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Näringslivets Internationella Råd
International Council of Swedish Industry



PALESTINE INTERNATIONAL BUSINESS FORUM

**FUTURE ECONOMIC RELATIONS BETWEEN
THE PALESTINIAN AND ISRAELI ECONOMIES**

.....

*A PRIVATE SECTOR PERSPECTIVE:
IMPACT OF THE POSSIBLE TRADE SCENARIOS*

RESEARCH PAPER

December 2007

Israeli and Palestinian Business Leaders Speak Out: The Future of Our Communities' Economic Relations

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As *Palestinian and Israeli citizens and businesspeople* and members of the ***Palestinian International Business Forum***, we wish to express our opinion and position on the future economic relations between our two territories. Our aim is to provide a reference framework for our authorities to undertake the next round of negotiations.

Over the past six months we have conducted a comprehensive research and consultation exercise on possible scenarios of trade agreements between Israel and a future Palestinian state and their respective impacts on key sectors of common interest, namely tourism, agrofood and agribusiness, construction materials and fast moving consumer goods. We also explored specific areas where cooperation may yield particularly attractive results. A team of Palestinian, Israeli and international specialists supported our work.

Our research proves that trade between both territories is crucially important for the prosperity of our companies and our citizens from both communities. Israel today accounts 90% of all Palestinian exports and 74% of all Palestinian imports. The Palestinian territory imports US\$ 2.4 billion from Israel, 6% of total exports. The current conflict situation and the poor implementation of the “Paris Protocol,” the trade agreement still in force, have had radically (direct and indirect) negative effects on both sides, most notably on Palestinian businesses and citizens.

Globalization and the liberalization of our economies have increased the competition in both our local and traditional export markets. At the same time new opportunities in growing markets in Europe, the United States, Asia and the Gulf countries are emerging. Extraordinary gains that may reach about US\$ 25 billion in combined exports and income as well as more than 1 million jobs for both sides appear well within reach.

We, Palestinian and Israeli businesspeople, have fundamental joint interests including normality, stability, absence of conflict, viable Palestinian statehood, all of which are required to realize the potential of synergies and cooperation through trade, investments and joint projects.

The new opportunities and risks in the global market require new business strategies from ourselves *and* new, modern and forward-looking policies from our governments. The cost of no agreement is already too high now; furthermore a “No Agreement” scenario in the future would be a plain disaster. Negotiations therefore must lead to an economic treaty framework that provides a reliable

basis for predictable business relationships in open, competitive markets. This new framework should promote cooperation as well as the rule of law in our markets. Nothing can do more to help Palestinians rebuild their economy, in the interest of Palestinians and their Israeli partners alike.

Separation is an opportunity for better cooperation. But we need to do it right. Cooperation in trade means to develop a bilateral regime that optimizes our bilateral economic relations in the greater international framework of rights, obligations and opportunities, namely the World Trade Organisation, the EuroMed (“Barcelona”) process and our relations with key international partners and neighbours.

We call for the immediate resumption of trade and economic negotiations between the PLO/Palestinian Authority and the Israeli government to develop as soon as possible a new economic agreement to enhance bilateral, regional and global opportunities that would be otherwise lost, with detrimental consequences on both sides.

On the basis of our research ***we recommend to adopt a “Free Trade Agreement Plus”*** as the basis of our future relationship. It is both the best and the most feasible option. An “FTA Plus” should provide for (1) free trade in goods and services, but (2) with economic borders and hence economic sovereignty, while containing (3) additional elements of “deep integration” where cooperation will make a key difference for businesses, such as:

- Shared food safety infrastructure, harmonization and mutual recognition of safety standards and inspection certificates.
- Mutual recognition of professional qualifications and specific business licenses.
- Cooperation and IT-interfacing of customs and tax authorities.
- Some harmonization of external customs tariffs, reducing smuggling pressure.
- Specific sectors where full or far-reaching liberalization of specific sectors towards a *de facto* single market can be negotiated across economic borders (e.g. mobile telephony)
- Cooperation in “trade-related and other areas” such as anti-dumping, competition authorities, public procurement, and investment promotion.

