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Economic Perspectives and the Peace Process

Adam Smith

Edinburgh Lectures

(around 1750)

Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.

Adam Smith

Glasgow lectures

(as reported by John Millar)

(1751-1763)

Upon this subject he followed the plan that seems to be suggested by Montesquieu; endeavouring to trace the gradual progress of jurisprudence, both public and private, from the rudest to the most refined ages, and to point out the effects of those arts which contribute to subsistence, and to the accumulation of property, in producing correspondent improvements or alterations in law and government. (...) In the last part of his lectures, he examined those political regulations which are founded, not upon the principle of *justice*, but that of *expediency*, and which are calculated to increase the riches, the power and the prosperity of a State.

Stewart D. (1795[1980]) *Account of the Life and Writings of Adam Smith*, LL. D. 1795 (Reprint in *The Glasgow Edition of the Works and Correspondence of A. Smith*, III, 1980).

A political environment of peace and freedom, transparent institutions that guarantee protection of private property, freedom of initiative and appropriate incentives to economic activity, and the absence of predatory behaviour by political elites, promote economic growth.

Along the path a country is following in economic development, institutional and political changes emerge according to the opportunities open to different social groups, to the legitimate interests economic actors may or may not voice in political society, to the control over resources by political elites and their power to rule by patronage.

Will economic growth in Gaza and/or the West Bank, if it indeed is going on or a take-off is to be expected as a result of appropriate policies, facilitate the peace process with Israel?

Will opportunities of economic welfare and success in business give political space to Palestinian elites choosing to invest for the future in peace and trade with Israel and other States of the region, more than in terrorism and rockets or the patronage by Syria and Iran to destroy Israel?

May economic opportunities opening in Gaza and/or the West Bank rise new hope among Palestinian youth for a life horizon based on expectations of achievement in work and professional success or business in a market economy, instead of martyrdom, militias or smuggling?

Along a path of economic development may political and economic elites emerge in Gaza and the West Bank who derive their resources from business activities in open, competitive markets instead of having their source of income in aid, political patronage by foreign States or illegal activities?

Let us look at these crucial questions from the perspective of a brief overview of the current economic situation in Israel, Gaza and the West Bank, on the base of available data.

Both Israel and the Palestinian territories (the geographical region at present under the rule of Palestinian authority that might become the new Palestinian State whatever the exact borders may be) are small regions in terms of economic activities.

They have low population (7.5 million in Israel, 2.4 million¹ in the West Bank and 1.4 million in Gaza), limited extension (Israel's area is lower than Toscana in Italy, West Bank's and Gaza's areas jointly cover an area somewhat larger than Liguria) and lack major natural resources (with the possible exception of gas in Israel).

To achieve economic success, both of them are condemned to be open economies relying on exports to finance their imports.

Their internal markets being of limited extension (the more so for the weaker economy because of the lower purchasing power), both of them have to be open economies integrated with trading partners to achieve the extension of the market that favours productivity gain.

Both economies have been exposed to the heavy costs of long-term conflict, though with different results and varying intensity in the years.

It is clear that no growth process might flourish in small areas secluded and isolated from the trade flows in the international economy.

The weaker economy (West Bank and Gaza) -still at a low level of per capita income and in need of a major take-off- should enter on a path of sustainable growth by expanding its export markets, acquiring specialization along a curve of learning by doing (the so called Kaldor-Verdoorn law).

Studying the outlook for economic development especially in Africa, the World Bank emphasizes the agglomeration economies - competitive advantages that arise because of favorable localization in regions at high density of economic activity.

In a context of free trade clusters of firms enjoy advantages because of their localization near other firms in differentiated economies, and easy contact with partners within a regional net of trade.

Gaza and the West Bank have no easy prospect for long-term economic growth if disconnected from their regional trade partners, *in primis* Israel, by far the largest and more advanced economy in the area, but also Jordan and Egypt.

To the meaning and implication of this easy forecast will shall come back soon.

Israel achieved a remarkable success in economic growth in the long term, and especially in the last 15 years, notwithstanding war, isolation from various countries in the area and repeated boycotts.

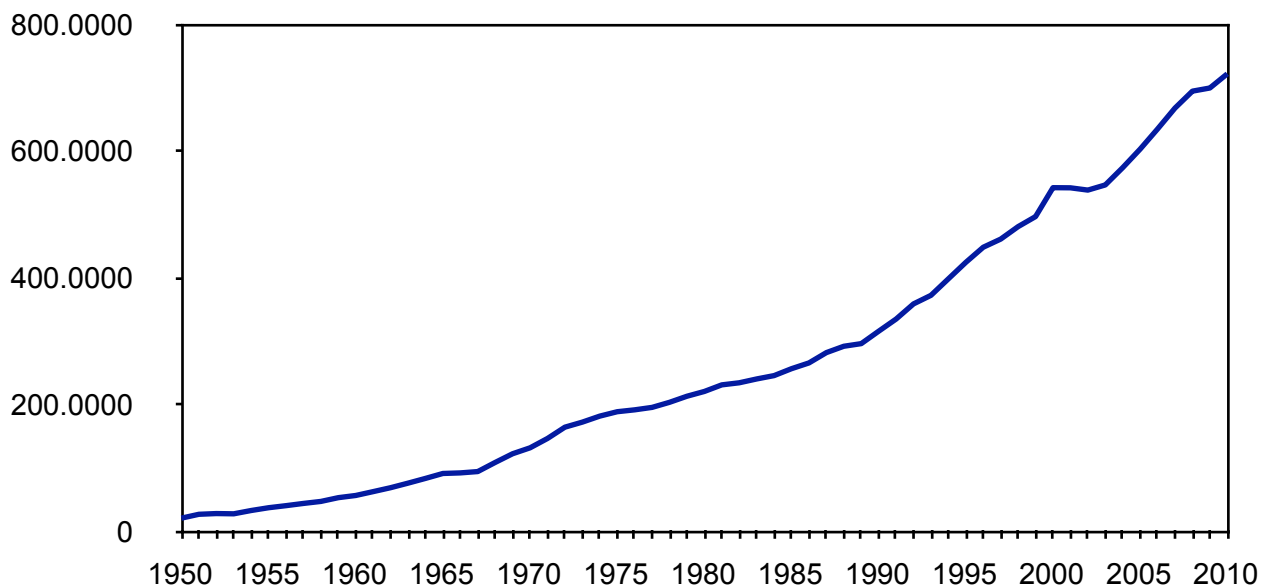
It is but a partial deviation from Smith's propositions.

