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Editor: **Mark A. Heller**

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ECONOMIC CONSEQUENCES OF THE ISRAELI-PALESTINIAN CONFLICT

Imri Tov

Jaffee Center for Strategic Studies

The Israeli-Palestinian conflict, which until recently was waged primarily by political means, has now intensified and moved to the streets. Both sides employ a wide range of weapons in the confrontation, including economic levers such as almost complete Israeli closure of the Palestinian-controlled territories and efforts by Palestinians to boycott commercial ties with Israel.

Any assessment of the economic consequences of the conflict requires a survey of the damage at three levels. The first is the direct damage. The second refers to changes in the behavior of economic units provoked by higher security risks. The third refers to the consequences of the spillover from the previous two levels into the various sectors of the economy. The importance of this component continues to grow as the conflict drags on. In economic terms, this is the "multiplier effect."

The economic consequences of the confrontation for Israel and the Palestinian Authority (PA) have not been symmetrical. For Israel, the effect has been marginal, for the territories under PA control, the effect has been dramatic, verging on paralysis if not collapse of economic activity.

This asymmetry stems from several factors, especially the disparity in the size of the two economies (Israel's GNP is twenty times larger than that of the PA). The Palestinian economy is highly dependent on Israel in every respect. labor markets, markets for goods and services, financial and capital markets, foreign trade, and infrastructure. The proximity of centers of Palestinian economic activity to sites of violent clashes exposes them to direct damage. With a few exceptions (e.g., direct terror attacks), Israeli economic activities are not nearly as vulnerable to disruption. Moreover, the structure of the Israeli economy and its long experience in operating under the shadow of security threats allow most of its units to function normally despite the escalating conflict.

Estimates of the damage to the two economies (assuming the confrontation lasts until the end of 2001) indicate a possible cut of 1-2% in the Israeli growth rate but a drop of 25-75% in the product of the PA-controlled territories. A cutback of such proportions will inevitably touch every sector of the economy. That means that any reconstruction will take a long time and will depend on resources that will almost certainly not be available in the amounts and manner required by existing programs.

In short, escalation of the conflict drags the Palestinian economy backward and acts as a boomerang on the PA's efforts to build an infrastructure appropriate to a national economy.

As far as the Israeli economy is concerned, direct damage is largely confined to the construction and agricultural sectors, which are deprived of manpower by the closure on the

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Palestinian territories. Allowing more foreign workers to enter the labor market would make it possible to bypass the closure and mitigate the damage to these sectors, but it would also defer and complicate the recovery of the Palestinian economy. It is doubtful whether the PA can, in any reasonable timeframe, create alternative jobs for the 130,000 or so workers who depend directly on access to the Israeli labor market for their livelihood and who are now unemployed as a result of the violence.

The decline in tourism and the slowdown and changes in patterns of private consumption have also inflicted blows on the Israeli economy. Damage to the tourism industry has been particularly pronounced and it will take several months of relative calm before this sector can begin to recover.

But in contrast to developments in the Palestinian territories, the financial markets in Israel have hardly been affected at all. Fluctuations in currency exchange rates attributable to security risks have been marginal. Moreover, any devaluation of the shekel, which escalation of the violence may well precipitate, may actually benefit "old economy" industries that might otherwise be adversely affected by the violence. By the same token, there has been no perceptible change as yet in capital flows to or from the country, though protracted violence may induce foreign and local investors to defer investments while they consider the security risks. The rise in the unemployment rate, by ½%, may be attributed to problems in the tourism, agriculture, and (to a lesser extent) construction industries.

The direct economic damage, which is of secondary importance, is overshadowed by a pessimistic mood prompted by the sharp shift in the geo-political situation. The response of the security establishment has a major impact on current and future economic processes. The outbreak of violence found the army prepared operationally but lacking the budgetary resources for a protracted confrontation. Moreover, the assessment that a wider regional clash has become more likely demands a higher state of readiness. As a result, the defense establishment has requested an increase in the shekel budget. This request (along with an election campaign – itself another consequence of the violence) may well shatter the framework of the government's fiscal policy. If that happens, the damage to economic policy will be much more dramatic than the direct economic costs.

From an economic perspective, prolongation of the violence will produce two contradictory effects. On the one hand, it will stimulate some sectors to find ways around the obstacles engendered by the violence, such as the cessation of commerce along the "seam line" between Israel and the West Bank, that amounted to some 500 million shekels per annum. On the other hand, it will cause the direct damage in some sectors to spill over into other sectors thus far unaffected by the violence, such as those leveraged with bank credit or those supplying the tourism, agriculture and construction industries. A spillover into the banking system could well lower Israel's credit rating, which has thus far not been hurt by the deterioration in the security situation. Finally, prolongation of the violence might necessitate the mobilization of reserve units, and that could also cause localized economic damage.

In sum, eight weeks of escalating violence have already inflicted a huge setback to the Palestinian economy, and prolongation of the de facto separation from the Israeli economy is likely to result in even more disastrous consequences, perhaps leading to socio-economic collapse. For Israel, the violence threatens the government's economic guidelines, and if these are shattered, especially under the pressure of "election economics," the capital markets may also be dragged into the morass. That outcome can be avoided, but only if the government stands firm in the face of demands to bend fiscal policies in response to transitory needs.