TOWARDS A TRADE POLICY FOR PALESTINE

Osama B. Dabbagh and Quhafah Mahasneh

Working Paper 2038

Abstract

International trade plays a pivotal role in the context of the Palestinian economy that goes beyond defining a prospective framework for export and import flows. This study in particular, sets out to outline pros and cons of two types of trade connections and trade cooperation that could exist among Palestine and both Jordan and Israel; viz., the special arrangements related to establishing a customs union ,or those related to the formulation of a free trade area. In brief, our analysis suggests that a trade policy responsive to Palestine's economic interests would gain by changing the nature of existing trading relationships with Jordan and Israel. If the present trends persists the absence of tariff protection from Israeli and Jordanian competition, and other forms of government support will mean that Palestinian industry would only likely to develop when it plays a role complementary to those prevailing in these two countries. Therefore, we see that the objective of trade policy should address, above all, the issue of regaining balance to the Palestinian economy through the use of incentives and tariffs. In this way local industry can grow protected from the existing biased entry of Israeli produce.

I. Introduction

For almost five decades the normal external economic relationships of the West Bank and Gaza (WBG) with neighboring countries, have been distorted; due to political reasons. The 1948 war resulted in the severance of normal economic ties for these two regions with the larger more developed part of Palestine that became Israel. Since 1967 trade with Israel has been restored but has been dictated by all kinds of prohibitions and regulations. Also, the Arab boycott of Israel by Jordan and other Arab countries was applied to trade with the occupied territories. In recent years the restriction on trade and development intensified during the first *intifada*, as the endogenous Palestinian people introduced their own boycott of Israeli produce, resulting in even tighter Israeli restrictions on trade and labor movements from the WBG.

Recent years have witnessed additional hindrances to the WBG economy. Since the 1988 Jordanian disengagement from the WB, there have been restrictions on the export of products from the territories to Jordan, and following Iraq' s 1990 occupation of Kuwait and the PLO stance on the issue, exports to the Gulf states have also been restricted.. Finally, the WB has been gravely hurt by the 40-50 percent devaluation of the Jordanian dinar (JD) and the reduction in the transfer of remittances from Palestinian expatriates working in the Gulf states.

More recent developments on the political sphere resulted in a limited autonomy for the WBG that could hinder their progress to full statehood. On the economic sphere, two arrangements were negotiated between the Palestinian entity and both Jordan and Israel. These were intended to set guidelines for future economic and trade associations among these countries. In particular, they implicitly envisaged arrangements that could develop into closer economic and trade integration by reviving past institutions (e.g., reopening branches of Jordanian banks in the WB), as well as evoking new frameworks that could better address changing economic needs of the area..

These asymmetric economic and trade relations of the WBG are among the main reasons for the downward trend in 'the endogenous population's real standard of living the high unemployment rate and the uncertain nature of economic development. Above all, the local economy remains highly vulnerable to external developments as shown vividly by the economic hardship being experienced in the aftermath of the recent border closure with Israel in response to the on-going second *intifada* that began in September 2000.

2. Trade: Past Developments and Constraints

The two most striking developments in the WBG trade during the past three decades are a major redirection of trade towards Israel and the emergence of a large trade deficit. From no trading relations before 1967, Israel has become practically the sole trading partner of the WBG; exports to Jordan as a share of total WBG exports declined from 45 percent in 1968 to 15 percent in 1991.[1] Exports to Jordan are constrained by regulatory and security restrictions imposed by Israel, as well as by requirements regarding proof of origin and seasonal quotas on agricultural produce imported by Jordan especially since the mid-1980s.

Furthermore, as a result of the security restrictions imposed by Israel, the WBG can import virtually nothing from or through Jordan, although in a number of cases (cement, household durables, agricultural inputs) Jordanian products could prove competitive in the WBG.