Its almost extraordinary performance in conditions of long-term conflict with regional partners was achieved thanks to an extremely well succeeded institutional construction of the State and the building of a rich human capital that compensates for the lack of natural resources.

¹ This figure from Palestinian census in 2007 is somewhat controversial, since other sources give lower estimates of the West Bank population.

Chart 1

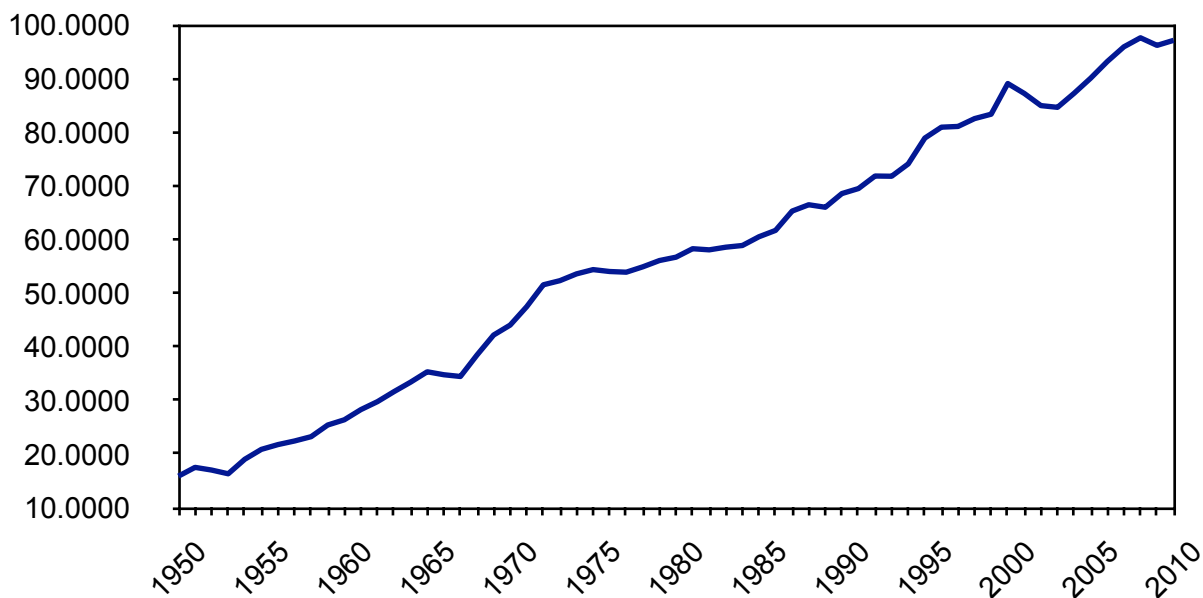
Israel: Real GDP (Billions of shekels, at 2005 prices)



Source: CSC calculations based on data from the Central Bureau of Statistics, Israel; IMF estimates for 2010.

Chart 2

Israel: Real Per Capita GDP (Thousands of shekels, at 2005 prices)

