Palestine Economic Policy Research Institute

M A S

Palestinian-Israeli Foreign Trade: Reality and Future Prospects

By :

Mahmoud El-Jafari

August 2000

MAS

Palestine Economic Policy Research Institute

Palestinian-Israeli Foreign Trade: Reality and Future Prospects

By

Mahmoud El-Jafari

August 2000

The Palestine Economic Policy Research Institute (MAS) was founded in 1994 as an independent, non-profit institution to address the socio-economic policy making process through appropriate and relevant applied economic and social policy research.

MAS MISSIONS:

- ✧ Identifying developmental challenges and priorities and enhancing applied research.
- ✧ Promoting participation of civil society institutions in socio-economic policy formulation and decision-making.
- ✧ Providing technical support to PNA bodies to enable them to function more effectively.
- ✧ Broadening public debate on socio-economic issues and ensuring oversight of government performance.
- ✧ Disseminating information and enhancing transparency.
- ✧ Strengthening economic policy research capacity in Palestine.

P.O. Box 19111, Jerusalem and P.O. Box 2426, Ramallah
Tel: ++972-2-2987053/4, Fax: ++972-2-2987055,
e-mail: mas@planet.edu / Website: www.palecon.org

M A S

Palestine Economic Policy Research Institute

Palestinian-Israeli Foreign Trade: Reality and Future Prospects

By
Mahmoud El-Jafari

August 2000

Palestinian-Israeli Foreign Trade: Reality and Future Prospects

Prepared by: Mahmoud El-Jafari: Research Fellow, MAS and Professor of Economics, Al-Quds University.

Editorial Assistants: Sami Kilani (Arabic)
Layout Lina Abdallah

Palestine Economic Policy Research Institute (MAS)
Jerusalem and Ramallah
August, 2000

Publication Standards at the Palestine Economic Policy Research Institute-MAS

The Palestine Economic Policy Research Institute –MAS- engages in the publication of applied research papers and studies related to the Institute's program in the area of economics and social science and conducted by full or part time researchers.

The Institute abides by the following standards and procedures to ensure the high quality of its research publications:

1. The approved research project should be conducted or supervised by a specialist senior researcher. The research must not have been published previously or submitted for publication elsewhere.
2. The terms of reference of the study are approved by an internal MAS scientific committee (consisting of senior researchers) to ensure accurate goals, appropriate use of scientific methodology and procedures and the timetable for completion.
3. The internal scientific committee supervises the work of the researcher or team of researchers through periodic progress reports.
4. The initial draft of the study is reviewed by the scientific committee for objective content-related amendments to be added to the second draft.
5. The second draft is then submitted for evaluation in accordance with the terms of reference to two or three external academic experts specializing in the subject. Provided that there is a positive evaluation by at least two experts, the researcher is asked to review the study taking into consideration the objective recommendations of these experts.
6. The study is presented for discussion at a public workshop attended by academics, researchers, and representatives from public and private sector institutions related to the subject of the research.
7. Comments and feedback from the workshop are incorporated into the study and the final draft is reviewed by the scientific committee to ensure that the necessary amendments have been made. The study is then edited.
8. Research papers written in English are translated into Arabic and published in both languages. An executive summary in English is attached to research papers written in Arabic.
9. The author is not permitted to reproduce, in whole or in substantial

Abstract

This study concentrates on evaluating potential trade relations between the Palestinian territories of the West Bank and Gaza Strip (WBGS) and Israel during the period 1967-1998. It aims to forecast the future prospects for these relations by the end of the interim period.

An analysis of Palestinian-Israeli external trade data was used to determine the factors and policies governing the flow of goods and services between Palestine and Israel. A projection of possible options and alternatives for trade relations was also used, particularly relating to the end of the transitional stage which should differ in character from the interim period itself. The post-transitional period should take into account Palestinian economic interests and developmental aspirations that were neglected during the interim period.

