The Economics of Middle East Peace

EDITED BY

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Foreword by Joseph A. Califano, Jr.

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Views from the Region

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Foreword

Joseph A. Califano, Jr.

The Institute for Social and Economic Policy in the Middle East was founded ten years ago on this proposition: politicians sign papers, but people make peace. This volume, the only one of its kind, records two years of extraordinary meetings of Egyptians, Israelis, Jordanians, Lebanese, Palestinians, and Syrians to discuss and develop common economic development plans for the Middle East. The Institute is proud to have this as its first book.

Located at Harvard University's John F. Kennedy School of Government, the Institute's unique mission is to put Middle East Arabs and Israelis together—to study and to work with each other on common problems ranging from economic development and environmental protection to health care and social services. In the process these professionals, Jews and Arabs—the latter either Christian or Moslem—come to appreciate that they share the same dreams for their children and grandchildren, the same concerns for the future, and the same hopes and anxieties. By harnessing their energies and skills, they lay a foundation for peace far more solid and durable than any number of international agreements.

No dream has been more cherished and elusive than the dream of peace for all in the Middle East. Just imagining peace between Israelis and Palestinians, and Israel and its other neighbors, has until recent months seemed an impossible dream. In the winter of 1992–1993, it remains an ideal in which hope takes precedence over experience. But at least, for the first time, something is happening that can fairly be called a peace process. Burdened by history, yet inspired by hope, the participants have turned their energies toward a joint search for peace throughout the Middle East.

Peace is not likely to come as a sudden transformation from the chronic conflict of past decades. It more probably will be achieved in bits and pieces, through laborious and uneven developments and understandings that move the parties along a bumpy, winding road. The search for peace demands courage from the political leaders on all sides, and understanding from their peoples and the rest of the world.

The Institute for Social and Economic Policy in the Middle East seeks to help ease the peace process by shifting attention from past to future, from history to hope. The Institute's focus is on palpable opportunities for economic cooperation among the parties once peace has been achieved—the kind of joint enterprises that can cement a lasting peace.

We are mindful that peace is a product of the parties engaging each other in serious discussion of concrete issues, arguing out disagreements, exploring constructive collaboration. While the initial emphasis of the Institute was on cooperation in the post-peace era, we now are deeply concerned with the economics of transition from conflict to peace. In our view, detailed policy planning for the transition period can accelerate the advent of lasting peace.

That's why the Institute has established the Seminar on Economic Cooperation in the Middle East. The Institute inaugurated the Seminar in 1989 at the John F. Kennedy School of Government. The Seminar brings together economists and business people from the Middle East as well as from Europe, Japan, and North America. Among the Middle East participants are Egyptians, Israelis, Jordanians, Lebanese, Palestinians, and Syrians. Participants from several Gulf States joined the Seminar in the summer of 1992.

This volume is a product of the Seminar, a record of a forum where for the first time in history, Arab and Israeli economists from these places worked together to discuss, assess, and identify opportunities for economic cooperation among all the peoples of the Middle East.

The guiding purpose of the Seminar on Economic Cooperation is to develop a framework for the economic development of the Middle East. To that end, the Seminar focuses on such regional topics as health planning, jobs, economic alliances, data banks, and joint ventures, public or private. In its first year, our Seminar sponsored several large conferences for a general discussion of economic issues. Then the focus shifted to discrete topics, examined in small workshops. At a 1992 workshop on regional health planning, Egyptian, Israeli, Jordanian, and Palestinian participants developed a proposal that called for early concentration on infectious diseases, health information systems, medical and paramedical training, establishing and improving health services and facilities in the West Bank and Gaza, and financing the delivery of health care.

The Institute is greatly indebted to the Seminar's Steering Committee of Harvard and Massachusetts Institute of Technology faculty members. This group includes Professors Thomas Schelling, who acts as chair, Richard Eckaus, Stanley Fischer, Frank Fisher, Richard Freeman, Zvi Griliches, Joseph Newhouse, Dwight Perkins, Henry Rosovsky, and Lester Thurow. They have all participated actively in the Seminar and its workshops.