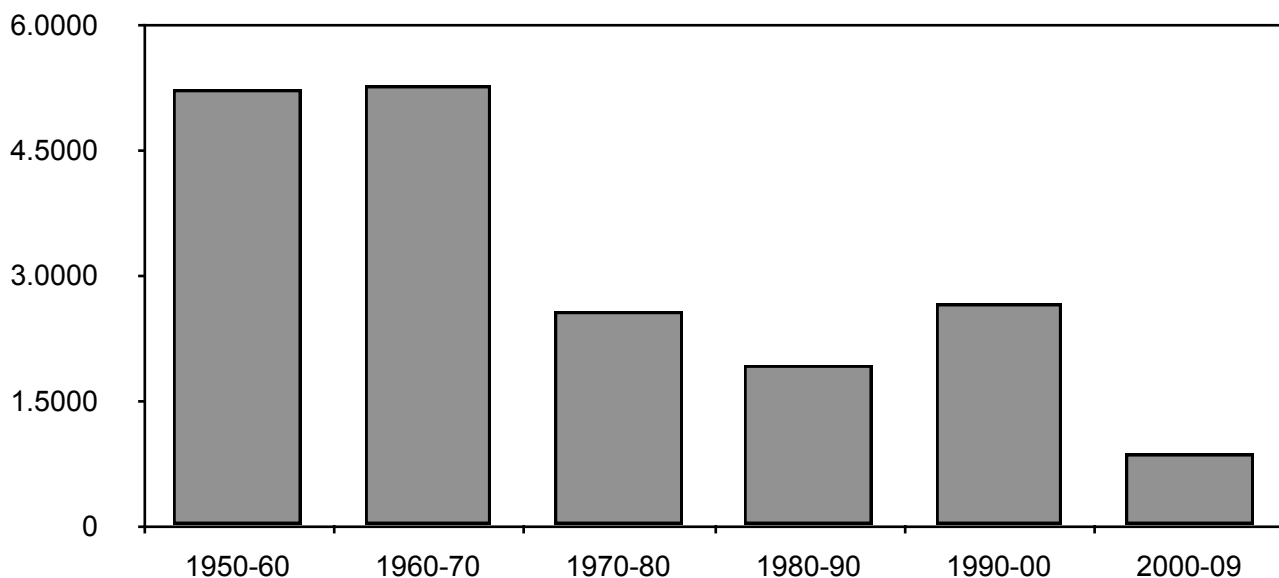


Source: CSC calculations based on data from the Central Bureau of Statistics, Israel; IMF estimates for 2010.

In 2009 the Israel real GDP per capita at PPP was comparable to the Italian one and to the Euro zone average (IMF data 2010).

Chart 3

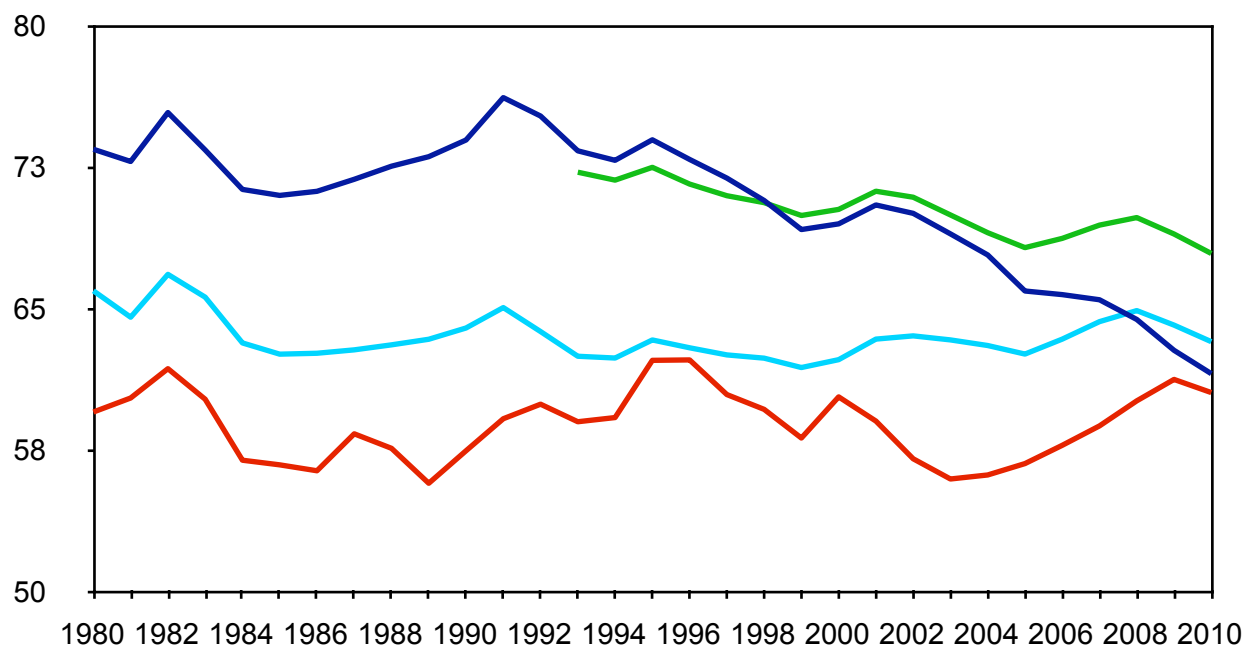
Israel: Average Per Capita GDP Growth Rates (In PPP \$)



Source: CSC calculations based on data from the Central Bureau of Statistics, Israel.

Chart 4

Per capita GDP (In PPP; United States = 100)