The Arab economic boycott of Israel as it is related to the WBG, as well as other impediments to free trade with the world community, have also acted to further distort the trade pattern of these two regions. In fact, if one looks at the factors relating to the geographical proximity, the freight advantage, the economic size and cultural and social similarities, one could conclude that Israel's dominant share in the WBG trade would have been much lower. In the absence of trade restrictions imposed by the military occupation, Jordan, Egypt, the Gulf states and European countries could have become significant trading partners for the WBG. The disproportionate reliance on Israel for exports is in part related more to the development of subcontracting of Palestinian industry for Israeli firms

[1] See, The World Bank, Developing the Occupied Territories: An Investment in Peace, vol. 1 (Washington D.C., September 1993) p.8

(especially in clothing and footwear) rather than to normal comparative advantage in manufacturing.[2]

In addition, the heavy reliance on Israel for imports has in many cases lead to inefficient supplies of inputs for the WBG manufacturing industry and agriculture, diminishing their overall competitiveness. These asymmetric trade patterns have been accompanied by a relatively sizable trade deficit for the WBG, which in 1997 was as high as US$ 1856 million, or 44 percent of GDP. This trade deficit was mainly with Israel, while the occupied territories enjoyed a trade surplus with Jordan. (See Table 1.)

Although the trade deficit with Israel has been to a large extent offset by incomes of Palestinians working in Israel, the resulting reliance on a single market has made the WBG's economy highly vulnerable to external shocks. A collapse in labor income from work in Israel or the obstruction of free trade with the WBG, has a depressive effect on domestic growth and should draw attention to the adjustment problem that will face the national authorities in the future.[3] This suggests two lines of trade strategy to be considered.

First, a reversal of the trend of dependence on the Israeli market for exports and imports by exploring new trade openings for Palestine. Second, reasserting the issue of trade policy for Palestine with a view to examining how the total effect and nature of external policies facing the country could affect its development prospects, followed by assessing how far these conditions need to be taken into account in Palestine's development strategies. It must be noted, however, that since this exercise is abstract in nature, given the basic layout of trade policy is non-existent for Palestine, this paper will draw on the experiences of emerging industrialized countries in Asia and Latin America.

[2] See, B.V.Arkadie, Benefits and Burdens: A Report on the West Bank And Gaza Strip Economies Since 1967, (New York, Carnegie Endowment for international Peace, 1977) p. 84-7

[3] In the 1970s, B.V.Arkadie was first to draw the attention to the adjustment problem and stressed the necessity to take offsetting measures to disentangle the WBG economies from that of Israel. See, B.V.Arkadie. Ibid., pp. 53-76

3. Prospective Export Markets for Palestine

Of all the factors that would determine the economic viability of Palestine and the direction of its development, market demand for its produce appears to be among the most potent.

The WBG currently produce considerably more agricultural products than can be absorbed locally.[4] Some products are exported, however, three factors have been the main contributors to a substantial decline in agricultural exports: Demand for agricultural products has changed in export markets, quotas have been imposed on imports of agricultural products by Jordan, and the competition in local and foreign markets.[5]

As far as manufacturing is concerned, the primary channel of distribution in the WBG is direct sales to customers, which was practiced by almost 80 percent of industrial undertakings in 1989.[6] The result of this practice has been the concentration of marketing channels in a limited geographical area, with the effect, in the case of many products, of reducing competition and introducing inefficiencies. In other words, the WBG are suffering lost opportunities in trade, marketing and development prospects.

In a normal situation where the WBG would be allowed free unimpeded entry to international markets, the development of the acquired marketing skills and distribution systems for both exports and domestic markets would most likely have introduced greater efficiency and would have helped promote product and market diversification.

The underdevelopment of marketing systems and distribution channels have reduced competition and affected efficiency by limiting the capacity of manufacturers to expand markets. Therefore, the development of the trade sector requires an enabling environment that includes an appropriate legal framework, especially with respect to contracts and collateral; an efficient

[4] See, O.B.Dabbagh, Indicators of Economic Performance in Occupied Palestinian Territories, (Amman, Jordanian-Palestinian Joint Committee, 1989).

[5] The World Bank, *op. cit*., vol. 3, pp. 33-4

[6] A. Abu-Shokor, A.Saleh and A.Alawneh, *Industrialization in the West Bank*, (Nablus, Al-Najah National University, 1992).

financial system; good communication systems, and workable transport system.[7]

If Palestine's future trade relationships are freed from existing restrictions and impediments, what might be their overall pattern?

Exploring the potential trade pattern for Palestine, the World Bank mission to the WBG in 1993 employed a simple approach based on a few key variables that include the size of relevant economies, economic distance among them and other variables such as common language.[8] Although results from that approach should be treated with caution,[9] the model is useful in so far as it is indicative of future trends in trade.

