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TRADE POTENTIAL BETWEEN ISRAEL AND THE ARAB COUNTRIES

by Dan Kaufman and Tal Harel

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FIRST DRAFT

A. GENERAL BACKGROUND

1. Introduction

The Middle East has recently undergone major political changes, not least of which is the commencement of the peace process between Israel and its Arab neighbors.

On September 1993, Israel and the PLO declared mutual recognition and a peace agreement was later signed in oslo. In the spring of 1994 an agreement was reached, at the Paris meeting, the two bodies agreed to form a customs union.

At the beginning of October both Morocco and Tunisia informed on the forming of low level diplomatic ties with Israel (establishing mutual liaisons offices). At the same time, the Gulf countries announced they were ending the secondary Arab boycott against Israel, which forbade any country doing business with Arab countries to do business with Israel. At the same day it was announced that an Israeli delegation has arrived, for the first time, in Kuwait.

At the Casablanca convention, which took place at the beginning of November, Oman, Bahrain and Qatar announced they were establishing low level diplomatic ties with Israel. Morocco and Tunisia informed that they will most probably will establish full diplomatic ties with Israel by the end of the year.

This process opens up many opportunities, as well as raises important questions, one of which is its economic implications.

Benefits for Israel arising from the peace process are threefold: Establishment of economic ties and trade between Israel and the Arab countries; Reduction in defense spending; Opening up of new economic opportunities resulting from the end\termination of the lifting of the Arab boycott. Reduction in the defence spending and the establishment of new trade relationships will, of course, benefit also the Arab-countries.

In this chapter we will attempt to analyze the economic potential of the establishment of trade relations between Israel and the Arab countries.

Our task is a difficult one, because there is no historical framework on which to rely: Israel does not, and has not had in the past formal economic ties with an Arab country, with the sole exception of Egypt. Although Israel has had economic ties with the Judea, Samaria and Gaze regions (JSG) dating from 1969, this cannot (for reasons which will be discussed below) be strictly described as international trade. We will therefore have to rely almost solely on the Egyptian trade experience (which is problematic in itself) and on several assessments based on economic theories and

studies done on the subject in the past.

On the other hand, the swirling pace in which economic relations are being established these days between Israel and some of the Arab countries (which have forced us to go back and update this chapter, sometimes on a weekly basis) gives us the rare opportunity to first, view and analyze the construction of a trade pattern, which usually takes many years to form, and second, allow us to actually test and therefore improve previous assessments of trade potential between Israel and the Arab countries, within the framework of this chapter.

Of course, analysis of trade potential between previously hostile countries must first take into consideration the lasting effect of the remnants of hostility (as can be seen in the Egyptian example) and the cultural differences existing between Israel and the Arab world. However, in the short time that has passed since the signing of the Oslo agreement we have learned that these differences are not as great as was previously assumed, and also that there is a great divergence in this respect between the Arab countries themselves.

It is also important to note that although no formal trade relations exist today between Israel and the Arab countries (excluding Egypt), economic ties do exist, mainly through JSG, whose economy has been closely tied to the Israeli economy since 1968.

These economic ties are expressed primarily through fluctuations in the Israeli economy as a result of economic and political changes in the Arab countries - and vice versa. An example of this are the fluctuations in labor supply from JSG to Israel, which occurred as a result of economic changes in the Gulf countries (such as the reduction in world oil prices in 1981 and 1985, which reduced demand for Palestinian labor, thus increasing labor supply in Israel), Iraq and Jordan.

Our analysis will proceed as follows:

1. A review of the basic economic structure of Israel, as well as its trade performance.
2. A review of the economic characteristics and trade performance of the Arab countries. within this section we will differentiate between three groups of countries:
    A. the JSG area which already has extensive economic relations with Israel.

    B. the Arab countries which are in geographical proximity to Israel: analysis of trade relations with Egypt and trade potential with Jordan.

    C. the Gulf states, which include Saudi-Arabia, the Arab Emirates, Qatar, Oman, Bahrain and Kuwait.

3. Possible terms of trade and their economic implications, including customs agreements, free trade zones, preferential trade agreements with some of the Arab countries. This last category relates mainly to the Judea, Samaria and Gaze regions (JSG), which will be assigned a special discussion within the framework of this chapter, because of its special economic ties with Israel.

2. Analysis of the Economy of Israel

Israel is a country poor in natural resources (including land and water), and both local and foreign business investment are low. Because of these conditions, Israel has a comparative disadvantages in sectors which require natural resources, economies of scale, cheap labor, and extensive foreign investment.

On the other hand, Israel is endowed with highly skilled human resources. In addition, it has a good science base and has developed skills in defense production.

Table 1: Main Indicators-1991 (in U.S. dollars)

GDP (Billion)	60.800	Total Imp.(Billion)	16.8
Income (per capita)	12.425	Total Exp.(Billion)	11.9
Population(Mill.)	4.95	Balance of payments	-5257

Source: World Tables 1993

As shown in Table 1, Israel had in 1991 GDP of over 60 billion dollars and income per capita above $ 12,000. In 1993 GDP reached 66 billion dollars and income per capita stood at 12,500 dollars. In 1995 it is estimated that GDP will reach between 80 and 85 billion dollars and income per capita will stand at about 14,000 dollars. This estimate was made according to the current rate of economic growth, which stood between 1990 and 1993 at 5.5% per annum. In 1994 growth is expected to exceed 6% and in 1995 it will drop to around 5%.

From analyzing existing production and export components (in 1993) we can detect the following pattern:

The industrial sector makes up 32% of local production, trade and services makes up 33%, transportation and communications account for 15% and agriculture accounts for 5% of production. This, along with income per capita, puts the Israeli economy in line with the economies of the advanced industrial countries.

However, there are two major differences. One is the service sector, which is still proportionately smaller than the G7 average. The second is the size of the public sector, which makes up almost 20% of local demand.

In the main sectors which comprise the industrial sector are machinery and electronics (33%), chemicals and plastics (16.4%), food and beverages (17.6%), light industries (11.5%), textiles (8.7%), diamonds (net. 6.7%), and extractive industries and minerals (6.1%).

The industrial exports (excluding diamonds) are machinery and electronics (50%), chemicals and plastics (24%), light industries (10%), textiles (9.2%), food and beverages (5.3%) and minerals (3%).

From this data a few facts can be discerned. First, Israel specializes in producing goods with relatively high added value and this specialization is magnified the export pattern. This can be seen both by relative weight of the sectors which made up local production and exports, and also by the export destination, which is detailed below. The U.S and the European Union together account for 65% of Israel's exports.

A closer look at the products which make up the exports from Israel show, that these are mainly intermediary products for advanced high-tech industries: goods which embody a high level of research and development, and are targeted mainly at specific niches.

This pattern is not incidental. It allows exploitation of the local human resources and production capabilities, while overcoming the lack of natural and capital resources.