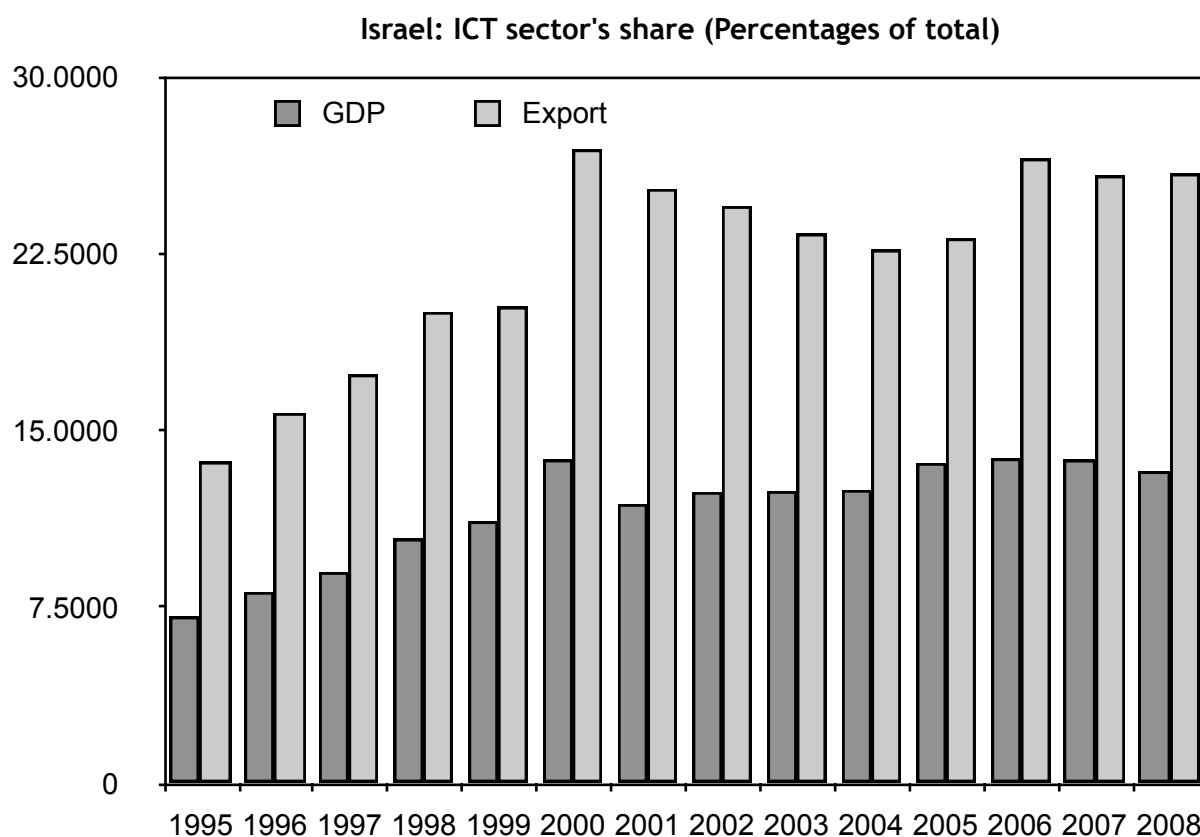
Source: CSC calculations based on IMF data.

— Italy — Israel — Euro Area — European Union

After the early quasi-socialist phase of the construction of the new State, the Israeli economy had a decisive turn towards an open market economy, dependent on exports as an engine for growth.

More recently Israel had extraordinary success in building appropriate institutions to achieve competitive advantage in advanced technologies, its social and institutional environment being favorable to start ups and open to foreign direct investment (Timpani, Mazzocchi eds. 2009).

Chart 5



Source: CSC calculations based on data from the Central Bureau of Statistics, Israel.

Human capital, education and training of the young generation, scientific research centers of high international standard and high public investment in research, lively democratic life, and even the style of governance in the army proved to be a favorable environment for the incubation of innovative starts up, with extraordinary success in international markets (Senor, Singer 2009).

The Israeli economy has been the incubator of major innovations that changed contemporary technologies in health care, telecommunication, nanotechnologies, biotechnologies, etc.

It has often been underlined that Israel is a unique example of a well-established and functioning democracy in the Middle East region. We all appreciate the immense value this has and how it should be protected by the menace of destruction.

Israel is also the most advanced economy in the region, offering to other regional partners a unique chance to enjoy easy access to innovation, education and infrastructure by cooperation and trade.

A strong economy at the center of an area of developing countries should be considered a major opportunity by its neighbors, if ideological preconceptions were set aside in favor of an enlightened vision of the future ahead, having in view gains of welfare for the civilian population at large.

In the perspective of peace, as Utopian as it may today appears, and welcoming the new Palestinian State as a Sovereign, independent political actor in the Middle East, there are plenty of benefits to be gained by regional partners in innovation and scientific cooperation, opening of markets, training specialized work-force and trading with Israel.

Let us hope that such a foresighted vision of the future will prevail; it requires -being clear- the full acceptance of Israel as a sovereign State in the area not to be reversed in the short or the long-term.

