Economic Consequences of a Middle East Peace Settlement: The Best Case

Highlights

This paper is a conceptual look at potential economic benefits from genuine peace in the Middle East; it is not an intelligence estimate of what would likely take place with a peace settlement. Three critical conditions are assumed. The first is a peace settlement acceptable to all sides. The second is that foreign aid will be sufficient to cover all reasonable financing needs. The third is a building of mutual confidence. Since confidence building takes a long time, the kinds of benefits that would follow fairly quickly from a peace treaty are distinguished from those that might not develop for many years.

An Arab-Israeli peace settlement would fairly quickly yield some important economic benefits to the confrontation states if it provided for a substantial reduction in military forces. For Israel such a peace would:

-- Permit a cut in the $4 billion of military spending, which now constitutes about 40% of the state budget, roughly the same share of gross

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national product, double the level of civilian investment, and two-thirds the level of personal consumption.

-- Ease current shortages of civilian labor by demobilizing part of the military establishment, which is now absorbing about 15% of available manpower.

-- Induce a sharp drop in emigration -- now about a thousand a month -- and spur a pickup in immigration.

-- Induce an even faster growth in tourism, which already is booming.

-- Given all of these gains, Israel could reasonably expect to be able to support real GNP growth at the prewar rate of about 10% a year in contrast to near stagnation since the 1973 war.

For the Arab states, a peace settlement would:

-- Help rationalize development planning, open up indigenous sources of project financing, and improve the foreign investment climate.

-- Insure the continuation of the current tourist boom.

-- Release much needed skilled labor to civilian uses in Syria and Jordan.

-- Enable Egypt to go forward with promising Gulf of Suez oil development, which is now being harassed by Israel. Over the next several years, Cairo could see up to 400,000 barrels per day ($1 billion a year) flowing in from oil.

Under the further assumption of more open borders, a freer flow of labor and capital, and limited regional cooperation, additional benefits would be expected.

-- Jordan and Israel already have reached a preliminary agreement on allocation of Yarmuk River water resources, although engineering decisions must be worked out before the project can be launched. A peace accord would also pave the way for other water projects, particularly agreements on sharing the now wasted Litani River waters.

-- Jordan and Israel have also shown interest in joint exploitation of Dead Sea potash deposits.

-- Cooperation could be highly effective in expanding and modernizing the area's road network and eliminating redundant airline facilities. In turn, an integrated transport network would be a boon to industrialization, commercial agriculture, and tourism.

-- Israel could develop unique and mutually profitable lines of exports to Arab countries in a wide range of specialized goods and services in such areas as medicine, agriculture, engineering, educational/vocational training, and repair and maintenance of vehicles and aircraft.

-- A freer flow of labor throughout the region would not only result in full employment in the West Bank and Gaza, where unemployment has already been much reduced by the effects of the Middle East oil boom, but also would create a heavy demand for surplus Egyptian labor.

Under the heroic assumption of a genuine buildup in Arab-Israeli confidence, more ambitious projects might be undertaken. Several project ideas have been considered over the years, including:

-- A Mediterranean-Dead Sea canal that would permit the development of hydroelectric power for a multi-faceted industrial complex utilizing mineral resources near the Dead Sea.

-- Joint nuclear and other power projects.

-- A pipeline to carry natural gas from Saudi Arabia to Israel, Jordan, and Syria for use as industrial fuel and petrochemical feedstock.

Introduction

1. This memorandum examines the possible economic dividends that would flow from real peace in the Middle East. It is a conceptual look at economic possibilities that might emerge from a peace settlement; it is not an intelligence estimate of what would be likely to happen. It assumes that political and security conditions would be created that are most favorable to economic interchange in the region, and that adequate foreign financial support and ample project assistance will be available to both Israel and the Arab states. The key assumption is that a steady buildup of confidence between Arabs and Israelis will take place.

2. The picture that would thus emerge amounts to a basic transformation of the economy of the area. Realistically, even with a full peace treaty, it might take many years, perhaps decades, to build confidence to the point that all the cooperation discussed below would become possible. But even before such a high level of confidence develops, a peace agreement which permitted large cuts in military expenditures and provided a substantial

level of foreign assistance would enable Israel to regain high rates of economic growth and substantially improve the Arab economies as well.

<u>A Settlement Scenario</u>

3. In a best-case scenario, a comprehensive, internationally guaranteed peace settlement would have the following economic results, it would:

- require the parties to sharply reduce force levels and defense spending, enabling a shift of resources to the civilian sector;
- remove artificial commercial barriers;
- minimize restrictions on the movement of labor and capital;
- abolish the Arab boycott;
- eliminate travel restrictions; and
- establish regional institutions to develop water, minerals, transportation, etc.