In addition to the Seminar on Economic Cooperation, The Institute for Social and Economic Policy in the Middle East sponsors the Middle East Educational Fellowship Program, which brings midcareer professionals in the fields of health, human services, and income security from the region to study for one year at the Harvard School of Public Health and the Kennedy School of Government. The Fellows so far have included Egyptians, Israelis (both Arab and Jewish), Jordanians, Lebanese, and Palestinians, and shortly will include Syrians as well as Fellows from the Gulf countries. The Fellows live and work with each other, helping to prepare for shared endeavors in the Middle East, as political circumstances permit. In great measure, this program owes its start and vitality to John Cardinal O'Connor, the Archbishop of New York, the chairman of the Institute's Fellowship Committee.

The Seminar on Economic Cooperation has functioned since September 1989 only through the generous support of far-sighted philanthropists, led by Charles R. Bronfman and Zein A. Mayassi. Important contributors include Malcolm Brachman, Leo Fields, Leo Kahn, Paul Singer, Henry Taub, and Investcorp. I also wish to acknowledge the significant generosity of: Omar Al-Askari, Nicholas Chammas, Max Factor III, Alan Gold, Edwin Jaffe, Raymond Johnson, Melvyn Klein, Leo Nevas, Lyndon Olson, Irving Rabb, and Bernard Rapoport. Most of the above are members of the Institute's unique board, composed as it is of leading Arabs, Palestinians and others, and Jews.

The Institute for Social and Economic Policy in the Middle East hopes that this, its first book publication, will contribute to the quest for peace in the Middle East.

Joseph A. Califano, Jr.
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The Institute for Social and Economic Policy in the Middle East
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We wish to thank Professors Stanley Fischer, Dani Rodrik, and Elias Tuma for editing the first published volume of The Institute for Social and Economic Policy in the Middle East. Their sustained effort is greatly appreciated. As well, we would like to acknowledge the contributions of the authors of the papers.

The board of this Institute, led by its chairman, Joseph A. Califano, has guided, financed, and defended the Institute through a difficult first decade. On the occasion of the Institute's tenth anniversary, this volume is dedicated to the members of its board.

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Director

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(compared to 5% in all developing countries). Consider that political instability and the prospect of regional hostilities are the prime deterrent to private investment in the region, both domestic and foreign. Consider that the continuous threat of war has legitimized and entrenched inefficient, inward-looking development strategies, as well as authoritarian political regimes. Consider finally the huge loss of human life, as well as of human and physical capital, in the recurring conflicts of the region. Can anyone seriously doubt that real, durable peace will be an economic boon to the countries of the Middle East?

The answer at the most fundamental level is of course negative. War, or the threat of war, is costly to human life and well-being. The chapters in this volume describe in great detail the detrimental economic consequences of war and the potential benefits of peace for each of the economies in the region. However, one of the important themes that also emerges is that the full benefits of peace, even a comprehensive and durable peace, will not be reaped automatically. Transition costs will have to be paid as armies are demobilized and military factories converted to civilian uses. Governments will have to change the way they manage their economies. They will have to liberalize their economies to unleash entrepreneurial energies in the private sector and balance their budgets to stabilize the macroeconomic environment. Although the transitional costs can be partially offset by external capital inflows, the availability of large amounts of external financing is uncertain and will depend in any case on domestic policy. Hence the benefits of peace will accrue primarily to those countries in which the required changes are undertaken.

What, precisely, are these benefits? As El-Naggar and El-Erian point out in their chapter, peace allows a higher level of national security to be "purchased" at a lower level of spending, and is therefore just like an exogenous improvement in an economy's technology. The resources released can be used to increase present consumption as well as future consumption through productive investments. Because military spending is so high in the Middle East, the potential for such benefits is very large indeed.

Some simple calculations can help quantify these benefits. Suppose that the countries concerned reduce their military spending from the current level of 15% of gross domestic product (GDP) to the developing-country average of 5%. This would release resources worth 10% of GDP. Note that this is a *permanent* increase that would accrue year after year: with a discount rate of 8% (and no growth otherwise), the present value of the savings would be 125% of current GDP. Now suppose further that only half of the resources saved (i.e., 5% of GDP) are invested. At an incremental capital-output ratio (ICOR) of 3, this would yield a permanent increase in the economy's growth rate of 0.05/3 = 1.67%. At a higher ICOR of 4, the increase in growth would be 0.05/4 = 1.25%.