Producers of final products (clothing, medical equipment, plastics, flowers) have also specialized in specific niches targeted at developed countries. Here, too, such specialization enables these industries to exploit the well developed science base while overcoming the lack of investments and opportunities of mass production.

However, the relatively great geographical distance of Israel from countries with which it has had historical trade relations has led Israel to develop industries aimed specifically at the local market, which are not internationally competitive. These products usually embody high transportation costs and include food and beverages, plastics, home electrical appliances (air conditions, refrigerators, etc.), construction, etc.

However the major sector which has developed as a result of political historical, and not economic, reasons is the agriculture sector, which today makes up around 5% of GDP.

2.1 Trade Performance:

The total export of Israel in 1993 was $ 14 billion (U.S) while total import was $ 20.5 billion. Distribution by sectors is presented in Table 2.

Table 2: Import and Export by Economic Use

	Import	Export
Food, Beverages, Tobacco	6	7
Fuel, Fuel Products	8	0.5
Crude Materials	3	3
Chemicals	10	14
Manufactured Goods	32	36
Machinery, Transport	32	27
Miscellaneous	9	12.5
Total	100	100

Source: Statistical Abstract of Israel 1993

The distribution of export and import by destination is presented in Table 3.

Table 3: Import and Export by Destination

	Import	Export
European Communities	50	34.5
EFTA	9.5	3.1
Other European	1.5	2.8
Asia	9.4	15.6
Africa	1.7	1.7
U.S.A	17.2	30.5
America (excl. U.S)	1.7	3
Other	9	8.8
Total	100	100

Source: Statistical Abstract of Israel 1993

Most of Israel's export activities are manufactured export, machinery and chemicals from the Dead Sea. Its main export markets are the E.C., and the U.S.A. A more specific examination of the export data reveal that most of Israel's export are industrial export (92%). Of these 18% are electrical and electronics, 26% are processed diamonds, 12% phosphates (which is practically the only abundant natural resource) and other chemical products. The rest lays in plastics, metal products, agriculture (4%), textile, machinery and others. It is important to notice that 25% of Israel's exports are defence products (military electronics, weapons, air-crafts).

3. The Economy of the Arab Countries

In this chapter we will refer to some representative countries of each of the categories defined in p. 2. Table 3 displays the major economic indicators of these countries.

Table 4: Main Economic Indicators- 1991 (Millions U.S. Dollars)

Country	GNP p.c. (dollars)	Income p.c.	Imports	Exports	Population (millions)
Egypt	610	680	7683	3887	54
Jordan	1060	1840	2507	879	4
Syria	1160		3002	5594	12.5
Saudi-Arabia	7820		25540	54736	15
Gulf[1]	10300		15035	16266	3.6
Morocco	1030	830	6827	4278	26
Tunisia	1500	1360	5179	3709	8
JSG	1600	1772	1051[2]	385[2]	1.8
Total	25080		66824	89734	124.9

Source: World Tables and Statistical abstract of Israel

[1]. Bahrain, Kuwait, Oman, Qatar

[2]. Data is for 1987.

GNP in the Arab countries is derived mainly from industry and services (76%), and from agriculture (15%). The recent years have seen considerable growth in the services sector and a decline in the industrial sector. The highest added value is on average derived from the food, drinks and tobacco sector.

3.1 Trade performance:

If we look at total imports and exports of the Arab countries we see that the Gulf countries export about 48% of the total products of all the Arab countries, and import 35%, although the Gulf countries themselves account for only 10% of the total population. 60% of total export is accounted for by oil. Without the Gulf countries, oil export falls to 18% of total export, with textile becoming the main export at 23% of the total, and chemicals a close third at 14%.

The inter-trade between the Arab countries and themselves is presented in table 5.

Table 5: The Weight of Trade (as percentages of total).

Import from/ export to	Middle-east	All Arab Countries	All world
Middle-east	7.9	7.8	5.3
All Arab Countries	8.6	8.6	6.3

Source: E. Kleiman 1992.

From Table 5 it may be seen that Middle-East Arab countries import to each other only 7.9% of their total imports. All Arab countries import only 8.6% of their all imports from other Arab countries. At the same time, Middle-East and All Arab countries supply 5.3% and 6.3% of all the world imports, respectively. This means that Middle-East countries and All Arab countries tend to import from one another only about 50% more then their weight in the world total trade. This is relatively low ratio which emphasizes that Arab countries have a relatively low tendency to trade between themselves. This low tendency may stem from two reasons: wrong government trade policy, or similarity between these markets. Attempts have been made to correct wrong government trade policy by various trade agreements councils: The GCC- Gulf Cooperation Council; The ACC- Arab Cooperation Council; The AMU- Arab Mugreb Union. However such agreements did not make any major change and with the AMU a decline was even observed. Therefore, it can be concluded that the trade potential between the Arab countries is limited because of similarity between the markets.

4. Trade Potential Between Israel and the Arab Countries

In light of the given economic characteristics, as described in the previous sections, it seems, prima fascia, that there is only limited potential for trade between Israel and most of the Arab countries, for a number of reasons.

The first reason is the great disparity in income and living standards between Israel and its Arab neighbors. For example, the total GDP of all countries bordering Israel, whose total population is 80 million, is smaller than that of Israel. The Israeli income per capita is six to ten-fold that of its neighboring Arab countries. Moreover, the total GDP of the Arab countries is $340 billion, which is only 7% of the total GDP of the European Union, which is Israel's major export market.

This means that there is limited demand in these countries for the products in which Israel has a marked comparative advantage and from which it derives the lion's share of its income from exports (high technology defense related products and advanced intermediary products for the high-tech industry).

Moreover, it is unreasonable to assume that defense products, which currently make up 25% of Israel's export, will be exported to these countries in the foreseeable future.

Another reason is that a substantial part of Israeli exports are in direct competition with exports from Arab countries (mainly minerals and especially phosphates from the Dead Sea, which constitute more then 12% of Israeli exports, vs. exports of phosphates from Jordan and Morocco).

A third reason is the fact that, at least in the near future, remnants of hostility and cultural differences will simply make it difficult to do business.

One should also remember that the richer Gulf countries have been conducting trade with foreign firms (especially from Japan), a fact which will make it hard for Israeli firms to penetrate these markets.

Zilberfarb (1994) examined the trade potential between Israel and a few Arab countries, including Egypt, Syria, Jordan, Morocco,Tunisia and Saudi-Arabia. he measures compatibility by viewing similarities in export and import composition of the two potential traders. The index provides values between 0-1, where 1 represents high correlation between export composition of one country and the import composition of the other.

The results are illustrated in tables 6 and 7. The index values of some other countries are given for the purpose of comparison. As fuel exports make up a significant proportion of trade, for most of the countries included in the study, the index values were calculated both with and without the fuel component.