To assess trade relations between the WBGS and Israel, the study employed quantitative analysis methods. Trade relations were characterized by specific features during the following different periods: 1968-1987, 1988-1994, and 1995-1998. Trade similarity coefficients were calculated over four areas: between Palestinian exports and Israeli imports; Palestinian imports and Israeli exports; Palestinian imports and Israeli imports; and between Palestinian exports and Israeli exports. They were also calculated at both macro and micro levels for ten types of goods between 1995-1998.

This study differs from others in that it has used trade similarity coefficients to determine the value of Palestinian imports of goods coming from Israel and manufactured by Israeli firms. That is, Israel produces and exports to both international and Palestinian markets. The study also determined the value of Palestinian imports from Israel (Israeli products) exported only to the Palestinian market rather than to the international market.

For the last three decades, Israel has developed production structures to meet local demand in both Israel itself and Palestinian markets, with Israel considering these markets as an extension of its own market. As a result, Israel has been able to increase the production efficiency of many of its industries directed towards meeting local demand. Moreover, Israel has created bases and production and economic plants that produce goods

uniquely to meet Palestinian local demand. It has provided direct and indirect support, leading to the growth and development of these industries. This has reflected negatively on the potential growth and development of sectors in the WBGS since they have been subjected to unequal competition from subsidized Israeli products, plus restrictive Israeli measures imposed on them.

Through the use of estimated trade similarity coefficients, the study was able to determine the actual relative importance of the Palestinian market to Israeli producers. It also determined the degree of flexibility available to the Palestinian economy to diversify Palestinian imports by replacing them with locally produced goods or by imports from countries enjoying a relatively higher competitive advantage in production and exports. The potential and cost of substitution is a very important factor in formulating policies and choosing appropriate alternatives. Trade similarity coefficients were also employed to determine the importance of the Palestinian market to Israel in terms of re-exportation. This is done by determining the volume of non-Israeli products imported to the Israeli market and then re-exported to the Palestinian market.

The results of the quantitative analysis are important in determining the financial leakage from customs duties and taxes imposed on Palestinian imports from or via Israel. This analysis will also help in understanding the nature of economic relations between Israel and Palestine and in identifying aspects of inequality and the extent of Israeli exploitation. This is essential in order to determine the requirements for reformulating Palestinian-Israeli trade and economic relations by the end of the interim period. Balanced relations that are more equitable to Palestinian interests need to be established.

Gravity trade equations were used to estimate the export supply and import demand for Palestinian goods and services. Empirical results were utilized to determine the factors influencing flows of these goods and services between Palestinian and Israeli markets during three periods: 1968-1987, 1988-1994, and 1995-1998.

The empirical results showed no structural changes in Palestinian foreign trade (services and goods) during the three periods in question. This means that Israeli trade policies have remained unchanged towards Palestinian markets in spite of the changes in the political environment governing Palestinian-Israeli relations. The forces of supply and demand and overall economic changes in Israel govern the flow of goods and services to and from Palestinian markets. The statistical results revealed a number of findings that require analysis prior to formulating recommendations for future economic and trade relations between Palestine and Israel in the final status negotiations.

Findings

Based on the empirical results, the study has concluded the following findings summarized below:

1. Israeli economic and trade policies towards the WBGS since 1967 have totally favored the Israeli market. The import-consumption ratio has increased while the ratio of exports to GDP has decreased. In addition, the flexibility of imports has decreased as opposed to a decrease in the degree of flexibility of priced imports. This has made Palestinian goods for export highly sensitive to price changes in the Israeli market rather than to price changes in the local WBGS markets.

2. Economic and trade relations between the WBGS and Israel were, and still are, interrelated and interdependent owing to the large volume of trade and the size of financial flows between them. The volume and influence of foreign-trade multipliers on Palestinian-Israeli mutual trade (goods and services) is evidence of this.

3. Any form of Palestinian-Israeli trade and economic relations that depends on market mechanisms to regulate the flow of trade between the two sides will lead to the maintenance and deepening of the existing Palestinian economic and trade status that is a legacy of the occupation period. The 1995-1998 data attest to this unfavorable situation. Palestinian-Israeli foreign trade developed during the interim period was affected more dramatically due to the financial resources available for this growth.