One very revealing result from the mission's report is the view that the extent to which the WBG are oriented toward Israel in their trade patterns, is far greater than what would have been expected. Even under a scenario that assumes a common language and a free trade area, Israel's share in Palestine's trade would not be expected to exceed 36 percent of total exports, and 20 percent of imports, as compared to 90 percent of exports and 75 percent of imports in the late 1980s. Trade with Arab countries would be expected to be much higher, at 40 percent of total exports, but a rise in trade with Europe, to some 15 percent of total exports, could also occur.[10]

On the other hand, a measure of what might have happened in the absence of the post-1967 customs union with Israel, is shown by the share of trade if neither a common language nor a free trade area is assumed. The report suggests that the share of both exports and imports with Israel would have been a mere two percent under these conditions.[11]

While, these results should be approached with caution, they do nevertheless support our assumption that the potential trade pattern of Palestine would be much more diversified, in the absence of existing regulations and restrictions.

An important issue that would affect Palestine's capacity to develop export markets beyond that of Israel, relates to its successful attempts to optimize a production structure, either in agriculture, manufacturing or in services, that caters more to existing demand in these markets. Although Palestine could begin its export drive with labor-intensive products, overtime it should be able to shift the composition of its manufacturing exports in particular, towards more sophisticated and knowledge-intensive products that make use of the skilled Palestinian work force. However, any successful drive in this direction would require that exporting firms keep up with modern technology and bring managerial skills up to international standards to maintain and improve their markets.

While, the overall quality of the Palestinian labor force is important, the number of people with technical and managerial skills is also relatively high. From a very general point of view, it is clear that the level of education and skill of the labor force, whether in the WBG or in the Diaspora is reasonably above that of neighboring countries, with the exception of Israel. Nevertheless, it will be important for the Palestinian authorities to exercise a very strong influence on the process and direction of education in order to meet the demand for the high-quality labor needed to build a sophisticated, advanced manufacturing industry.

Arab countries, especially oil-producing Gulf states, are a natural target for industrial goods and for services. Their proximity should act as an advantage. Although the competition for this market is fierce, it still amounts to about US $50-60 billion, mainly in civilian goods. Thus, capturing one to two percent of this market (equivalent to some 40-50 percent of the territories' GDP) could mean a breakthrough for the Palestinian economy. Sharing a common language, culture, life style and

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[7] See, The World Bank, *op. cit.,* vol. 3, pp. 33-4.

[8] The World Bank*, op.cit.,* vol. 2. See annex 3 for a description of the "gravity" model employed in the study and related empirical estimates.

[9] The model does a poor job of catching the consequences of very short trading distances to Israel of almost all locations in the WBG. The model does not also address the question of what happens to overall trade levels, but simply trade shares. It does not examine relative competitiveness, and it is almost entirely policy-free. However, it is the only model with any success in explaining international trading flows.

[10] The World Bank, *op.cit*., vol. 2, pp. 45-6.

[11] The World Bank*, op.cit*., vol. 2, pp.45-6.

particularly knowledge of the special traditions of doing business and the many contacts which the Palestinians have acquired through their Diaspora, should provide a comparative edge over other-non-Arab exporting countries. However, any successful penetration of this market would depend on the ability of the Palestinian economy to provide an extension in the range of exportable products, in which it would not have to face the Gulf states competition for these products or sectors.

In this context, perhaps Jordan stands as a special case in lost export opportunities due to political developments in the past. Since 1967 the East Bank and the West Bank of Jordan have gone separate ways in the pursuit of economic goals, with Jordan growing less dependent on the West Bank in lines of production in which the latter formerly had a comparative advantage. Recently, Jordan has grown self-sufficient in almost every item of production that was imported from the WBG. Accordingly, import quotas and time limitations (which are negotiated annually) limit the amount of WBG products that may enter Jordan. In order, therefore, to recapture this rather important market it is imperative that the Palestinian economy grows less competitive with that of Jordan, in both agriculture and industry. This should translate into serious steps to coordinate production policies in the two countries along lines that are determined by the concept of relative advantage.

Perhaps, the trade options facing Palestine are the same as those that faced Israel in its pursuit of trading relationships. A relatively small economy with virtually no natural resource base of commercial value and dependent on external aid for economic survival, Israel considered its trade relationships with the advanced economies of Europe and North America as vital to improve product quality and to stimulate competition and efficiency.