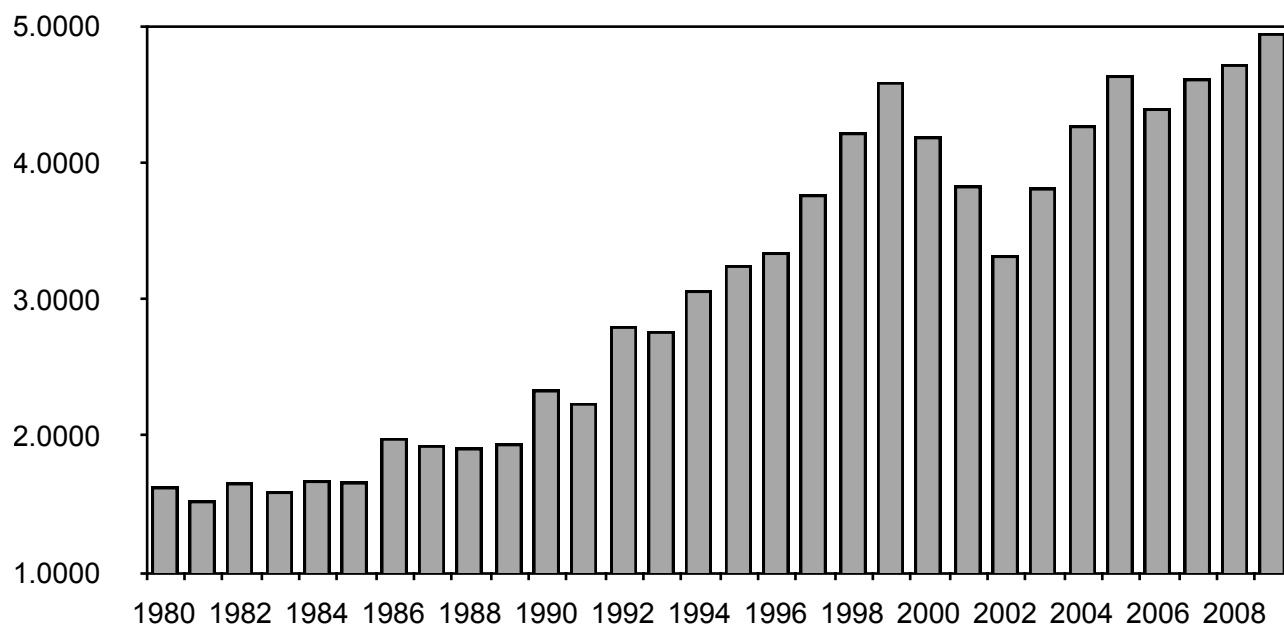
In the West Bank and Gaza, the overall performance in the last ten years has been bleak, but in

the West Bank important signs of recovery appeared in 2008 and especially in 2009.

Not so in Gaza, though weak signs of improvement appeared also there after the severe damage brought by the recent war.

Chart 6

Palestinian Authority: GDP (Billions of 2005 dollars)

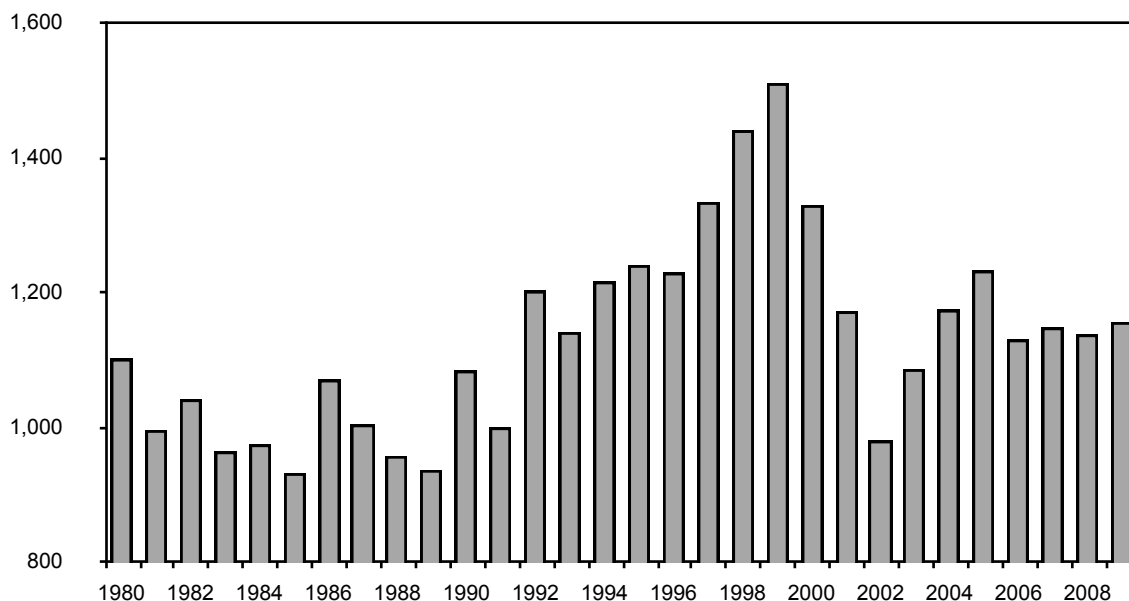


Source: CSC calculations based on Global Insight data.

In the West Bank and Gaza real per capita GDP was declining for a number of years; in 2008 it was estimated at around \$1,300 or lower; real GNI per capita at less than \$1,500, disposable income per capita at around \$2,200. In 2009 real per capita GDP is estimated at around \$1,400. It is up to \$1,800 according to some comparative estimates at PPP.

Chart 7

Palestinian Authority: per capita GDP (Real 2005 \$ per capita)



Source: CSC calculations based on Global Insight data.