Table 6: Index of Similarity between imports to Israel and exports from the Arab Countries

	Incl. Oil	Excl.Oil
Egypt	0.209	0.157
Syria	0.183	0.128
Jordan	0.287	0.295
Morocco	0.163	0.147
Tunisia	0.310	0.274
Saudi-Arabia	0.154	0.136
U.K	0.701	
France	0.620	
Germany	0.544	
The U.S.	0.600	

Table 7: Index of Similarity between exports from Israel and imports to the Arab Countries

Egypt	0.413
Syria	0.369
Jordan	0.395
Morocco	0.398
Tunisia	0.419
Saudi-Arabia	0.485
U.K	0.513
France	0.526
Germany	0.518
U.S.	0.461

Source (6+7): Zilberfarb 1994

Import potential of Israel from the Arab countries is relatively low, as may be concluded from table 6. The index value range between 0.15 for Saudi-Arabia and 0.31 for Tunisia. Index values which were calculated without oil are even lower, and vary between 0.14-0.27. Trade potential is especially low for countries such as Syria, Morocco and Saudi-Arabia but higher for Tunisia and Jordan.

Comparing these values to the index values of other countries with which Israel has well developed trade strengthens the assumption that these values are, indeed, low. For example, the total export of Germany is $ 400 billion, from which $ 1.8 billion is exported to Israel. Germany's export is 6 times that of the Arab countries (relevant to Zilberfarb's analysis). The similarity index for Germany is 2-3 times higher (excluding oil). Therefore the total value of import of Israel from the Arab countries is expected to be 1/12-1/18 that from Germany, i.e. 100-150 millions. Assuming a positive influence of the geographical proximity, import may reach the value of $ 200 millions (excluding oil).

In contrast, the export potential from Israel to the Arab countries is much higher then the import potential (Table 7). The index values range between 0.369 for Syria to 0.485 for Saudi-Arabia. Comparing these values to the index values of other countries points to relatively small differences.

Despite similarities between the Israeli exports and the Arab imports, Zilberfarb mentions two main hindrances: First, the low total value of imports to all the Arab countries included in the study. For example, total imports from these countries amount to only 25% of the total imports to the U.K. ($ 209 billion), while Israeli export to the U.K. stands at about $805 million. The import index to Israel from the U.K is 125% higher then that of the mentioned Arab countries. This implies an export potential of about $ 160 millions only.

A second hinderance to trade, as already mentioned, are the low living standards in most of the Arab countries, compared with European countries, which in itself lowers the export potential to these countries.

However, Zilberfarb stresses that geographical proximity is a positive factor which should be taken into account when assessing trade potential. in summery, Zilberfarb's results point to a total trade volume between 400 and 500 million dollars a year.

Another study of the trade potential between Israel and the Arab countries (Egypt, Syria, Jordan, Saudi-Arabia and the Arab Emirates) was made by Meir Ben-Chaim (1993).

Ben-Chaim distinguished between trade expansion and trade diversion.

Trade expansion includes expanding the market into former enemy countries, of existing export goods, due to lower transportation costs, and also the creation of trade in new products, which have previously been unprofitable to export (high transportation costs or lack of economies of scale.

Trade diversion refers to the redirection of trade with other countries to the newly created markets, because of the higher profits involved (again, usually due to lower transportation costs).

Trade diversion can take place in the short term and, unlike trade expansion, it does not require changes in the production and consumption patterns of both importing and exporting countries.

Both Trade diversion and trade expansion are influenced by the GNP level of the relevant countries and by trade resistance - which varies according to geographic and economic distance (income and consumer characteristics gaps).

The results of Ben-Chaim's study are far more optimistic then those of Zilberfarb. It is important to note, however, that Ben-Chaim assumes no trade barriers and no political intervention. His analysis evaluates pure trade potential.

The results of the study foresee a trade diversion from Israel to the Arab countries, which is expected to reach more than $2 billion. This amounts to 14% of current exports of goods from Israel. Of this, $725 million will be in industries sensitive to cross-border trade (meaning high transportation costs relative to profit margins), including meat products, food, fertilizers, rubber, textile and machine tools;

A $1.3 billion trade diversion is expected in industries more or less neutral to cross-border trade (or in cases where sensitivity is unknown), which include fruits and vegetables, inorganic chemicals, generators, industrial machines and electronics, communication, aeronautics and medical products;

$111 million of the trade diversion is expected in industries with low sensitivity to cross-border trade, including organic and other chemicals.

The potential for trade diversion from the Arab countries to Israel is expected to reach $1.06 billion. This amounts to 2.5% of total exports from these countries. Of this, $1 billion is expected to be in industries sensitive to cross border trade, including oil, petrochemical products, textile, cotton and metals. $40 million is expected to be in industries neutral (or where sensitivity is unknown), including chemicals and petrochemical products.

Total trade potential is expected to reach $3.2 billion, which is 13% of the total Israeli trade and only 3.7% of the aggregate Arab trade.

Nevertheless, it is important to note that this estimate refers to trade diversion only, i.e. the redirection of trade with other countries to the new Arab markets. It does not take into account total trade potential, namely trade in services and trade expansion due to changes in production and consumption patterns and a rise in the standard of living.

Both researches, despite the major quantitative differences in their results, point to a substantial gap between the export potential from Israel to the Arab countries, and the export potential from the Arab countries to Israel.

A study made by the World Bank (1993) estimates the export potential from the Arab countries to Israel to be much higher then their import potential from Israel (?).

According to this study, Israeli exports to the Arab countries are expected to reach 7% of total Israeli exports ($500 million in 1989 terms). This comes to between 0.5% to 2.7% of the total imports to the Arab countries.

On the other hand, 7% of total imports to Israel are expected to be from the Arab countries ($ 830 million in 1989 terms).

Exports to Israel are expected to make up a significant part of some Arab countries' exports, including Egypt (20% of total exports) and Syrian and Lebanon (10%) (what about Jordan?).

From the studies done on trade potential between Israel and the Arab countries[1] it emerges that the sectors which have the greatest export potential to Arab countries are food products such as meat and milk, fertilizers (although Jordan is a major competitor), chemicals, textiles, machine tools, non-defence electronics, medical equipment, communication equipment and agriculture machines and equipment. The greatest import potential from the Arab countries is oil and petroleum products, natural gas, cotton and vegetables.

It is also reasonable to expect a flow of Israeli tourists visiting the Arab countries, as well as a rise in international tourism to the area, due to the forming of combined tourism packages, the open borders and the more secure atmosphere in the region.

Tourism from Arab countries to Israel is expected to be less significant, because the relatively low income, the lower tendency for traveling and lower leisure consumption in the Arab countries (as can be seen from the small number of Egyptians visiting Israel). However, it is likely that traveling from these countries to Israel, to visit the Islamic holey sites will increase.

Total trade potential between Israel and the Arab countries varies between 2% of Israel's total exports, in Zilberfarb's study, 5% in the World-Bank study and 13% in Ben-chaim's study.