With the development of industrial and agricultural know-how, of appropriate marketing methods that satisfy the high demand in quality and standardization, and the establishment of more sophisticated industries, Palestine might also become a competent competitor in the Western markets. But this is a process which takes time. The often-cited successes of Israel, Singapore, Hong Kong, Malaysia and South Korea have not been achieved overnight; they are the result of efforts over a protracted period of time.

Israel's experience in the export of agricultural products in particular, is a useful example that Palestine could benefit from. The limitation of the local demand has forced Israel to seek markets in Western Europe where agricultural products are consumed in large quantities. However, Israel has always realized that it is rather naive to draw export plans, which concentrate only on consumption figures. Israel's experience has indicated that the penetration into the European market is a rather tedious process requiring a search for crops and seasons in which exports are economically feasible.[12.] In this context, concentration on "off-season" exports of carefully selected agricultural items could prove highly profitable for Palestine as well.

4. Perspectives on Trade Policy

The question of the role of policy toward trade in developing countries has been extensively investigated,[13] but a review of the literature is outside the scope of this paper. Some of the elements of the debate, however, offer lessons in the search for an "optimal" policy structure for Palestine.

In brief, three conclusions would seem to emerge from the studies of developing countries' trade policies, particularly the countries referred to as the newly industrialized economies of South-East Asia.[14]

Firstly, that policies can matter to trade, but secondly, that the way in which they affect trade, and through trade the rest of the economy, depends strongly on how exporters, potential exporters and importers respond to them, rather than simply a focus on the legal details of the policies. Thirdly, it is also relevant; that the way in which policies interact beyond their effects on exports and imports, and on other areas of the economy, depends on a variety of conditions in each country. Any conclusions from the experience of other countries with regard to trade policy should be placed in

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[12] See, H. Ben Shahar, E.Berglas, Y.Mundlak and E.Sadan, *Economic Structure and Development Prospects of the West Bank and Gaza Strip,* (Santa Monica, Rand, September 1971) pp. 127-45

[13] 13 See for example, S.Page, *How Developing Countries Trade* (London, Routledge 1994), and Chowdhury and I.Islam, *The Newly Industrializing Economies of East Asia* (London, Routledge 1993)

[14] See, S. Page, *Ibid*.

the context of these conditions and any attempt at generalization should not be encouraged.

The first of these conclusions - that policy matters - helps to justify our study of trade policy for Palestine, although the second and the third will be equally relevant in our case. In particular, it is possible to show a change from a reduction to an increase in protectionism in the Arab countries and in Western Europe (the existing market for exports from the WBG). More recently a process of reduction in protective measures in some developing countries has begun, which could constitute a potential export market for Palestine. Of course, there are identifiable differences in the distribution of protection in these markets, arising from the nature and extent of preference arrangements, as well as differences for different products or for different stages of production. All these could affect the total value or the composition of Palestine's trade.

The purpose of this section is to examine how the external policies facing Palestine can affect its production strategy by their total effect and their nature, and therefore, how far such conditions need to be taken into account in the country's own industrialization strategy. However, we will need to look beyond this to suggest the range of possible responses. This means looking at the scale and nature of each of the possible policy interventions, and then examining how they could interact, and what possible reaction they could generate from Palestine's trading partners (Jordan and Israel in particular).

Exploring trade policy options for Palestine is exhausting experience full of paradox. On the one hand, there is an extensive range of choices of trade options ranging from the status quo of incomplete customs union with Israel, to alternatives with Jordan, with or without Israel, to free trade areas as a variant of these, to going it alone with an independent trade and industrialization policy. On the other hand, actual choices will be impacted by the political and economic negotiations and by the costs and difficulties of having a customs border between Palestine, Jordan and Israel.

