

# Economic Peace: Theory versus Reality

Nizan Feldman

The consistent declarations by Prime Minister Binyamin Netanyahu about the potential impetus that “economic peace” can give to negotiations over a permanent settlement between Israel and the Palestinian Authority have been received with criticism and skepticism by many in the international community and the PA, and among political circles in Israel. While the gist of the criticism claims that Netanyahu confers importance on the economic dimension in order to avoid placing the core issues on the agenda, few have attempted to examine if there are theoretical foundations or relevant empirical data to support the rationale presented by the prime minister.

Of the critics who have actually related to the essence of the idea, some have argued that it is naive to think that economic issues can affect the development of negotiations over disagreements that run so deeply. This intuitive claim sums up one of the basic positions of political realism, which states that issues of “lower politics” cannot significantly affect the shaping of foreign policy concerned with issues of “higher politics.” However, against this familiar widespread contention, it is possible to point to some recent academic studies that have tried to promote the old liberal belief that economic growth and economic interdependence are factors that may reduce the probability of violent confrontations between nations.

The theoretical origins of most of these studies – commonly labeled studies of “commercial liberalism” – are those informing Netanyahu’s program. However, similar starting points are not necessarily proof that

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the formal research models and the empirical evidence displayed in the academic research can support the prime minister's analysis.

This article contends that even if we ignore the wealth of criticism directed at studies of commercial liberalism and rely solely on models developed by the most ardent proponents of the concept, it is still difficult to argue persuasively that increased economic cooperation between Israel and the PA and the creation of conditions conducive to economic growth on the West Bank can pave the road to political peace. The models at the heart of commercial liberalism studies would indeed claim that significant improvement in the West Bank economy is likely to reduce the probability of an outbreak of another round of violence between the sides. However, the analysis of such models, in the context of a number of economic and diplomatic events that have gathered momentum in recent months, teaches that exclusive focus on the economic dimension is liable to contribute to increased political tension between the sides and even compromise Israel's room to maneuver in future negotiations.

### **Economic Peace Theory**

Although it is possible to point to a long line of classical liberal thinkers in the last three centuries who argued that economic interdependence and growth can positively affect political relations between states, it is only in the last thirty years that research has attempted to test the claim and support it with firm theoretical and empirical underpinnings. Most of the research on the topic focuses on the issue of the alternative costs involved in the conflict, or in simpler words: what states and their citizens are liable to lose by taking violent steps.

Proponents of commercial liberalism assume that economic cooperation between two states increases their absolute economic welfare, and therefore raises the alternative costs involved in political confrontations. The deeper the economic cooperation, the more the economic welfare of both sides grows, thus dampening their enthusiasm for taking steps that are liable to interfere with regular economic activity. An analysis of Netanyahu's statements reveals that the issue of alternative costs is a central component of his idea of economic peace. At the 2008 Herzliya Conference, he noted that the economic reality of the West Bank "is liable to lead people to think that they have nothing

to lose, and the road from here to terrorism is short.”<sup>1</sup> According to Netanyahu, there is a great deal of evidence for cases where promoting economic issues has contributed to paving the way for political peace between two hostile sides.

And indeed, it is possible to point to a long list of studies that have tried to support the rationale of commercial liberalism by presenting empirical evidence. The growth of globalization processes has been accompanied by a significant increase in studies attempting to assess the statistical connection between economic issues and violent conflicts. Nearly all the quantitative studies have in fact succeeded in locating a negative correlation between economic interdependence and conflicts.<sup>2</sup> However, the dependent variable in these quantitative studies is violent confrontations between states. In other words, the thrust of the theoretical underpinnings supports the claim that economic growth or cooperation between states reduces the probability that they will go to war with one another, but does not address the possibility of these economic elements leading to conclusions of peace treaties.