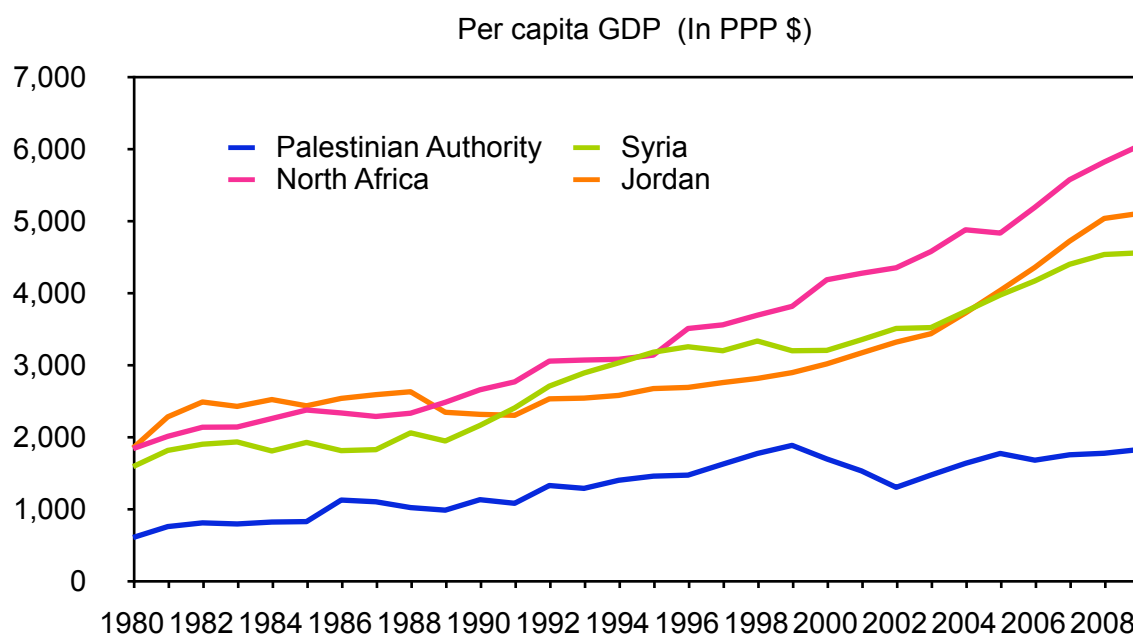
Table 1

	PER CAPITA GDP				
	(In PPP dollars)				
	1980	1990	2000	2005	2009
West Bank and Gaza	591,6	1116,8	1682,1	1758,6	1812,5
Syria	1576,0	2147,8	3189,6	3957,6	4543,4
Jordan	1834,3	2301,3	3002,2	4021,7	5090,4
North Africa	1825,8	2642,5	4169,9	4818,1	6029,0

Source: CSC calculations based on Global Insight data.

On the long-term horizon, since the launching of the second Intifada in 2000 the Palestinian economy paid a very high price to the political choice of pursuing a radical confrontation with Israel, breaking the peace agreements and pursuing a campaign of terrorist attacks.

Chart 8



Source: CSC calculations based on Global Insight data.

Employment (especially men employment) declined sharply since 1999 due to the loss of previous employment in the Israeli economy as a consequence of conflict (World Bank 2009: 32)

These poor results are most often imputed by international sources (e.g. the latest World Bank assessment, World Bank 2009) to the effect of Israel blockade.

In the vein of Smith's suggestions, it should carefully be evaluated how much they were due also to the lack of good governance and/or predatory policies by local elites in the areas under the control of the Palestinian authority, and especially so in Gaza after Israel's unilateral disengagement.

The Palestinian political groups, who fuelled the policy of public statements to destroy the State of Israel, who organized terrorist attacks and armed the conflict with Israel, are to be held responsible of pushing their country onto a path of economic decline with disastrous effects for the civilian population.

It is hard to see how under terrorist and military attacks, with declared aims of war and final destruction as those vociferously expressed by Hamas leaders, the archenemy -the Zionist entity

to be annihilated- might have opened the doors to promote free movement of people and free trade.

All over the world, trade cooperation, free movement of people across borders, easy passage of goods and facilitated procedures for import and export, are normally the result of agreements between countries that reciprocally recognize their respective rights and sovereign political institutions, and that have built friendly diplomatic relationships.

In the last two years the outlook in the West Bank and Gaza changed, with both increased opportunities and increasing risks, since the two regions, which compose the Palestinian territories, have shown divergent paths in the overall process of economic growth and political development.

In September 2009 the IMF estimated real GDP growth for year 2009 on average at 5.5% , with a remarkable divergence in the rates of growth between the West Bank and Gaza that the average result conceals (IMF 2009: 11). The same IMF report estimated the real GDP growth for 2009 at 7% in the West Bank, about 1%. in Gaza (IMF 2009: 11).

Table 2

Major Indicators in The Palestinian Territory at Constant Prices, in dollars

(Base 1997 for the period 2000-2003, base 2004 for the period 2004-2009)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP	4,119	3,765	3,264	3,750	4,198	4,560	4,322	4,554	4,821	5,147
Gross National Income	4,771	4,097	3,512	4,012	4,430	4,897	4,720	4,994	5,249	-
Gross Disposable Income	5,427	5,081	4,691	4,822	5,151	5,989	5,903	6,907	8,169	-
Gross Domestic Product (Per Capita)	1,428	1,270	1,070	1,195	1,317	1,387	1,275	1,303	1,340	1,390
Gross National Income (Per Capita)	1,655	1,381	1,151	1,279	1,390	1,490	1,393	1,429	1,459	-
Gross Disposable Income (Per Capita)	1,882	1,713	1,538	1,537	1,616	1,822	1,742	1,977	2,271	-

Excluding that part of Jerusalem which was annexed after the 1967 occupation by Israel.

Preliminary estimate for 2009.