These increases in growth are as large as any that economists can hope to engineer by their usual advice on policy reform. Moreover, this may not be all. The diminished external threat, we hope, can unleash policy reforms that have been resisted before. The private sector may be given freer rein, regulations and controls eased, and trade liberalized. With the burden of military spending greatly reduced, fiscal deficits and macroeconomic instability may become easier to escape. One effect of these changes in the policy environment would be to channel investments to more productive areas, and to lower the economy's ICOR. This would magnify the effect of the increase in investment. For example, a reduction in ICOR from 4 to 3 on marginal investments would yield an additional increase in growth under the above scenario of just under one-half of a percentage point (0.42%).

In addition, private capital, from both domestic and foreign sources, may be crowded in. As domestic economic management improves and the threat of regional hostilities disappears, investors are likely to perceive the region as a much better investment risk. Although precise figures do not exist, it is widely believed that past capital flight has led to the accumulation of vast resources abroad. If the experience of Latin America is any guide, we can expect a portion of these resources to be repatriated some years after the economic (and political) situation stabilizes.

Finally, peace will make regional economic integration more probable. Looking at regional trade from the perspective of basic customs-union theory, the presumption would be that the economies of the regions are basically competitive with (rather than complementary to) one another and that their natural trade partners are countries *outside* the region, not their neighbors. This would limit benefits from regional trading arrangements such as free trade areas or customs unions. Some integration will take place naturally, however, even in the absence of regional arrangements designed for that purpose: trade flows will become less distorted by the effects of enmities, boycotts, mutual restrictions, et cetera. Arab countries are a natural market for Israeli-manufactured products, as Nadav Halevi argues in his chapter. Egypt's trade with its Arab neighbors is at ridiculously low levels (see the chapter by Heba Handoussa and Nemat Shafik), and this trade can only increase. Moreover, given the small size of the region's economies and the ubiquitous externalities, there is much to be gained by cooperating in areas such as water and infrastructure (e.g., power plants, airports, hotels, tourism projects).

Hence it is not difficult to construct a virtuous-circle scenario under which all of these beneficial consequences feed on one another and enhance the effect of the others. The *indirect* benefits of peace in the form of repatriated private capital and increased incentives for economic reform may turn out to be quantitatively more significant than the direct peace dividend through cuts in military spending.

There is no inherent reason this scenario could not be made a reality. But note the various links in the chain of logic. Peace must be real and durable, and perceived as such. Governments must take advantage of peace to reduce military spending. The resources thereby released must be used—at least in part—for productive investment. Governments must elect to reform their macroeconomic and microeconomic policies. The economies must experience an increase in the efficiency with which resources are utilized, and not get bogged down in transitional adjustment costs.

While one of the central themes in this volume is the large potential for gains, others are more cautionary. Practically all of the chapters stress the need for domestic policy reform in order to reap the peace dividend. They also stress the likely transition costs in the short run, as budgets are adjusted and resources are reallocated. They caution that unless peace is comprehensive there will be little economic gain: the Israeli and Egyptian peace dividends from the Camp David accords were constrained by the continued state of war in the broader Arab-Israeli relationship. They also highlight two important uncertainties in the background. First, how likely is peace to enhance—rather than reduce—the incentives of governments to undertake economic reforms? Second, can external capital inflows be mobilized in adequate quantities to enable the reforms and alleviate short-term costs?

To varying extents, all countries of the region suffer from a complex syndrome of inefficient economic policies and bloated government budgets, a syndrome made possible by external capital inflows and the perceived needs of national security. How are governments likely to respond to changes in the external political environment? On the face of it, the reduction of the external threat should make governments more willing to adopt efficiency-enhancing reforms such as trade liberalization. As noted above, the real gains of peace will be reaped by countries that choose to do so. But as Diwan and Papandreou remind us in their chapter, things need not be that simple. There is considerable latent political instability in many countries of the region due to high levels of urbanization, unemployment, and repressed political activity. The elimination of the external enemy may make it more difficult for these governments to contain the instability. Under the circumstances, economic liberalization, with its short-term costs and dislocations, may be perceived as too dangerous by fragile governments. Paradoxically, this would only delay the economic benefits of peace.