The present, almost total dependence of WBG on trade with, or via, Israel is the result of the incomplete customs union, which has been imposed upon them since 1967. It thus reflects both trade creation and trade diversion. A negative factor causing trade diversion has been the imposition of the Israeli customs tariffs on imports from the rest of the world. These are generally much higher than those which were applied during the Jordanian rule over the West Bank. Thus, for example, the average duty on manufactured goods imported into the WBG, rose four-fold, almost overnight in 1967.[15] Raising the price of imports from the rest of the world, but not from Israel, the higher tariff could have been expected to result in manufactured goods being substituted by Israeli commodities, which have been exempt from tariffs. By the same argument, this should also have encouraged domestic production in the WBG as substitution for this category of imports. However, in view of the very narrow production base the practical effect, if any, has been negligible. On the other hand, as exports from the WBG continue to enter Jordan duty-free, the trade diversion effects on exports could have been expected to be comparatively small when compared to those on imports.[16]

In view of these developments trade policies available to Palestine will be dependent upon the choice of trade regime that could take effect between it and both Jordan and Israel. For reasons which are apparent in the preceding analysis, it will be quite difficult, at least in the short-term, to retrogress to the pre-1967 total absence of trade with Israel. The question of a trade relationship with Israel becomes, therefore, one of the customs tariff policy to be chosen by Palestine.

In this respect, there is the relevant question of how far Palestine can have an incentive regime significantly different from the one in Israel. One scenario that could make that impossible is if a free trade regime takes effect between Palestine and Israel. The open border would imply that Palestine would have to have the same tariff and indirect tax structure as Israel. This would not affect the status of imports from Israel (which are already admitted duty-free). However, if a free trade regime is extended to include, in addition to Israel, Jordan and other potential markets - while it would not affect imports from Israel - it would greatly reduce Israel's role

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[15] E.Kleiman, " Some Basic Problems of the Economic Relationships bBetween Israel and the West Bank and Gaza", in S.Fischer, D. Rodrik and E. Tuma (eds.), *The Economics of Middle East Peace,* (Cambridge, the MIT Press 1993) p. 318.

[16] On this point see, O.Hamed and R.Shaban, "One- Sided Customs and Monetary Union: the Case of the West Bank and Gaza Strip Under Israeli Occupation", in S.Fischer, et.al., *Op.Cit*., pp. 117-48.

as the main supplier of imports by reducing the cost of competing imports from other sources. However, due to geographical proximity to Palestine, Israel is expected to continue to have a freight advantage *vis-à-vis* other sources of imports.

An extended free trade regime, on the other hand, would also remove the competition protection from sources other than Israel, particularly Jordan, which domestic producers in the territories enjoy under the Israeli tariff. In view of the rather superior industrial structure that prevails in the East Bank, the effect of any ensuing decline of protection could be harmful to the fledgling infant industries that could materialize in Palestine.

The key question is whether or not the industrial policies of Jordan and Palestine can be coordinated in such a manner as to produce uncompetitive production patterns over the long-term. Any feasible trade relationship with Jordan over the short-term, however, would require the removal or relaxation of the existing regulations imposed by Jordan on imports from the WBG. This step will encourage the expansion of manufacturing and raise its total trade volume.

If administrative feasibility is not a constraint, how would this option be evaluated? In fact, there is no obvious answer, in part because it would depend on what Jordan and Israel may be willing to offer on the issue of trade deregulation. In addition there is perhaps an urgent need in Palestine to go beyond the issue of market opening and trade deregulation in order to initiate the growth and reorientation of its productive sectors after almost three decades of operating under an extensive set of biases.

On the first issue, i.e., the reaction of both Jordan and Israel to trade deregulation, our analysis seems to abstract from the interest of these two countries. As long as these two countries continue to maintain protective measures towards international trade in general, they might be unwilling to see it circumvented by the free entry of imports from Palestine. One possibility, therefore, is that these countries could resort to subjecting imports from Palestine to their tariff schedules. Alternatively, they could solve the problem by excluding imports from Palestine originating elsewhere.[17] In principle, however, both such alternatives - exclusion and differential tariffs - are difficult to enforce, and both invite evasion and smuggling.[18]

Israel, unable to check smuggling across its border with Palestine, might pressure it into adopting a customs tariff on imports from the rest of the world similar to its own in lieu of a free trade policy. Palestine, in consequence, would be facing a problem of choosing between two alternatives that are not in its best interest: either accepting Israel's demand, or having to face the latter's tariff barriers applicable to agricultural products in particular.

In. the first eventuality, a customs union with Israel, not basically different from the existing one, could be the result of Palestine's acquiescence to Israel's demand. Nonetheless, unlike the present situation, Palestine may be deprived of duty-free access to international markets, resulting in an increased dependence on Israel. In the second eventuality, Palestine would loose its comparative advantage *vis-à-vis* Israel in some limited basic agricultural products, which at present find a market in Israel.