Economic Impact of Peace

4. A genuine peace settlement would produce a dramatic change from the present siege mentality to an optimistic view of the future. The short-run tangible benefits would include a reduction in the defense burden and a shift of resources into the civilian economy. This dividend would be highest for Israel, which has put more of its eggs into the military basket than the Arabs since the 1973 war. Other major benefits -- such as the growth in intraregional trade and national as well as regional development programs -- would take much longer.

Israel

5. Israel is the only principal confrontation state whose economy is worse today than before the 1973 war. The overhang of a massive military program forced the Israelis in 1974 to institute an austerity program. Since the war:

- real GNP has grown only 1%-2% a year, compared with 10% a year prior to 1973;

- the annual rate of inflation has exceeded 35%, compared with 10%-15% before 1973, largely because defense spending consumes 40% of GNP;

- the $3 billion current account deficit is triple the pre-war levels;
- foreign exchange reserves have edged down to $1.3 billion, compared with a peak of $1.8 billion in the months just after the war;
- construction activity has ground to a halt, and non-military imports have barely inched ahead in the past two years; and
- net immigration, 30,000 people a year in the early 1970s, has fallen to a trickle.

6. Peace would immediately give Israel a substantial shot in the arm. Reduced defense spending would permit -- indeed pressure -- the government to relax the austerity program and resume civilian construction

activity. The result would be a damping of inflation and a sharp boost in non-military imports, investment, and industrial production.

7. At the same time, cutbacks in defense, even with a moderate boost in other spending, could easily wipe out the budget deficit -- one of the main spurs to inflation. Skilled workers would be released to the civilian sector, easing the tight labor market. The military now absorbs 15% of available manpower in Israel, including both the standing army of 160,000 and reserve training time of about one month a year per man.

8. Peace and the reduction in military imports would mean immediate gains in Israel's current account position. The expected increase in civilian imports would be roughly offset by higher earnings from services and private transfers and from the continuing rise in commodity exports.

9. Peace would fairly quickly attract new resources to Israel. Tourism, already booming, would increase even more rapidly. Foreign investment also would rise sharply, particularly in the tourist sector and in re-export industries such as electronics. New immigrants, and reduced emigration, would reinforce the flow of labor into Israel's civilian economy. Israel would of course

also be able to tap workers in the Gaza Strip and West Bank who were laid off during the postwar slowdown.

The Arab States

10. In contrast to Israel, the Arab confrontation states have fared well since the war. Egypt, Syria, and Jordan have boosted economic growth rates, reflecting large reconstruction and development programs. Except in Egypt, where labor underemployment remains endemic, unemployment has disappeared, even among the Palestinian refugee population. The main problem has been periodic financial crunches, especially in Egypt which has been chronically in the red.

11. Only Egypt among the Arab states is facing a serious guns-or-butter dilemma. Cairo lacks the domestic resources to develop the military and civilian sectors simultaneously, even if the requisite foreign exchange were available. None of the Arab countries now has a defense industry of any consequence, and the military rolls are a serious drain on the workforce only in Jordan. Except for perhaps Syria, the Arab confrontation states have incurred no substantial new military debt since 1973; practically all purchases of Western arms have been financed by the Arab oil states.

12. The most immediate benefit of peace for Egypt would be the ability to expand its development of high-

potential oil fields in the Gulf of Suez; operations are now being harassed by the Israelis. Rapid development of the fields would yield 400,000 barrels of oil a day, worth roughly $1 billion to Cairo. Suez oil is Egypt's most promising export sector and its strongest magnet for foreign investment. Increased revenues from a widened and deepened Suez Canal -- one able to accommodate supertankers -- could yield several hundred million a year. Peace also would improve the confidence of foreign investors in other sectors and would insure a continuation of Egypt's current record tourist boom. Unlike the other confrontation states, Egypt would have to find labor intensive projects like roads, or export workers, to absorb redundant labor released from the military.

13. Jordan and Syria, although already developing rapidly, would benefit from a peacetime shift away from the military sector. Jordan, currently experiencing a tight labor market, would especially gain from a reduction in its standing military force. Both countries would experience a rapid rise in tourism and in new foreign investment.

14. A new Palestinian state would need access to the Israeli labor market as well as to the East Bank. With adequate foreign assistance, major infrastructure projects -- power plants, improved roads, etc. -- could get off the ground. Small scale Israeli-sponsored projects, such as hospitals, schools, irrigation, and the like,

would continue and trade with Israel would increase. The West Bank and Gaza now import $450 million in Israeli goods and services and export about $350 million.

