Palestine Liberation Organization (PLO) on September 13, 1993, and of the recent peace treaty between Israel and Jordan.

- (11) It is interesting to note that even the expectations of peace could turn the business cycle up.
- (12) Since the West Bank economy was also in a downturn prior to 1993, the following discussion of Figure 3 can also be carried out also in reference to West Bank economy.
- (13) The scale of the horizontal axis in Figure 3 is not necessarily the same for the period after 1993 as the scale for pre-1993 period.
- (14) In preparation, the PNA established the Palestinian Economic Council for Reconstruction and Development (PECDAR) on October 31, 1993 for economic policy making and programming, management and administration as well as coordination of aid in the interim period.
- (15) About this point, see, for example, "Getting Nowhere " The Economist, August 13, 1994.
- (16) On Israeli practices of restricting investment in West Bank and Gaza, see, for example, Makhool and Abdel-Razeq.



- (4) For an analysis of the welfare costs of involuntary customs union forced by Israel, to the residents of West Bank and Gaza, see. Hammed and Shaban.
- (5) For a detailed analysis of the consequences of regional co-operation on a project basis, see. Ben-Shahar, Fishelson and Hirsch (passim). For more general discussions, see, for example, Clawson; Anani, or Ahiaron.
- (6) These international dimensions are discussed in the paper by Müftüçler presented at this conference.
- (7) As for as economists are concerned, this realization is not sudden at all. As the discussion in the rest of the paper will indicate, there is an abundant literature on economic implications of peace both in the bilateral sense between Palestinians and Israelis, and in the more comprehensive sense of peace among all countries involved in the Middle East conflict.
- (8) Bahiri, for example, states that "This second option {i.e., peaceful separation of West Bank and Gaza from Israel within the framework of an overall regional settlement} does not rule out a degree of mutually beneficial and agreed upon economic co-operation" implying that economic co-operation is not essential.
- (9) Fishelson estimates this as more than 3-4 years.
- (10) The bilateral track was meant to provide a channel for negotiations directed toward resolution of the historical problems between Israel and its neighbours. Immediately following the opening conference in Madrid, bilateral talks between Israel, on the one hand, and Syria, Lebanon, Jordan and the Palestinians on the other were held for the first time in history. The ultimate goal of these bilateral negotiations was signing of peace treaties between Israel and the Arab states, and achievement of peace between Palestinians and Israel after the completion of a transition period called Interim Self-Government Arrangements (Israel

El-Naggar, S. and M. El-Erian (1993). "The Economic Implications of a Comprehensive Peace in the Middle East," in Fischer, S., D. Rodrick and E. Tuma (eds.) *The Economics of Middle East Peace: Views from the Region*, Cambridge, MA: MIT Press.

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