On the second issue, i.e., the search for a trade policy that could foster unbiased economic growth in Palestine, our analysis so far has ignored the question of how far a free trade regime would affect the country's capacity to provide for long-term sustainable growth. The external connections of the WBG through commodity trade have exhibited a pattern characteristic of less developed regions. The WBG are primarily producers of basic agricultural products and importers of manufacturers. However, the limited development of the local industrial sector has been a result of factors both internal and external to these regions.

Even with protection or other support, comprehensive industrialization could not be readily achieved. The local economies are small and natural resources limited. Any claim that there is a swift and straightforward path to industrialization would be naive. However, any national authority concerned with the long-term needs of Palestine would naturally concern itself with the selective development of industry, seeking to develop some expertise in new lines of industrial endeavor for the local and export market – similar to what Israel did with its own industry.

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[17] On this point see, E.Kleiman, *op.cit.*, pp. 324-25.

[18] *Op.cit.*, pp. 324-25.

Whatever the immediate costs and benefits of the existing trading pattern there will be long-term consequences on the industrials structure of Palestine. If the present trend persists, the absence of tariff protection from Israeli and Jordanian competition, other forms of government support will mean that Palestinian industry would only likely to develop when it plays a role complementary to these two countries' industry. In the extreme case, in relation to some agricultural products, the subsidization of Israeli producers will make it particularly difficult for Palestinian producers to compete.

As it is often the case with newly emerging industrialized economies[19] (South East Asian countries are cases in mind), the Palestinian economy should opt for a protective tariff policy, both with respect to the world-at-large and with respect to Israel, in particular. Such a policy would temporarily be trade destructive; as by making imports more expensive, it will encourage their substitution by domestic products, this being the reason behind its adoption (protection for domestic infant industries).

There is, of course, a school of economic thought that judges such an absence of industry to be perfectly sensible. The argument is that any industry created with the support of heavy protection is of no benefit, and that regional division of labor (that is among Palestine, Jordan and Israel) is both rational and economically efficient.[20] Such a view is, in fact, unsubstantiated by the experience of newly industrialized nations of South East Asia, Latin America. Moreover, Palestinian opinion, critical of existing policies that perpetuate industrial backwardness in the WBG, reflects a viewpoint widely held in the Third World in general. This opinion is based on a plausible interpretation of the nature of economic underdevelopment.

[19] In the case of the newly industrialized economies of East Asia, see for example S.Page, *op.cit*., A.Chowdhury and I.Islam, *op.cit*., and D.Siddon and T. Belton-Jones, "The Economic Determinants of Economic Flexibility with Special Reference To the East Asian NICS", in T.Killick (ed.), *The Flexible Economy*, (London, Routledge 1995) pp. 325-65. For the policy of Israel, see for example, N.Halevi and R.Klinov-Malul, *The Economic Development of Israel*, chapter 10, (New York, Praeger 1968), H. Pack, *Structural Change and Economic policy in Israel*, chapter 4, (New Haven, Yale University Press 1971), M. Saker, *Israel's Foreign Trade*, (Amman, Muasasat Al-Risala 1971) Arabic.

[20] M.Michaely, *Foreign Trade Regimes and Economic Development: Israel*, (New York, National Bureau of Economic Research, 1975), N.Halevi, "Prospects on the Balance of Payments", in Y.Ben-Porath (ed.), *The Israeli Economy: Maturing Through Crisis*, (Cambridge, Harvard University Press, 1986) pp. 241-63, and O.Dabbagh, "The Impact of Monetary Variables on Israel's Balance of Payments 1960-90", *Dirasat*, vol. 21, no. 5 (1994) pp. 63-81.

The imposition of imports from Israel and the same structure of tariffs as on Palestine and Jordan, would affect their relative competitiveness precisely in the same way as would the elimination of tariffs on all imports. The trade regime presently applied in the WBG discriminates in favor of imports from Israel. A uniform protectionist regime would put an end to this preferential treatment by equalizing the entry conditions of imports from the rest of the world with those now reserved for imports from Israel. Thus, this policy would divert trade away from Israel towards more expensive sources.