Intraregional Trade

15. With the removal of barriers to trade, Israel's more sophisticated economy would add a new ingredient in an area that never has produced much commercial interchange. Both the oil-rich countries and the non-oil Arab states have filled nearly all their import needs from outside the region. Aside from oil, intraregional trade now consists of a small scale exchange of foodstuffs, textiles, footwear, and other local manufactures.

16. Israel already produces some goods that the Arabs now buy from the West and that would be redirected to Arab markets. The best candidates are processed foods, communications equipment, scientific and medical equipment, pharmaceuticals, and furniture. Israel has successfully marketed these goods in Iran, Western Europe, and the US. The mushrooming Arab market and the expected further development of the Israeli export product mix would set the stage for sizable intraregional trade. In addition to an exchange of advanced Israeli manufactures for Arab oil, gas, and other raw materials, a market could spring up for Israeli reprocessing of Arab petrochemicals and other semi-manufactures.

17. Even more important is the Israeli portfolio of technical services, especially medical, animal husbandry, and agricultural services; aircraft, ship, and heavy equipment maintenance and repair; computer services; and educational and vocational training, all of which are increasingly in demand in the Arab states. An Israeli niche in the Arab world could develop in these specialized fields. Israel's main advantage -- especially in training programs -- is a widespread fluency in Arabic.

18. Peace, together with rapid economic development should also open the doors to a free flow of labor and job skills throughout the area. Palestinians already are working in both Israel and the Arab states, tending to follow the trend in demand and relative wage rates. An open border situation would rationalize the Mideast labor market, equalizing wages. In addition to returning Palestinians, the release of Egyptians from military rolls would provide a new pool of skilled workers for the area.

<u>Intraregional Project Possibilities</u>*

19. A number of joint Israeli-Arab projects could materialize in a lasting peacetime situation. The most promising area is joint development and sharing of water resources, which are mainly required in agriculture.

* See Appendix for more details on regional projects.

In 1954, the Israelis proposed a regional water program to include Syria, Israel, Lebanon, and Jordan that would be centered on the development and utilization of the water resources in the upper Jordan and Litani river basins. The most significant aspect of the plan was the proposal to bring surplus Litani water to the Negev desert. The Negev region is the one area in Israel that would have access to nearby labor in Gaza. The project would double Israel's irrigated area.

20. The only other viable water scheme appears to be related to sharing of Yarmuk River flows. Tel Aviv and Amman have already agreed in principle on Yarmuk water allocations, with the US as an intermediary. Desalinization of seawater does not appear attractive at this time, even though proposals for large scale projects periodically surface and research has been underway for some time. Israel uses desalinized water for personal consumption, but the cost still is too expensive for agricultural use.

21. Israel also has proposed a Mediterranean-Dead Sea canal that would use sea water for electric power generation and would establish a chemical complex based on minerals extracted from Dead Sea waters. One attraction of the Israeli scheme is that it provides an alternative

to the Oakridge plan, which proposed the eventual application of atomic energy to power agro-industrial centers producing food, fertilizers, and light metals. The Israeli canal proposal would allow such development in the Jordan valley with hydroelectric rather than atomic power.

22. In the transportation sector, peace would enable the region to coordinate disparate programs. Projects to upgrade and add to the area's road network would be a logical joint activity and a good way to use former or even still active military manpower. Jordan and the West Bank would benefit greatly, as would Israel. Moreover, Tel Aviv maintains up-to-date and extensive repair and maintenance facilities for civilian aircraft and could perform these services for the area as a whole. Similar services are already being provided for Iran and some Black African countries. The international air transport route structure could also be rationalized, eliminating duplication of service. Arab access to Israel's Mediterranean ports would reduce transportation costs and possibly also open new markets.

23. Another possible project is a joint 1,000 mile pipeline that would supply Saudi natural gas to Jordan, Syria, and Israel similar to the TAPLINE operation, that

now supplies Jordan and Lebanon. The gas could be used as feedstock for a joint petrochemical complex as well as a fuel for cement, copper refining, or other industries. The Saudis now flare their natural gas.

24. Among mineral resources that could profitably be exploited in a joint venture are copper, potash, and possibly phosphates. Israel and Jordan have copper deposits in close proximity to each other which individually are only marginally profitable. Both countries also have potash operations at the Dead Sea, and the Jordanians have expressed interest in Israeli technical assistance.