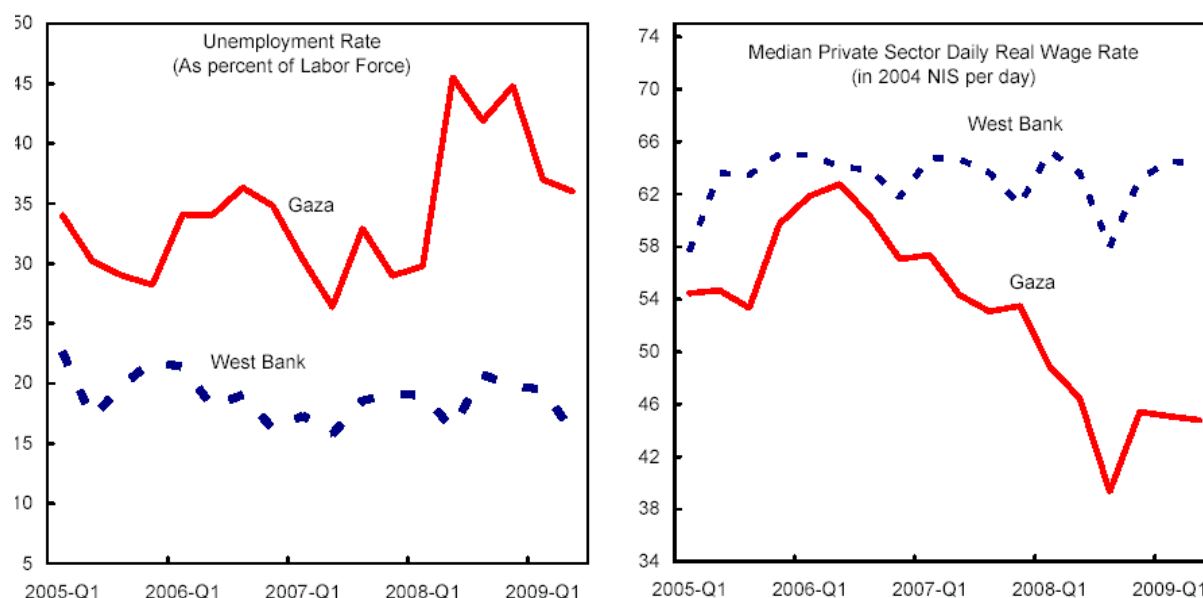
Source: Palestinian Central Bureau of Statistics .

Preliminary estimates for 2009 by the Palestinian Central Bureau of Statistics are more optimistic in terms of the average growth rate for 2009 (see table above).

Results in the two areas have been divergent also in terms of per capita GDP, rate of unemployment and rate of inflation.

Chart 9

West Bank and Gaza (Unemployment rates and Real Wages)



Source: IMF estimates.

In September 2009, the rate of growth of real per capita GDP was estimated at 4% in the West Bank by the IMF experts that defined this as the "first significant improvement in living standards since 2005." (IMF 2009: 11). Per capita GDP was still declining in Gaza, though less than in 2008.

The rate of unemployment, very high in both areas, was estimated at 18% in the West Bank versus 37% in Gaza (IMF 2009: 4). Divergence is remarkable in inflation rates; in 2008 the inflation rate was at 10% in Gaza, 4.5% in the West Bank (World Bank 2009: 9).

Since 2007 macroeconomic conditions showed remarkable improvement in the West Bank.

Better economic performance was achieved thanks to economic reform promoted by the Palestinian Authority, with improved economic governance, better security conditions for local civilian population, improved business confidence as a consequence, and last but not least, thanks to the climate of cooperation with Israel and the relaxation of Israeli restrictions on movement and access.

The remarkable result in 2009 has also been due to the disbursement of major aid inflows.

According to the World Bank evaluation, a higher rate of public investment and also private sector investment should sustain prospects for growth, jointly with some expansion of exports due to the relaxation of borders' restrictions by the Israeli government (World Bank 2009: 11).

New investment is going on or has been planned, such as a cinema and a shopping mall in Nablus, the project for an industrial zone in Bethlehem, a city project of 5000 housing units, the operation of the second Palestinian operator of cellular phones "Watania", some waste disposal sites and some waste treatment plants funded by foreign aid, construction of various schools, sanitation and road infrastructure, electricity infrastructure, greenhouses.

According to Palestinian sources foreign direct investment in the West Bank increased by 600% since 2008.

For the period from 2007 to early 2010 the government of Israel adopted a number of significant measures to promote economic development in the West Bank and help building security and improve public administration (Government of Israel 2010).

These include the reduction of key checkpoints from 41 to 14, the removal of roadblocks and other obstacles, the upgrading of the Gilboa-Jalameh crossing point in the northern part of the West Bank with a positive impact on the economy of Jenin, investment in upgrading of the commercial crossings, more permits of access to Palestinian traders.

In 2009 the number of Palestinian workers working in Israel or employed by Israeli employers increased by more than 5% (Government of Israel 2010).

Joint committees for economic cooperation between Israel and the Palestinian Authority have been established and are working on a more or less regular basis (Joint Economic Committee, Agricultural, Tourism, Transportation, Telecommunications, Health, Welfare, Water Committees).

On the contrary, in the absence of major political change the Gaza's economy runs the risk to become an economy based on smuggling, subsidized through covert flows of money by the Iranian republic oil rents and heavily dependent on international aid channeled in poorly transparent ways.

Satellite economies dependent on foreign rents or aid are exposed to severe political involution whenever the flows of foreign money are channeled through patronage relations or finance militias, supporting local clans and power groups that are not accountable to democratic constituencies.