The problems may be eased, and incentives for policy reform enhanced, by making external capital available at generous terms in the wake of peace. But here we face another question mark: what are the likely consequences of peace for the magnitude of external capital inflows? There is some feeling in the region that "good behavior" at the peace talks is likely to be rewarded by the West with financial assistance. However, it is not clear to us from where this assistance would come. Western Europe has its hands tied in the reconstruction of Eastern Europe; the United States has severe budgetary problems; and Japan has so far shown little direct interest in this part of the Middle East. Moreover, much of the Gulf money may dry up as the motivating reason—the state of war against Israel—disappears. This leaves only the multilateral institutions (the International Monetary Fund and the World Bank) and private sources (mainly repatriation of flight capital). Funds from these sources are unlikely to add up to a Marshall Plan for the Middle East. Hence, an extended financial bonanza in the wake of peace is unlikely. This may be too gloomy a picture to draw, but it is intended only to warn against unrealistic expectations, and to focus more intensely on peace as an economic asset in its own right and the potential gains from reduced military spending.

An Overview of the Volume

The contributors of this volume were asked to analyze the potential economic benefits from peace between the Arab countries and Israel, especially those arising from trade and economic cooperation. They did so in their individual capacities, as professional economists. The issues underlying a future Arab-Israeli peace are complex and intensely political, and the participants had different views on the essential elements of a durable peace. Rather than attempt to reach an agreement on this issue, on which we have no comparative advantage, we agreed that each participant should make his or her own assumptions about the political outlines of a future peace. Most of the authors in the volume have assumed there will be a Palestinian state.

The views expressed in these chapters are those of their authors and do not represent the views of the institutions with which they are affiliated, the editors, or of the Institute for Social and Economic Policy in the Middle East. As editors, we have tried to interfere as little as possible with the substance of the papers, except for technical issues that we felt needed clarification. However, we did provide all the authors with comments and suggestions for their consideration in preparing the final version.

In the first of the two regional chapters, Said El-Naggar and Mohamed El-Erian deal with the economic implications of a comprehensive peace in the Middle East. The key word here is comprehensive, which means that peace will be voluntary, durable, and satisfying to all parties, and therefore conducive to free economic interaction among them. In these circumstances, economic and structural reforms deemed necessary would become feasible, though they would not necessarily follow. Commitment to reform by policymakers of each respective country would be necessary to realize the economic benefits of this comprehensive peace. El-Naggar and El-Erian conclude that the benefits of peace would certainly be high because of the reallocation of resources that would follow in favor of productive activities, trade expansion, economic reform, and reduction of risk. These benefits would be enhanced by joint ventures, development of regional infrastructures, and eventual economic integration, all of which would be conducive to expansion of foreign trade and assistance. These potential benefits would of course require special financial institutions to make them possible. Peace would facilitate the establishment of these institutions and bolster the spirit of cooperation.

Ishac Diwan and Nick Papandreou focus on the relationship between peace and economic reform, noting that economic fluctuations in the 1970s and 1980s in the Middle East suggest the need to promote economic stability. Reform has been difficult, however, because the war environment creates rigidities that obstruct change. Furthermore, economic reform, as proposed by international institutions, tends to be perceived as threatening, especially because those types of reform have not always proved to be credible and effective. Finally, economic reform tends to be costly and redistributive and once again forms a threat to those in seats of power. A peace environment, in contrast, could have an impact on the economies of the region in at least three ways: by removing the negative factors generated by war; by giving more freedom and incentives to the private sector; and by increasing the probability of receiving foreign assistance, at least in the period immediately following a peace agreement. Gains may also be realized by potential cooperation in such areas as regional water use and management, labor mobility, and economic stabilization policies. The authors, however, are careful to warn that a peace agreement by itself does not guarantee benefits. In the immediate period following peacemaking, instability and dislocation may occur. Therefore, aid and cooperation from outside the region may be necessary to restore stability and help the respective countries adjust to the peace economy and environment.

In discussing these two chapters, John Waterbury raises some sobering and somewhat pessimistic observations. Both chapters seem to him to be too optimistic because they concentrate on economic variables only, virtually ignoring the unfavorable political structures and the regimes that dominate the Middle East region. Peace and economic cooperation are real possibilities, but unless basic changes in the political structures take place, it is unlikely that many of the potential benefits can be realized.

The next six chapters are case studies of the economic benefits that could accrue to individual countries as a result of peace. Heba Handoussa and Nemat Shafik analyze the economics of peace as applied to Egypt, a country that has had a decade of peaceful relations with Israel. The economic effects of the 1978 settlement with Israel, according to the authors, have been modest. Egypt still spends a high percentage of its GNP on defense, and few economic benefits can be observed. The positive effects have been limited because the peace settlement was partial, neither exhaustive nor applicable to other countries in the region, because of the boycott imposed on Egypt and because of the cut in aid it received from the oil-rich countries.