However, it is important to note that even the more optimistic predictions do not point to the more dynamic aspects of trade creation and trade in services (which Ben Haim pointed to), examples of which we can already see:

The North Africa Economic summit, which took place in Casablanca between the 30th of October to November 1st, hosted more than 200 politicians from 60 states, including the Gulf countries, the North African countries of Morocco and Tunisia, and more than 1,100 top executives from private enterprises around the world. The summit also hosted top officials from the World Bank and the IMF, as well as Jacques Delors, the president of the European Union Commission.

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[1] Ben Chaim, 1993, Sagie and Sheinin 1994.

The main achievements of the summit were political: Qatar, Bahrain and Oman announced they will set up low level diplomatic ties with Israel; Tunisia and Morocco, which already set up liaisons offices with Israel, announced they will set up formal diplomatic ties with Israel by the end of the year.

Another major achievement was the agreement to set up a regional development bank in the Middle East, a joint trade chamber, a joint tourism chamber and a joint secretariat to coordinate and supervise the establishment of these two organizations.

The U.S. has announced that it will lead the capital raising for the regional bank.

Some of the primary contacts made since the Casablanca economic convention do affirm the studies' predictions. At the Casablanca economic convention, which took place at the beginning of October, 249 proposals for joint projects were submitted by 137 Israeli companies. Of these, 42 were in the electronics and telecommunications sector, 25 were in the metals and machinery, 21 in plastics and packaging, 19 in energy and water, 16 in construction, 16 in health care and medical equipment, 15 in the agro-industry, 13 in chemicals, 11 in food and beverages, 11 in services, 10 in textile and 5 in tourism.

Preliminary talks on cooperation and trade have begun in the following sectors:

1. Milk products - the Israeli national milk distribution company, Tnuva, is currently in discussions to import milk to some of the Gulf states. A major Israeli producer of dairy products, Strauss, is conducting discussions of both exporting its products, technological know how and machinery to North African countries such as Tunisia and Morocco, and to the Gulf States.

2. Agricultural products - representatives of countries, such as Qatar, discussed the import of agricultural products from Israel.

3. Discussions are under way, on importing natural gas from Qatar.

4. Joint projects: Israel and Jordan agreed on connection of electricity systems, feasibility studies for common tourism and Free Trade Zones in the Dead Sea area and in the Red Sea Gulf.

Morocco and Israel have agreed to connect their telephone lines, and to set a common project for an advanced communication network, which will give services to the business sector, medical services and will include data bases on tourism, agriculture, etc.

Other developments in the economic sphere are the following:

It is an known secret that for years citizens from Arab countries have been coming to Israel to receive medical treatment. At the beginning of November, a Jordanian girl, which came to Israel to undergo bone marrow transplant the first Arab patient to openly receive medical services in Israel, only a few days after the peace agreement between Israel and Jordan was signed.

The potential of exporting medical services from Israel to the Arab is clear: For Israel, with its advanced medical and research base, and a closer geographical proximity to the Arab countries than Europe or the U.S., there is a potential of exporting not only direct medical services, but also connected services such as training, medical equipment and maintenance
(C.T. scanners, for example).

B. COUNTRIES ANALYSIS

1. The Judea, Samaria and Gaze Region (JSG)

The JSG regions are perhaps the only Arab regions whose analysis of the future commercial ties with Israel can be based on long past experience.

Total population in JSG is $ 1.6 million (957,000 in JS and 642,000 in Gaze), GDP stands at $ 1.6 billion in JS and $ 550 million in Gaze. GNP stands at $ 3 billion. The difference - net factor payments from abroad - comes mainly from manpower working in Israel. Income per capita is 2376 dollars in JS and 1400 in Gaze. 15- 22% of GDP comes from agriculture, 5-12% from industry and the rest (66-80%) comes from the service sector.

Between 1948 and 1968 the economy of JSG was based mainly on agriculture, small workshop based industry and services, with a marginal industrial sector. From 20% of GDP in 1967, the agricultural sector grew to 40% of GDP in 1969 and fell again to 20% by 1986. Most of the agricultural production in JSG is for local consumption (95%), and the rest is exported to Israel, Jordan and the Arab countries.

1.1 Industry:

The years after 1968 were characterized by accelerated economic growth in JSG, due mainly to the export of manpower and growth of the agricultural sector. The industrial sector, however, did not grow substantially, so its share in GDP actually declined between 1968 to 1988, from 9% to 7%. Dependency of the industry sector on Israel negatively affected the development of this sector. Israel did not make the life of competing Palestinian industries easy. Production of competing products required a set of licensing which hampered these initiatives. It is important to emphasize, however, that this policy was not efficient and was changed in 1990. First, some Palestinian entrepreneurs did succeed in developing competitive industries and in penetrating the Israeli market. Second, trade agreements with Europe and the U.S. exposed the industry to a substantial competition. Against competition, the weight of competition from JSG became marginal.

Moreover, import of raw materials, export of products and foreign trade relationships were fully determined by Israel. For example, Jordan is the only Arab country the Palestinians were able to trade with and only on certain products. Ironically, the life of Palestinian industrialists were also difficult as a result of the Arab boycott. The Arab countries refused to import products from JSG which included intermediaries from Israel.

Another reason for the decline in the industrial sector is embedded in the lack of a central economic body in JSG which can back potential investors. This was followed by strong economic ties and high manpower mobility between Israel and JSG which allowed the population in JSG to acquire a substantial part of their goods in Israel, making it less profitable to increase the industry base in

JSG.

This can be seen in the wages in the industrial sector. During the years 1968 and 1988 the wage gap in agriculture and services has decreased, whereas the wage differential between industrial workers in Israel and industrial workers in JSG stayed almost the same: 20-30%. Industry in JSG has been primarily based on processing of agricultural products. However, the largest employer in the industrial sector is the building materials industry, which includes mainly brick and tile making. It employs about 15% of the industrial work force. Another major and fast growing sector is the construction sector. Between 1969 and 1985 this sector grew in an average annual rate of 32% and its share in GDP grew from 5% to 15%.

After 1968 a few sectors developed which were based on subcontracting for factories in Israel, especially in textile and food processing.

The food processing industry is the largest sector. It is highly concentrated and, unlike other industrial sectors in the regions, relatively capital intensive. Another large sector is textile industry. This industry developed, to a great extent, as a result of the open borders with Israel after 1968. It is today in competition with the Israeli industry, in the sense that their products are aimed at the same markets. However, as mentioned before, a large part of it functions as sub-contractors for Israeli manufacturers.

Another large sector, and the fastest growing one, is the chemical and plastics sector. This is also the only sector whose major source of growth stems from local demand. Between 1968 and 1981 the share of these sectors in the industrial revenues increased from 15% to 25%.

Other industries are footwear, leather, furniture and wood products, which are characterized by small workshops. This sector has experienced slow growth, mainly because of the competitions from Israel and the slow pace of modernization.