While it is true that there are also academic works that focus on specific case studies – especially the example of West European states – that demonstrate the deepening of economic integration spilling over into expanded cooperation in broader fields, the ability to generalize from these studies is tenuous. One may wonder, for example, if the case of West European countries, which were under a common threat from the Soviets and signed peace treaties before agreeing on economic cooperation, can really be used to conclude that promoting economic cooperation will necessarily contribute to political cooperation in other parts of the world as well. The problem with generalizing from a specific case is what prompted the quantitative research on the subject. And in any case, both the quantitative and the qualitative studies focus on the interactions between pairs of states, but do not discuss the cases in which one of the actors has yet to achieve

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political independence. This is a critical question, as will be discussed below.

Even if we adopt the relatively narrow definitions suggested by the quantitative studies and analyze how economic factors have in the past affected the conflict between Israel and the PA, it would still be hard to draw optimistic conclusions. The quantitative research on the subject is based on large samplings that include economic and political interactions between dyads of states over long periods of time in various regions around the world. Including Israel and the PA as a dyad in these samplings would compromise the strength of the negative correlation between commerce and violence that is indicated by statistical analyses. In other words, the Israeli-Palestinian conflict is a clear case of an inverted example compared with the trends presented by the extensive quantitative research on the subject: expanding the economic integration between the sides, as well as their rates of economic growth, has often had an impact that is the opposite of what was expected. For example, one could note that the economic growth in the PA before the second intifada was more than 9 percent.

The last claim, often cited by Netanyahu's critics on this point,<sup>3</sup> reflects the difficulty in tapping quantitative studies to support the economic peace idea, but it still does not nullify the theoretical rationale for commercial liberalism. In recent years, most of the studies have in fact been based on empirical tests, but the forecasts presented by them are based on formal models that can certainly address cases where states enjoying extensive economic integration have fought with one another.

According to the basic model, decision makers strive to raise the aggregate value of their countries, and will therefore not initiate a violent conflict when the profits are lower than the costs.<sup>4</sup> The costs of a conflict are partly the result of loss of economic activity resulting from cooperation with the enemy state. This is the main reason that expanding economic cooperation reduces the incentive to initiate a conflict. However, that does not mean that reducing incentives is always enough to prevent the eruption of violence. States will choose violence when the potential marginal benefit of a conflict outweighs the marginal costs caused by the conflict's damage to economic cooperation. That is, even the model most closely identified with commercial liberalism indicates that along with the economic potential inherent in cooperation

between two sides, the importance of the interests that the sides believe they can advance through violence must be tested.

In order to explain the outbreak of the second intifada, proponents of the model would claim that the Palestinians believed that after the failure of the Camp David summit, taking violent steps would promote goals that would confer on them greater benefits than those gained through economic growth. However, at the same time proponents of the model would clarify that these parameters are not unchangeable static factors. Therefore, launching moves that would create growth on the West Bank – and therefore raise the costs of a future conflict with Israel – alongside steps that would reduce the belief that it is possible to attain successes through violence can indeed reduce violence between the sides.

When Netanyahu claims that “economic peace relies on two forces: Israeli security and market forces,” he is expressing just this principle. In all his statements on the subject, Netanyahu has also clarified that economic peace would not make political negotiations superfluous, rather would create conditions for them to mature. The rationale behind the models of economic liberalism supports this claim only to a limited extent, because it does not formally explain how reducing violence and expanding cooperation lead to a compromise on core political issues. However, even if we assume that reducing violence is a necessary condition for political negotiations between the sides, the model refers to interactions between states and has not been applied to cases in which one side has yet to achieve independence.

An analysis of this type of case is likely to be different. First, it is safe to assume that the benefits of changes in the status quo of a player who is fighting for independence would be greater in most cases than those of states. Therefore, even proponents of the model would agree that economic issues affect the decisions of such an actor only in cases in which it is enjoying significant economic growth. Second, the changes in the economic situation of this type of actor may affect its ability to realize national ambitions, and therefore also affect the political relations between it and the state from which it demands its independence. This last question may be critical in light of the momentum gathering for some of Palestinian prime minister Salam Fayyad’s ideas for launching economic and political steps that would create the conditions for a de facto Palestinian state.