4. Any arrangements for economic and trade relations between Palestine and Israel in the foreseeable future must correct structural imbalances by diversifying components and courses of mutual trade in the interests of both parties. The data of the Intifada years, namely 1989, 1988, 1990, are cases in point. External trade data indicate a change in the volume of trade and financial exports between Palestine and Israel which surpassed the GDP of the WBGS. This change was the

result of the implementation of policies that influenced the market mechanism in the trade and labor sectors.

Moreover, Palestinian exports to Israel are still very limited in terms of volume and variety compared with those imported from Israel. As a result, Palestinian trade of goods and services has been directed towards Israel only and this has reflected negatively on the performance of the Palestinian economy. The proportion of trade deficit to GDP was very high between 1995-1998 compared to previous periods and compared to Israel, Jordan and Egypt.

5. As regards the type of economic and trade relations to be created between the WBGS and Israel, such as a free trade area or a customs union, there are several adverse considerations to be borne in mind. These scenarios could have serious repercussions on Palestinian development strategies and goods as they are unable to correct existing imbalances or to restructure the Palestinian economy. Appropriate measures should be applied to create an environment conducive to promote and reinforce the process of Palestinian economic development. The results of the study showed that the scenarios of a free trade area and customs union would not, under the current circumstances, contribute to the correction of the structural imbalance in the Palestinian economy. On the contrary, these scenarios, if they materialize, will only deepen the imbalances. Nevertheless, these scenarios should not be ruled out as possibilities in the long-term future after the structural reform of the Palestinian economy has been completed.

6. Any future economic and trade arrangements with Israel must strengthen Palestinian economic ability to integrate the West Bank and the Gaza Strip. The existing state of separation and the disparities between their economies remain one of the major challenges facing the Palestinian economy.

This study therefore concludes that a new form of Palestinian-Israeli trade and economic relations is needed which should truly embody the principle of the geographical unity of the West Bank and Gaza Strip. There is also an urgent need to combat the underdevelopment and isolation of the Palestinian economy in order to allow it to integrate in regional and international economies.

7. Attention must be drawn to the conditions required for the

formulation of trade and economic arrangements between transitional economies, on one hand, and stable economies on the other. Lack of coordination in the field of financial policies (customs duties and taxes) and monetary policies (interest and exchange rates) impede the opportunities for successful economic cooperation between stable and emerging economies. In the Palestinian case, the potential for Israeli policy to be imposed on the Palestinians is very likely in the framework of a free trade area or a customs union due to the tremendous imbalances in economic and political power. This would prevent the Palestinians from having the leeway to adopt development policies.

The scenarios put forward to establish economic and trade relations between Israel and Palestine mainly focus on linking the significant customs revenues and the value added tax pertaining to general revenues to finance the Palestinian Treasury. The percentage of customs revenues generated from external trade with Israel amounted to more than 50% of total Palestinian general revenues. This means that an increase in the volume of foreign trade with Israel would lead to an increase in revenues. However, in return, it will deepen the balance of trade deficit and lead to a continuous increase in the budget deficit.

Evaluation of Trade Options

The options currently under discussion concerning future trade and economic relations between Palestine and Israel have been evaluated on the basis of the statistical results derived from the estimated gravity equations and trade similarity coefficients.

This was conducted in line with a vision that takes into consideration Palestinian interests in both the long and short term. The free trade area option called for by some Palestinians faces a number of structural problems and shortcomings. If the aim of this option were to check on financial leakage from taxes and duties imposed on Palestinian imports from or via Israel, then this option would be of limited value. In spite of some possible financial gains, this option would lead to the loss of sustainable development opportunities. It would also lead to a unilateral customs union that deepens the status quo via contractual agreements that would constrain the Palestinians at a time when current regional trade developments are heading dramatically towards free trade.