1.2 The service sector

Between 1948 and 1968 there was substantial growth of the service sector relative to other sectors: the average annual growth of the services sector was 7%, whereas the average growth of the other sectors was 2%.

The largest source of employment and income in this sector were the Jordanian Public Administration, the Jordanian Army and UNRWA (the United Nations Relief and Welfare Agency).

After the war of 1968 the Jordanian administration was replaced by the local education and health administration.

1.3 Trade Performance:

Since 1948 the Judea and Samaria region began to export its labor force, a trend which intensified after 1968 with the opening of the Israeli borders to labor from JSG, and with increasing educational level of the population. As a result, population growth in Judea and Samaria, during the period between 1948 and 1968, was about 33% although the natural rate stood at about 50%. Most of the immigration at that time was to the East Bank (Jordan) and starting in the 50s there was also immigration to the Gulf states.

After 1968 three major changes immediately took place. First, Israel adopted a policy of open borders that allowed export of manpower from JSG to Israel. As a result of the wage differentials between the Territories (JSG) and Israel, manpower became the greatest export from JSG to Israel, as well as to other countries.

A second, slower change, which occurred in the economy of the Territories, was the upgrading of the agricultural sector which stemmed from the transfer of know how from Israel to the Territories. Some of this transfer was done by the Agricultural Extension Services of the Israeli Ministry of Agriculture.

As a result of this the real annual growth rate of the agricultural sector reached, between 1968 and 1986, approximately 16% yearly. This is very high, especially if we take into account that during this time there was hardly any expansion of the cultivated area, there was a decline of about 10% in manpower employed in agriculture and most crops were dependent on natural irrigation, i.e. rain.

The third change was the sharp increase in the standard of living and private consumption in JSG. Between 1969 and 1972 private consumption grew at an annual average rate of 12.5%, between 1972 and 1980 it grew at an annual rate of 7.5% and between 1980 and 1986 at an annual rate of 3%.

1.4 Trade with Israel:

The trade between Israel and JSG cannot be called international, in the sense that it is more like trade between geographically adjacent regions in the same economy. The reason for this is that many factors which characterize international trade do not exist in this case: for example, currency exchange, effective customs policy and transportation costs.

Another important factor which distinguishes it from international trade is the high level of coordination in production structure of several sectors which brought about a high degree of economic integration. An example of this is the textile industry in JSG, which functions mainly as a subcontractor for Israeli firms. A second example is the coordination in agriculture, where there is differentiation in crops so as to avoid competition between the two markets.

The fact that the Israeli GDP is 25 times larger than that of JSG and that income per capita is almost tenfold dictates the trade relations between the two: JSG's main export to Israel is labor force, whereas Israel's export to JSG is in up-market products and services.

The trade between Israel and JSG is characterized by two periods:

1. 1968-1974: a period of sharp increase in export and imports (exports grew 23% annually, labor export grew 72% annually, and imports increased 14% annually). In accordance with this there was a sharp increase in GDP in the JSG.

2. 1974 -1994: a point of saturation was reached and the rates of growth slowed: import and export increased 3% annually and export of labor to Israel increased at a rate of 1% annually. Export to import ratio stood at 60% to 80%.

The Israeli export to JSG reached the amount of $ 580 million before the Intifada (1987). Since then, export diminished by 18%. The total export from JSG was in 1987 was $ 230 million, 160 of it was export to Israel.

The other main export market was Jordan, but this was limited because of restrictions, due both to the Arab boycott and the protection of the local Jordanian economy.

In the goods and services account of JSG there is a consistent deficit in the current account with Israel which is partly covered by transfer payments from Israel and partly by net capital flow from JSG to Israel. In trade with the rest of the world there is surplus which results in net capital flow to JSG from the rest of the world.

The close economic relations between Israel and JSG are likely to go on, at least in the near future, because the same economic necessities which underlined its formation still exist and will continue to do so for some time to come. These economic necessities include:

1. Excessive supply of labor in the territories.
2. A large gap in income per capita between Israel and the Territories.
3. A long common border.
4. The close economic ties which already exist in industry (for example, the subcontracting ties between the Israeli and the JSG textile sector).

1.5 Export of labor force:

The highest export from JSG is in labor force. This characteristic has existed before 1968 but intensified after 1968 and the opening up of Israel's borders to exports of JSG and was the first factor to respond to the opening of the borders.

Correspondingly, the main Israeli exports to the territories were goods and services. This reciprocity was economically necessary in order to maintain trade equilibrium, although the flow of labor force is more difficult and expensive. Obviously this form of trade was possible especially because of the common, and geographically wide, border between the two countries.

The size of the labor force in Israel from the early 70s on to the late 80s stood at almost five times the labor force in the Territories. In 1970 the total male labor force in the territories was 151.4 thousand, whereas in Israel it was 703.6 thousand.

Because of the extremely slow job creation in the territories (the increase of employment in the Territories is less than 1% annually) the natural increase in labor force in the territories is expressed in the impressive increase of this labor force in Israel: In 1970 13% of West Bank workers and 10% of the Gaze workers were employed in Israel. In 1990 the figures were 34% and 41% respectively[2]. Today workers from the territories make up 8% of the labor force in israel.

Workers from the territories serve mainly as a substitute for Israeli workers in industry, but because the majority of workers from the territories are employed in construction and agriculture, they are as a whole complementary to the Israeli work force. This may be seen when analyzing the affect of the 88-89 recession in Israel, which was caused mainly by the restructuring of the industrial sector. The level of unemployment in Israel reached 10% in 1989, while the decline in the amount of labor employed from the territories was very small.

In general, trade with JSG is expected to be marginal to the Israeli economy especially as the Palestinians will base their trade relationships with the Arab countries and the rest of the world. However, for the Palestinians the geographical proximity to Israel may serve as a bridge for economic development. Commonly, access of small developing countries to main world markets is difficult because the high entering costs consist both of financial problems and trade culture. The Palestinians must exploit their proximity to Israel to base their industrial positioning and to strengthen their trade relationships with the main world markets. The Palestinians need to enhance the process of technology transfer from Israel while they continue to be complementary to the Israeli economy rather then compete with it. The agriculture and textile sectors are examples where this process may be seen.

The recent agreements:

At the Paris meeting it was agreed that israel and the JSG will have a customs union. This means a free flow of goods, including agricultural products, between Israel and JSG (excluding livestock, eggs, tomatoes, cucumbers, potatoes and melons).

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[2]Fishelson, 92, p. 4.

The main reason cited for this was the long and open border between the two regions, which would make tariff control inefficient, and the historical reasons which have brought about the great dependence of Palestinian labor market on Israel, a dependence which would deem it impossible to disconnect free labor movement between the two regions, at least in the short term.

There is a problem regarding the trading status of Jordan with both israel and JSG. Jordan favors a free trade with JSG, however this will bring about a situation of a, de facto, costumes union with Israel as well. Israel is asking the removal of the strict rules of origin which Jordan applies to products originating in JSG, which exclude any products partly made in Israel. Until now it was agreed that Israel will allow Jordan to export 30 million dollars worth of goods to JSG. The Palestinians protested.