Nevertheless, the expected effect of such policy is that the contraction of trade with Israel would fall short of the expansion of trade with the rest of the world. This is because of the freight advantage Israeli exports enjoy due to geographical proximity with Palestine. This is, in fact, one reason why we think that Palestine should opt for the imposition of a discriminatory tariff against imports from Israel. Trade with Israel would then decrease to the optimal minimum that coincides with an effective protection to fledgling domestic manufacturing industry.

In the long-tem, and after a sufficient time lag that allows for the full development of selected industries in Palestine (reaping the fruits of increasing returns to scale), a customs union with Jordan could become feasible. With the removal of the existing restrictions on exports to the East Bank, a considerable rise in exports may be expected In the case of agriculture these exports would compensate for the contraction of exports to Israel.

However, as far as manufacturing is concerned, it is imperative that we realize that the main export opportunities to Jordan would be only in those products in which Palestine has real comparative advantage. Therefore, it should be stressed that such a customs union would expose the Palestinian economy to duty-free competition from Jordan's products. Nevertheless, the availability of importables in the East Bank, and the consequent competition potential would eventually produce a division of labor most beneficial to the two countries in the long-term.

5. Conclusions

The foregoing analysis suggests that a trade policy responsive to Palestine's economic interests would most obviously gain by changing the nature of the existing trading relationships with Israel and Jordan. Such a policy would have four elements:

1. To protect or subsidize some branches of local industry against Israeli and Jordanian competition.
2. To expose Israeli imports to discriminatory tariff.
3. To move gradually in the direction of a customs union with Jordan that would accentuate the comparative advantages of the two countries.
4. To develop markets for local products outside the Middle East region.

"Normal" trading relationships in the international economy typically involve neither absolute free trade nor total isolation. Without being unmindful of the powerful influence of non-economic factors that often determine whether the norm is achieved and whether the costs of either free trade or isolation are tolerable, it is possible to specify a range of trading policies for Palestine that approximate the norm and satisfy mutual economic interests of its trading partners.

For Palestine, there would be little loss by a substantial reorientation away from the present trading connections with Israel, resulting in a lower level of penetration into local market by Israeli commodities. This lower level would be set as imports from Israel and subjected to discriminatory customs tariff.

The application of discriminatory customs tariff to trade with Israel would not only reduce dependence on Israel as a source of supply, it also would provide an important fiscal source for the national authorities.

On the other hand, trade with the rest of the Middle East countries could be expanded, although its dimensions are difficult to predict given the fast growth and high rate of structural change being experienced by these countries.

Despite these uncertainties, it is plausible that Palestine's economic interests would make extensive involvement in foreign trade desirable. Natural resources are limited and high levels of imports are, therefore, inevitable. Economic growth, moreover, would require imported capital equipment. The size of the local market is small enough that manufacturing development would have to be selective and in many lines of exports would be necessary to achieve an acceptable level of efficiency. This means that it would be feasible not to create expanded industry solely through protection for the local market which is too small to provide a basis for self-sufficient industrialization. The creation of new industries in Palestine would require more than traditional protectionist policies, it would require active policies to promote new markets outside the Middle East region.

Table 1: Imports and Exports and Net Trade Balance for the WBG (million US $)

Country	Net Trade Balance			Exports			Imports		
	1996	**1997**	**1998**	**1996**	**1997**	**1998**	**1996**	**1997**	**1998**
American Countries	-28.1	-29.3	-40.3	0.8	ng	ng	28.9	29.3	40.4
Arab countries	-7.5	-36.6	-73.8	19.1	19.6	11.5	26.6	56.2	85.3
EUCC Countries	-146.7	-178.0	-224.4	ng	0.1	1.6	147.0	178.9	226.0
East Europe	-6.5	-8.0	-12.0	ng	2.1	ng	6.5	10.1	12.1
Asian Countries*	-1465.1	-1588.1	-1601.7	319.3	360.0	381.5	1803.5	1948.0	1983.2
Other Countries	-3.8	-16.2	-28.0	ng	ng	ng	3.8	16.2	20.0
Grand Total	**-1657.7**	**-1856.1**	**-1980.3**	**339.5**	**382.4**	**394.9**	**2016.3**	**2238.6**	**2375.1**

Note: Ng: negligible

Source: Palestine Central Bureau of Statistics <www.pcbs.org/english/trade/fo98-tl.htm>