The IMF estimated two scenarios of growth for the West Bank and Gaza in the years 2010 to 2012:

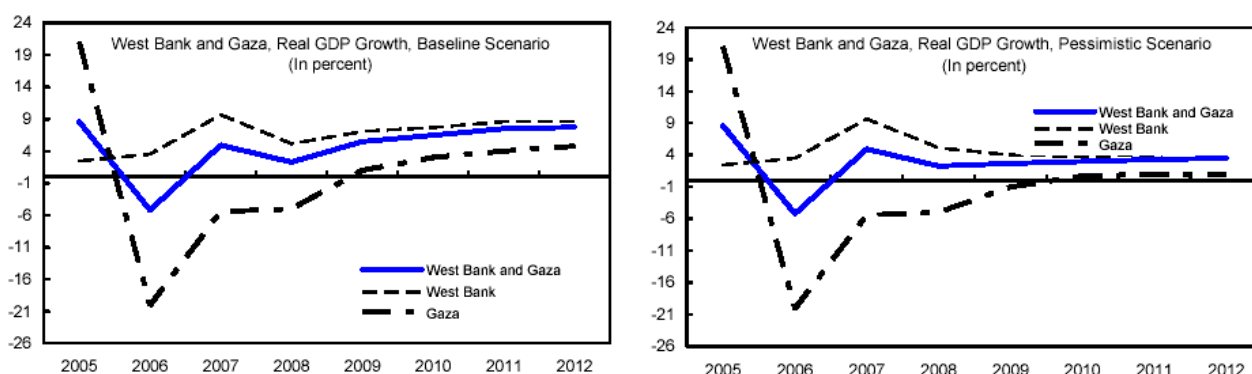
- ◆ a baseline scenario of positive rates of growth and some return even of the Gaza economy to positive growth, with a process of convergence, if the easing of restrictions is going on and the blockade on Gaza is somewhat relieved;
- ◆ a pessimistic scenario of low growth if the continuation of blockade persists and restrictions on movement and access are not further relieved.

These conjectural projections show how crucial the political scenario is to the continuation and further consolidation of the recovery in the Palestinian economy that has started in 2009.

Contrary to the exclusive focus often placed on the good or bad will of the Israeli government to easy access and movement in the Palestinian territories, the Palestinian actors in government as in civil society have today in their hands a major option to make between going ahead onto a path of growth and peace, or falling back onto the disastrous path of radical conflict and decline.

Chart 10

**West Bank and Gaza
(Alternative Scenarios)**



Source: IMF estimates.

This option will be crucial to the destiny of the Palestinian State and crucial questions relate Smith's proposition about peace, justice and easy taxes to the rise of a new Palestinian State.

May a Palestinian State, when it will be constituted, enter a long-term path of sustainable economic growth and increase of per capita income, if it will not enjoy an environment of peace in the region?

May it achieve sustainable development without peaceful relations with Israel, transparent institutions, protection of freedom and security, non-predatory behaviour by the ruling elites?

Would it be exposed to serious political instability in conditions of persistent conflict with Israel, extreme aid dependency, foreign patronage by Iran or Syria, lack of institutional transparency and political freedom?

In an environment of war, bad governance and insecurity, would the young State be exposed to soon become another among the collapsed States of the world?

“The Palestinian economy has been sustained by enormous infusion of foreign aid and the recent growth in the West Bank is the direct result of a large increase in such flows combined with increased security.” (World Bank 2009: 34).

Europe is pouring major aid flows into the Palestinian economy; but is aid always for the best? Which role might Europe’s aid play for stable and sustainable growth in the region?

Which forms of foreign aid are pro-growth? Which flows of foreign aid run the risk of fuelling vicious poverty traps by sustaining dangerous political elites?

There is large literature in development economics on the risks of aid dependency and the disruption induced by policies of unconditional aid flows on the quality of institutions in terms of increased corruption, domestic conflict, erosion of democracy or political instability.

Large aid inflows in percentage of GDP or the public budget may negatively affect the relationship between government and citizens.

When the financing of public policies does not depend on the contribution by citizens as taxpayers, the political elite in power is not accountable to its constituency. Large sums collected from foreign aid may be maneuvered to achieve consensus, gain political support, or invest in weapons.

Europe’s aid flows to the Palestinian authority should be planned and channeled on a new vision of what European aid policy should achieve for the peace process and the real welfare of the Palestinian population.

Through innovative policies, European aid should progressively be focused on productive investment and the rise of human capital and managerial capacities, having in view both the construction of essential infrastructure and the birth of competitive firms, to help the Palestinian economy build up new competitive opportunities in the region and in international trade.

Aid should be conditional on better transparency in the public budget and public governance along the road fruitfully opened by the Palestinian Authority in the West Bank, but also on the definitive abandonment of bigotry and propaganda to destroy the State of Israel in favor of a new climate of cultural and economic cooperation with the State of Israel, whichever the divergences may be.

The clear and outspoken acceptance of Israel as an established Jewish State in the area by both the Arab countries and the Palestinian political elites is at the core of all prospects for sustainable growth in the region, much as it is at the core of all sustainable road maps to build peace.

There are mutual benefits to be gained by both actors in the peace process. The Palestinian civilian population will surely gain large benefits improving its standard of life in an environment of peace, trade and economic cooperation with the State of Israel.

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