2. Egypt

The case of Egypt is different since 1980 Israel and Egypt opened their borders for trade. The Israeli-Egyptian case is important as it can serve as an indicator for the potential and manner of trade between Israel and its former enemies in the region.

However, the speeding up of trade projects since the signing of the Oslo agreement indicates that there is a potential for a further increase in trade between Israel and Egypt.

2.1 Economy:

The Israel-Egypt border is relatively far from both countries' economical centers. Most of the border line is an unpopulated desert area. The GDP of Egypt is $ 35 billion and it's population is 53 million. The service sector is the major contributor to the GDP (52%), industry contributes 30%, and the rest comes from agriculture. Income per capita is 680 dollars which is 5% of the Israeli income per capita.

2.2 Trade Performance:

The total import of Egypt is $ 7.6 billion and export is $ 3.8 billion. The main Egyptian export markets are Europe (42%), USSR (13%), Asia (26%), Israel (6%) and the U.S. (5%). Egyptian export to Israel is larger than its export to Japan, the U.S. and most of the European countries (except Italy and France). 54% of Egypt's imports are from Europe, 18% from the U.S and 15% from Asia. Israel supplies to Egypt only 0.3% of Egypt's imports, which are 0.2% of Israel's export. Egypt's main exports are fuel, fuel products, minerals, cotton and basic metals.

The main exports of Israel to Egypt are minerals from the Dead Sea (80-90%), food and animals (5-10%) and machines (5-10%). Other commodities are woven fabrics and irrigation systems. Israel imports from Egypt mainly fuel (97%) and almost all of the rest is cotton. The reason for this major gap is that Israel imports 12% of

its oil import from Egypt.

Trade relationships between Israel and Egypt are highly influenced by political considerations. Progress in the peace process, intra-Arab relations, Israeli-Palestinians relations and socio-economic developments will all affect the evolution of this trade. Therefore there is still a place to analyze this trade in terms of trade potential rather then a trade based on pure market forces. Trade potential between the two countries must assume a comprehensive peace situation in the region which will minimize political impacts.

Arad and Hirsch (1985) analyzed trade potential by classifying trade expansion and trade diversion as described previously p.6. They estimated the trade diversion potential between the two countries to be $ 496 million for Egypt and 428 for Israel. This estimate is very optimistic as it assumes no political or protection barriers. In 1989,Israel's import from Egypt was $ 170 million while its export was $ 22 million only.

It is possible to see that the existing trade between the two countries is mainly based on trade diversion, consisting of products of high transfer costs such as oil, raw cotton, phosphates, cotton oil and advance irrigation system from Israel to Egypt. This is a normal situation because trade diversion is naturally dominant in the short term.

Trade expansion which leans on creation of new production capabilities are still rare, and relates mainly to trade in live animals and gas which are products that are difficult to transport. Arad and Hirsch analyzed that trade expansion between Israel and Egypt is expected in products such as rubber, chemicals, metal and meat. Trade expansion from Egypt to Israel is expected to include petroleum, textile and aluminum.

Already, the advance of the peace process has brought about one major result: Israel and Egypt are close to signing a twenty year long agreement to import natural gas from the Delta sight in Egypt to Israel.

The project includes the completion of work on the sight and laying the 290 kilometers pipeline that will deliver gas to the electricity plant in Ashdod. Production is expected to begin in 1998 and will provide gas in the yearly amount of 2 million FOE (fuel oil equivalent).

Because Israel's consumption is expected to exceed this amount, by the year 2,010, another source is needed. Qatar is already in discussions with Israel, for the exporting of natural gas via tanks. However, a much cheaper alternative is the Tubok field in Saudi Arabia, which is located only 100 kilometers from the Israeli border - closer than the Egyptian field.

2.3 Common Projects:

There is considerable room for common projects between the two countries. The major water problem in Israel and the large arid zones between Israel and Egypt naturally call for regional water projects. One proposed project was to convey water from the Nile River to Israel and the Gaze strip. Such a project requires both technical and scientific cooperation aimed at supplying Israel with water while exploiting the project to enhance Egyptian agriculture. This project however, must be considered in light of water desalination possibilities.

Another project is importing natural gas from the recently developed Delta field in Egypt and Israel. Egypt has a surplus of natural gas while Israel's energy comes mainly from crude oil and coal which are far more environmentally. Of course, such a project must satisfy both countries' political and energy Policy. Other projects dealt with the possibility of establishing a free tourism zone in the Red Sea riviera.

Yet another project proposed cooperation in textile and clothing. The textile and clothing industries in both countries are complementary in many ways. Whereas Egypt produces and exports predominantly cotton and cotton fabric, Israel has advantages in producing clothing and an access to markets both in Europe and the U.S.

3. Jordan

3.1 Economy:

Jordan is the Arab country sharing the longest border with Israel, running along the Jordan river from the Sea of Galilee to the Red Sea gulf. Although it is larger than Israel, its population (4.1 million) is about three quarters of the population of Israel.

In 1992 the Jordanian GDP was 4.5 billion dollars - roughly 7% of the Israeli GDP. Income per capita is approximately 1,100 dollars - about 10% of the Israeli income per capita.

The Jordanian economy is service oriented: in 1992 65% of GDP originated in services, 14% in industry and 7% in agriculture. The service sector consists of tourism (aimed mainly at other Arab countries), trade, transport and the public sector.

The industrial sector, which accounts for 11% of total employment, consists of light industry (textiles, foodstuffs, wood and leather products), mining (phosphates) and chemicals (mainly the processing of phosphates for products such as fertilizers). Most of the industry is located at the Oman-Zarka region.

3.2 Trade performance:

Exports of products from Jordan totalled $ 1.2 billion (in 1992). Of this, 44% was export of phosphates and phosphate products (zinc comprises 25%), 20% chemicals, 19% industrial products (textiles, leather, foodstuffs), 8% agricultural products and 9% miscellaneous.

Most of the export (35%) is to other Arab countries, 15.2% to India, 3% to the European Union, 1.9% to Japan and 44.8% to the rest of the world.

Exports to India, Japan and the European Union are mostly phosphates and chemicals, whereas the exports to Arab countries are mostly industrial and agricultural products.

Export of services in 1992 totalled 893 million dollars, and was composed mainly of tourism and transport.

The imports to Jordan in 1992 totalled 3.339 billion dollars. Of this, 18.3% consisted of food and livestock, 13.35% in oil products, 10.8% chemicals, 26.6% machines and transfer equipment, 26.3% other industrial products and 4% miscellaneous.

23% of imports were from Arab countries, 28.6% from the E.U., 11.8% from the U.S. and 37.6% from other countries.

The trade balance of Jordan in 1992 came to a deficit of 1.247 billion dollars. This deficit was financed by: 29% capital transfers, 34.3% by income transfer form Jordanian citizens working abroad and 30.8% by foreign aid (6% error margin).