The other option is that of a customs union, advocated by the Israelis in return for guaranteed material gains for the Palestinians. This option would deepen the phenomenon of polarization. It would also deprive the Palestinian economy of any future opportunity to benefit from spread effects with their potential positive effects on Palestinian economic structure and sectors, such as the free movement of goods, services, and labor. The customs union would place restrictions on this movement according to the circumstances of demand and supply and the level and direction of overall economic variables in Israel.

For more than three decades, Israel has managed to forge economic and trade relations with the WBGS. However, these relations have become interrelated and amalgamated with time, as evidenced in the volume of mutual foreign-trade multipliers in the movement of goods, services and other financial flows between the WBGS and Israel and their influence on variables of GNP, GDP, consumption, and rates of employment. The impact of closures and blockades during 1994-1997 and the effect of the open door policy in 1998 and 1999, reflect the performance of these variables and the extent of the Palestinian economy's dependence on that of Israel.

The option of economic separation currently under discussion would be unrealistic and costly for both sides. It is not, therefore, in the interests of either party. Available data show that Israel uses this option as a threat to put pressure on the Palestinians. While it is true that it would be more detrimental to the Palestinians due to their high level of dependence on Israel, it would also be very costly and thus undesirable for the Israelis.

Recommendations

Based on the findings of this study, a fourth option is put forward for the formulation of Palestinian-Israeli trade relationships. This option paves the way for the establishment of a new type of relationship to respond to a settlement of the Israeli-Palestinian conflict. The option is based on cooperation and takes into consideration the mutual interests of both sides. It would be achieved gradually and in an accumulative manner according to a timetable of up to ten years. The results of this option should be defined and understood in advance.

In other words, it is possible to change the volume of mutual foreign-trade multipliers as well as their components and effects. This can be done through the substitution of polarization effects for spread effects to create reciprocal relations aimed at building desirable economic structures that depend on specialization.

It is possible to draw lessons from similar cases in relations between countries that have won independence from colonial powers. These countries have witnessed fruitful cooperation in lieu of conflict. The essence of these arrangements can be summarized in the following:

1. Decrease the dependence on Israel of the surplus Palestinian labor force by increasing the employment capacity of the WBGS.

2. This action must be phased with the replacement of current labor exports by labor-intensive products for export.

3. In order to implement the above, there are a number of reciprocal measures which can be implemented to create more balanced economic relations. The Israelis need to be convinced of the vital role of the economy in reinforcing and guaranteeing peace and stability. In this respect, it is possible to learn from the ties between ASEAN countries with Japan. The latter has transferred a number of labor-intensive industries to neighboring countries such as Malaysia, Taiwan, and South Korea to benefit from the large volume of labor and develop a combined import substitution and export promotion strategy.

4. Strengthen Palestinian specialization in a number of industries whose prospects to achieve competitive advantage are promising. This study outlines these industries in more than 20 tables. Israel may abandon all or some of them in favor of the Palestinian economy. These industries include foodstuffs, livestock, beverages, tobacco, oils and animal fat and some manufactured goods and fuels. Palestinian imports of these goods surpass Israeli exports. The percentage of Palestinian imports of these products is only 20% of Israeli GDP from them. Real Palestinian imports of these Israeli products represent some 50% of the value of Israeli goods flowing to the Palestinian market. The maximum volume of these imported goods from Israel is 12% of the volume of real imports from Israel. Therefore, investment in these sectors would lead to an increase in Palestinian GDP by 15%. Moreover, this would lead to an increase in the volume of goods exported by Palestinian firms by 14%. The increase in potential job opportunities might reach 10%.

5. The final results of the restructuring of the Palestinian economy would lead to the restoration of more than 25% of Palestinian GDP from the Israeli economy, particularly in the field of manufacturing products (agricultural and industrial). With the passing of time, its effect on the variables of macro economy would double, particularly in exports, labor imports and consumption. In the light of these results, trade relations between the WBGS and Israel could move from being a unilateral customs union entirely in Israeli interests, to more balanced relations based on a mixture of an equal customs union, a free trade area, and any other options.