### Economic Peace versus Fayyadism

While Netanyahu's idea of economic peace was greeted with suspicion and scorn by many in the international community, the emphasis on the economic dimension in Fayyad's program for nation building received much favorable interest among many in the West. After Fayyad made his program public in August, Thomas Friedman, who popularized the idea of commercial liberalism when he coined his "Golden Arches Theory" (the assumption that two countries with McDonald's franchises will not go to war with one another), coined a new term that is beginning to gain popularity: Fayyadism.<sup>5</sup>

Fayyadism refers to the ability to realize political goals through rapid economic development of the West Bank that would be accelerated thanks to increased transparency and efficiency of institutions. Constructing effective, efficient governmental institutions meeting Western standards would raise the level of attractiveness of the West Bank to foreign investors, and enable the laying of the foundations of a market economy. The combination of functioning institutions and a market economy would create the infrastructure for the future Palestinian state. The quick rise in the standard of living on the West Bank would present an alternative to Hamas' governance because it would clearly emphasize the profits inherent in abandoning the notions of Islamic rule.

There is much overlap between Netanyahu's notion of economic peace and Fayyadism. First, both ideas express the hope that market forces can promote political goals and moderate the effect of radical Islam

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without resorting to violence. Second, both ideas attribute decisive importance to the establishment of functioning bureaucratic institutions to ensure property rights and allow for improvements in the quality of life in the West Bank. However, while Netanyahu urged that creating a reality of economic freedom and security in the West Bank is what will allow the Palestinians to sit down

and start discussing real peace, Fayyad's program is meant to create the conditions for establishing a de facto Palestinian state within the next two years.

This discrepancy undermines the use of commercial liberalism models to support the claim that advancing economic cooperation and creating conditions for swift economic growth in the West Bank will necessarily contribute to achieving political peace. Achieving swift economic growth and building a market economy would likely lessen the PA's willingness to engage in violent conflict, yet if these are achieved without political negotiations it might encourage the PA to take unilateral steps that from Israel's standpoint are provocative. An improved security, government, and economic situation in the West Bank bolsters the popularity of Fayyadism among Western thinkers, who might encourage international elements to support a Palestinian unilateral declaration of a state.

### **The Effect of the Processes on the West Bank Economy**

An analysis of the economic developments on the West Bank indicates that both the steps taken as part of Fayyadism and the steps taken by the Netanyahu government – and presented as part of promoting the policy of economic peace – have contributed to an improvement in the economic situation. The international institutions that have examined the economic situation on the West Bank have listed the bureaucratic reforms made by Fayyad, the improvement in security, and Israel's removal of roadblocks as the three primary factors allowing for the renewed growth.

Recovery from the global recession and improvement in Israel's economy also contribute to a strengthened West Bank economic situation because they increase Palestinian exports and the scope of foreign assistance. The renewed growth in foreign aid, representing more than one quarter of Palestinian gross local product, will allow the PA to continue paying salaries in the coming months and even increase government spending on investments in infrastructures without creating irregular deficits.

Assessments by the International Monetary Fund project that growth in the West Bank for 2009 is expected to be more than 7 percent, with most of the production sectors expected to experience growth. Similarly, unemployment dropped in the second quarter of 2009 by more than 4 percentage points compared with the previous quarter, and now stands at less than 16 percent.<sup>6</sup> Judging by the growth in the volume of foreign

investments flowing into the West Bank, it appears that international confidence in the Palestinian economy has grown. In the past year, a number of deals were signed between the PA and foreign companies on infrastructure services, construction, and communications. Likewise, a number of funds have examined the possibility of investing in Palestinian companies, and two investment funds, from Britain and the UAE, have even invested in a number of companies traded on the Palestinian stock market.<sup>7</sup>

However, the current improvement in economic indicators does not demonstrate a higher standard of living or the achievement of sustainable growth. Government investments in infrastructures and the current rate of foreign investments are not enough to ensure that the West Bank economy continues to grow at a reasonable rate over time. Interest on the part of foreign companies must increase significantly in order to create a market economy in the West Bank that can ensure sustainable growth. The penetration of foreign companies focusing on the industrial sector, as well as the institutionalizing of trade relations with companies specializing in supplying input for industry are the requisite factors for establishing an export sector that allows the Palestinians to reduce their dependence on Israel and foreign donations.