From this data a few facts can be discerned. First, it is clear that Jordan suffers from a chronic trade deficit - only one third of imports are covered by exports and the trade deficit comes to 30% of GDP. The rest is financed by the income of citizens working abroad, by grants and loans.

It can also be seen from the data that Jordan is a net exporter to Arab countries and a net importer from the U.S. the E.U.

Before 1982 Jordan received extensive aid from the Arab Gulf countries. It also exported a sizable amount of manpower to these countries. Between 1974 and 1982 foreign aid and transfers from citizens working abroad accounted for 58% of the GNP. However, income from both sources diminished considerably after the Gulf war.

During the 70s and 80s trade with Iraq and transport services of oil from Iraq became an important source of national income. Because of this, the Jordanian economy became dependent on the fluctuation of oil prices. It therefore benefitted from the rise in oil prices in the 70s and was hurt by reduction of prices in the early 80s.

Because of the close trade ties with Iraq, the Jordanian economy was greatly hurt by the Gulf war. In 1989 23% of Jordanian exports were to Iraq. In 1991, however, this was reduced to 9% of Jordanian exports. The 1991 Gulf war dramatically reduced Jordan's income, both because of the reduced trade with Iraq and the decrease in oil transport (because of the international embargo on Iraq), and also because it reduced another major Jordanian export, namely the Jordanian labor force in the Gulf countries.

In 1990, Jordan's total labor force in was 835 thousand, 300 thousand of which (36%) worked abroad, mainly in the Gulf countries. After the Gulf war about 100 thousand workers returned from the Gulf countries to Jordan. As a result, the unemployment level in Jordan rose to 30% of the labor force in 1991 .

3.3 Trade policy:

Jordan has preferential trade agreements with a few Arab countries, but it is not a GATT member. The trade policy encourages import substitution, via high tariffs on products competing with local industry and subsidization of inputs for locally made products.

In recent years Jordan was forced to partially liberalize its trade, as a condition for loans by the World Bank and the International Monetary Fund. However, at the end of 1993 Jordan still had tariffs on most agricultural products, foodstuffs, medicine and chemicals. The effective tariff protection is estimated at 40%. Revenue from taxes makes up 25% of the Jordanian government income. Jordan has set up free trade zones in Aqaba and Zarka.

3.4 Trade potential with Israel:

Trade potential between Jordan and Israel is not considerable, for a number of reasons. First, the demand of the Israeli market for Jordanian exports is low. The only products which could compete with other imports and local manufacturers are certain foodstuffs, agricultural products, leather and wood products, and steel scraps. It should also be noted that in most of these products Jordan would be competing with exports from JSG in the Israeli market.

Second, the potential demand of the Jordanian market for Israeli exports is limited, because the Jordanian economy is small in comparison with the Israeli manufacturing base: in 1992 total imports to Jordan, of products in which Israel has export potential, came to 5% of the actual export volume of these products from Israel.

These products include mainly chemicals, medicines, cosmetics, textile fibers, paper products, shoes, medium technology electronic equipment and machine tools. The trade in foodstuffs, artifacts and agricultural products will find support in the geographical proximity.

There is one definite exception in inputs for construction (cement, wood products, tiles etc.), which Jordan produces and for which Israel has a relatively sizable market. Imports of these products from Jordan could be cheaper than the current imports, some of which come from Europe. However, this is another area in which Jordan would be in fierce competition with exporters from JSG.

It is unlikely that a trade agreement between Israel and Jordan will take the form of a free trade zone or a common tariff zone in the near future, because this would violate the trade agreements Israel has with the U.S. and the E.U.

It is also unlikely that Jordan would allow an agreement which would completely expose its local industry to foreign competition.

What is likely, is that Israel would give Jordan the trading status of "third countries", meaning countries with which it does not have special trade agreements.

In addition to this, there will probably be preferential trading agreements between the two countries regarding specific products or sectors (the GATT agreement contains a clause which allows preferential trade agreements between countries which previously belonged to the Ottoman empire). This will undoubtedly be necessary because of the close economic ties of both Israel and Jordan with JSG.

It is likely that the Palestinians will endorse a preferential trade agreement with Jordan. Due to a lack of an effective economic border between Israel and JSG, Israel will insist on both joining these agreements and making them reciprocal.

Israel will probably also insist on abolishment of the strict local content rules which Jordan has imposed on products imported from JSG (which forbid import of products containing inputs or labor originating in Israel).

A special agreement will have to be reached regarding exports of phosphates (which are considerable from both Israel and Jordan), especially if Jordan will be allowed access to the mediterranean ports of Haifa and Ashdod.

3.5 Common projects:

1. connecting the Israeli and Jordanian electricity system. The savings from this are already apparent: Israel would immediately save 200 million dollars - the cost of laying a high power line from the middle of the country to Eilat. Instead, it will use the high power line from Amman to Aqaba.

Jordan would immediately save 78 million dollars by the discontinuation of the Taba - Aqaba underwater line. Instead, Aqaba and Taba will be connected to the Eilat electricity system - Taba has already been connected.

2. Jordan has agreed to make the Aqaba airport into an international airport that will serve also Eilat. A road will be laid, that will connect Aqaba, Eilat and Taba. Feasibility studies have already started, on making an international resort center and a Free Trade Zone in the Dead Sea area and in the Red Sea Gulf.

Trade potential between Israel and Jordan lies mainly in common projects, because of the geographic proximity of the two countries.

One major area for cooperation is tourism: There are already discussions on building an international airport which will serve the tourist area of Eilat-Aqaba in the Red Sea Bay.

Other projects include joint development of a common riviera on the Red Sea Bay and hotels and spas in the northern area of the Dead Sea, as well as joint free trade zones (Aqaba and Eilat are already established free trade zones).

Another important project under discussion is a joint water desalination facility, and there is also talk of a shared electricity infrastructure.

4. <u>The Gulf Countries</u>

The Gulf countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the Emirates. The population of the Gulf countries is about $ 20 million of which 15.5 million is in Saudi-Arabia. The GNP per capita varies between $ 6200 - 7800.

These countries export almost solely oil and oil products. Almost all of their consumption is imported. The total import to these countries in 1991 stood at 52 billion dollars.

The main export to Israel from these countries would be oil, oil products and possibly natural gas.

4.1 Export from Israel to the Gulf countries:

One of the main problems facing the Gulf countries is water desalination. Desalination of a cubic meter of water costs about 1.8 dollars, which today does not pose a major financial inhibition because of the cheap energy available in these countries. However, in future, when this energy source will be significantly reduced, the current desalination methods used will be too expensive. Israel could sell existing improved desalination technology or join in the development of even cheaper methods.