In contrast to ideas raised in the past by Peres and Netanyahu about the establishment of industrial parks in West Bank cities that would provide employment for Palestinians, Fayyad's program stresses the severing of the economic dependence on Israel and foreign donations. However, in order to achieve this there is an initial need for closer cooperation with Israel over both security and economic issues. The removal of individual Israeli roadblocks increases freedom of movement and therefore contributes to a growth in personal consumption and economic activity, but investors looking to make long term investments must be convinced that there will not be a regression in terms of freedom of movement in the West Bank. Similarly, the rate of foreign investments will not increase significantly if foreign companies have reason to believe that the instituting of transparency in the bureaucratic establishment is unlikely to gain further momentum.

## Conclusion

For now, one may conclude that continuing short term growth processes in the West Bank as well as laying the initial foundations for attaining sustainable growth depend on close security coordination between the PA and Israel and the rate of reforms in Palestinian government institutions. Because the economic dimension is a decisive component of Fayyad's program for establishing a state, and because economic growth in the West Bank is in Israel's best interests, there is a possibility of promoting cooperation that would to some extent raise the standard of living on the West Bank even in the absence of progress of the political negotiations.

Making such moves is crucial because an improved West Bank economic situation promotes the alternative to Hamas rule and is likely to contribute to calm on the security front. However, one must not err in hoping that these processes alone are the central key to a political breakthrough. It is precisely because the economic dimension and other issues of "lower politics" are gaining momentum on the Palestinian agenda and in international discourse that the assumption that exclusive focus on economic cooperation will spill over to political peace in the future is flawed. Not only does an Israeli focus on economic cooperation in the absence of political negotiations not contribute to the maturation of conditions for future political negotiations between the sides; it is also liable to give the Palestinians an opportunity to take unilateral steps that can reduce Israel's scope for political maneuvering.

## Notes

- 1 In the last two years, Netanyahu has presented the principle of economic peace on many occasions. The most detailed speech on the issue was given at the 8<sup>th</sup> Herzliya Conference. Unless otherwise noted, all citations attributed to Netanyahu in this article are from this speech, <http://www.netanyahu.org.il/blog/2008/11/>.
- 2 The professional literature on the subject is quite extensive. For a good overview of the literature supporting the concept of commercial liberalism from a quantitative point of view, see Edward Mansfield and Brian Pollins, "The Study of Interdependence and Conflict: Recent Advances, Open Questions, and Directions for Future Research," *Journal of Conflict Resolution* 45, no. 6 (2001): 834-59.
- 3 See, e.g., Ephraim Kleiman, "Is There Anything to 'Economic Peace'?" *Haaretz*, December 12, 2008, <http://www.haaretz.com/hasite/spages/1044770.html>.

- 4 The model cited was developed in 1980 and almost all quantitative studies on the subject cite it as the basis for presenting their hypotheses: Solomon Polachek, "Conflict and Trade," *Journal of Conflict Resolution* 24, no. 1 (1980): 55-78.
- 5 Thomas L. Friedman, "Green Shoots in Palestine," *New York Times*, August 4, 2009, <http://www.nytimes.com/2009/08/05/opinion/05friedman.html>.
- 6 The sharp drop in unemployment from the first to the second quarter is also linked to seasonal changes that affect employment in the agricultural sector. However, unemployment in the West Bank dropped by more than 1 percent in comparison with the same quarter in 2008. *Palestinian Economic Bulletin*, Portland Trust, Issue 36 (September 2009).
- 7 *Palestinian Economic Bulletin*, Portland Trust, Issue 33 (June 2009).