A second source which is in short supply in the Gulf countries is agricultural products and foodstuff. The Gulf countries import about 60% of their food consumption. A large part of the food imports (including agricultural products) comes from the U.S. and Europe. Israel has an advantage in exporting food products to the Gulf countries because of its geographical proximity to these countries, which makes its exports cheaper. For example, it would be cheaper to import oranges from Israel, than from Florida.

Israel could also export agricultural technology to the Gulf countries. Experience gained from trade with Egypt since the early 80s shows that there is great potential demand for agricultural technology and also for agricultural equipment, such as irrigation.

A second potential export is associated with the religious dietary laws of the Islam which are similar to the Jewish dietary laws. This could be particularly advantageous in exporting meat products.

A third potential export to the Gulf countries is medical services and know-how. Today the Gulf countries, and especially Qatar and Oman, import a large part of their medical services. Many of their citizens often go to Europe or the U.S. to receive medical treatment. Israel could export its medical services, which, again, would be cheaper because of the geographical proximity and also because of the relatively cheaper medical manpower.

A forth potential export is in consumer goods as well as electronics equipment. However, it is important to remember that in general these countries already have well developed trade relationships with international firms which supply these goods. These firms enjoy reputations which have been gained throughout the years. For Israel, especially as a former enemy, penetration of these markets will not be an easy one.

In regard to common projects, Qatar and Israel are considering laying a gas line which would enable export of gas from Qatar to Israel.

6. <u>Trade Agreements</u>

The specific trade arrangements which will be decided on between Israel and the Arab countries will have a significant effect on the development and extent of trade in the Middle East region. Four types of agreements will be discussed: Common market; Unify custom; Free trade area; Preferential trade agreements.

The type of agreement will undoubtedly be decided according to both economic and political considerations, which do not always coincide.

For the Palestinians, for example, while economic interest dictates an arrangement that will allow the free flow of goods between JSG and Israel, certain customs protection will probably be established in order to solidify the region's status as an economically independent territory. It is also quite likely that the will of JSG to establish itself as part of the Arab countries will lead to formation of trade connections which will favor the Arab countries, mainly Jordan - although the economic rational behind such a move is debatable.

It is likely that other Arab countries as well will be very hesitant to open their markets to Israeli imports. This stems from the fears of an Israeli economical capture, although such fears are unrealistic. Therefore, common market agreements are very unlikely, at least in the preliminary stage.

It is also unlikely that Israel will agree to a common market because these are based on free flow of labor. Given the current gap in income per capita between Israel and the Arab countries, the opening of borders to free labor flow will unsettle the labor market and wage structure in Israel. In additions to this, common market and free flow of labor can only take place in areas in which there is long time political stability and relations of mutual trust, and most important - the lack of any war tension or defense problems. In the present situation, a close supervision of labor mobility will be needed, mainly for security reasons.

The idea of a unified customs area is problematic because it entails giving up independent trade policy. Such unification will require its members to set common policies in relation to trade with the U.S. and Europe. It is doubtful whether a common policy can be optimal for such different economies.

In addition to this, a common customs agreement will jeopardize Israel's trade arrangements with the European Union. it is quite unlikely the Union will agree to Israel making agreements with developing countries with low wages. Custom union arrangements are forbidden according to the European Union's law and also according to the trade arrangement between Israel and the U.S.

A free trade zone is feasible, because on the one hand it provides the different sides with an independent trade policy, and on the other, it does not endanger the current trade agreements between Israel and other countries. The primary problem with free trade zones is that they require tight control over the source of the products imported to each country.

In the case of Israel and JSG this is very problematic, as there is a long common border, and high mobility of labor between the two regions. This makes border control very difficult. In addition, free trade agreements expose the industry to tough competition from members' industries. However, in general the economies Israel and its neighbors are characterized by a considerable degree of mutual complement, which at the aggregate level reduces loss from uncontrolled competition.

A fourth possibility is preferential trade agreements in certain sectors. This will enable a country to import products which are complementary, rather than competitive, to the local industry. It also allows a gradual development of trade. There is a big catch here, though - preferential trade agreements are generally not allowed according to the GATT agreements. The only exception, as specified under Section 3A of the GATT agreement, are "preferential trade agreements between countries which were previously included in the Ottoman Empire and were disengaged from it after July 23rd, 1923". This section applies to Israel, Jordan, Syria, JSG and might include Egypt.

It seems, therefore that finally an agreement of a free trade area will be signed. Common markets and unification of customs are unrealistic simply because they threaten the existing agreements between Israel and both Europe and the U.S. However, it is also reasonable that in the long term Israel, the Palestinians and Jordan will strive to unify their customs. Such unification will make trade within this triangle much easier and will greatly reduce the possibility for tax smuggling.

7. Concluding Remarks

The trade potential between Israel and the Arab countries appears to be limited by a number of factors:

1. The basic economic characteristics of Israel and the Arab countries are dramatically different. GNP and income per capita are 10-20 times higher in Israel, therefore, only limited demand may be found in the Arab countries for Israeli goods.
2. There is little similarity between the Arab countries' export and Israeli import. Most export goods of the Arab countries consist of oil, oil products, cotton and chemicals.
3. In the short- and mid-term it is likely that uncertainties concerning the peace process, remnants of hostility and cultural differences will impede the development of trade relationships.

Assessments of the trade potential between Israel and the Arab countries vary between $ 0.5-3 billion (U.S), which includes oil. Trade with Arab countries is expected to be 2-13% of Israel's export. Even the most optimistic approach does not predict a dramatic change in the composition of Israeli export. Alternately, export from the Arab countries to Israel is expected to be more significant. Studies of the trade potential between Israel and the Arab countries suggest that export to Israel may be 10-20% of their total export. Egypt serves as an example of this possibility. Whereas Israel export 0.2% of it's total export to Egypt, it's import accounts for 6% of Egypt's total export.

The different cultural, political and economic background of each of the Arab countries results in major differences concerning their trade potentials with Israel. The Israeli-Palestinian trade relationship is likely to continue to be characterized by dependency, with manpower as the major export from JSG and goods from Israel. In addition, it is expected that the number of Israeli factories sub-contracted in JSG will increase. Although there is a special relationship between Jordan and JSG, trade potential between Jordan and Israel is low. This is both because the Israeli demand for Jordanian products is low as a result of competition with local products, and because the Jordanian market for Israeli products is extremely small. The trade relations with Egypt are likely to expand in the future, particularly because the continuing peace process will enable an expansion of oil import by Israel. In addition, import of natural gas is likely grow. The Gulf countries are expected to have increased trade relations with Israel, despite the potential competition between the Gulf countries and Egypt, since main exports will probably include oil, oil products and natural gas. Import from Israel to the Gulf countries is expected to be high-tech products and medicine.

Despite the fact that peace may not be expressed immediately in increased trade relations in the region, the dividends of peace will be numerous for all countries. First, a reduction in defense spending will occur in all countries, second, stability in the region will bring foreign investments, and third, regional and international tourism is expected to grow. In addition, there is much potential for cooperative projects within the region which can lead to economic prosperity.

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