We believe that an “FTA Plus” approach opens the door for further integration while maintaining some key features of autonomy, most importantly the freedom of each side to manage relations with third parties. An “FTA Plus” would thus allow fine-tuned integration bordering on a customs union, but would nonetheless allow Palestine to design its own foreign trade policy, including membership in GAFTA, the *Greater Arab Free Trade Area*.

We therefore recommend the urgent implementation of immediate and transitional measures, identified in our research, using the existing framework of the Paris Protocol in order to promote cooperation *now* and eliminate impediments for both business communities, so as to gradually achieve the objectives of a final trade agreement, such as:

- Guarantee of movement and access in security for everybody.
- Creation of autonomous Palestinian exit/entry points for goods, services and people.
- Removal of obstacles to trade within the WBG and full use of existing infrastructure.
- Stop to all discrimination at airports, seaports and in all administrative processes.
- Full reciprocal information sharing between customs and tax authorities on relevant matters. Harmonization wherever possible.
- Full reciprocal information sharing of ministries/agencies dealing with standardisation, technical regulations, health & safety regulation incl. food safety, etc. Systems of mutual recognition and harmonization wherever possible.
- Establishment of an effective territorial link between the West Bank and Gaza.
- Review of the Paris Protocol's goods lists A1, A2 and B to address Palestinian trade issues in relations to third parties (Arabs in particular).
- Making use of the Joint Economic Committee as tool for a constructive working relationship on all pending issues and to pave the way for a future FTA Plus agreement.

We are ready to cooperate immediately in a series of different projects that are both highly beneficial to both sides and of strategic relevance, in the fields of agriculture, tourism, fast moving consumer markets, construction and tourism, based on partnership initiatives.

Trade is not only good for business. It is a key tool for building peace. We need to do our best to make it happen.

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Acknowledgements

The Palestinian International Business Forum:

Zakhi Khouri, Amiram Shore, Iyad Joudeh, Shraga Brosh, Danny Catarivas, Emanuel Dotan, Benny Gaon, Eli Gonen, Khalid Hussein, Yehuda Kahana, Bassem Khoury, Dov Lautman, Tareq Maayah, Yair Rotloy, Motty Shapira, Shmuel Tzurel, Rami Zeidan.

Palestinian and Israeli Business Communities

We would like to thank over 140 Israelis and Palestinians businesspeople from different sectors, representatives of business organizations who significantly contributed with their time and efforts to the success of this project. Their participation in the different sectoral working groups and consultative meetings was fundamental for completing this challenging research.

Institutions and Organizations

We would like to thank the following institutions and organizations for their substantial contribution, support, and dedication to this study:

The International Council of Swedish Industry (NIR), Stockholm.

The Peres Center for Peace (PCP), Tel Aviv.

The Palestinian Federation of Industries (PFI), Ramallah.

TAS Europrojects, Brussels.

For their valuable efforts, without which the project could not have been completed the PIBF would also like to thank the research team:

Mr. Saeb Bamyia, Team Leader of the Palestinian Research Team, Economic Advisor to PFI.

Dr. Ron Pundak, Team Leader of the Israeli Research Team, Director General of the Peres Center for Peace.

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Mr. Hugo Ruiz Taboada, Director. TAS.

Mr. Hannes Schloemann, Trade Policy expert. TAS/WTI.

Dr. Jorge Vila, Legal & Banking expert. TAS.

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Mr. Graham Thompson. Editor. TAS.

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Executive Summary of Research Paper on Future Trade Relations

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Palestinian-Israeli trade matters. It currently feeds many people on both sides. More importantly still, it holds an immense potential for business opportunities that can benefit millions of Israelis and Palestinians, their economies and their countries – if leaders succeed to provide a good, ideally the best, framework for such trade. It would represent a solid, peaceful future for generations of Palestinians and Israelis.

What agreement would be the best for both sides – and why? The answer is almost surprisingly clear. Both sides would be by far best served by a solid and enhanced free trade agreement (“FTA Plus”), because it optimizes the gains from both cooperation and separation. Details, however, will matter, and negotiators and businesses on both sides must make every effort to understand, and negotiate, those details.

The Forum

This Research paper has been prepared by about 30 Israeli and Palestinian business people from the Palestinian International Business Forum (PIBF) with the participation of another 150 - mainly from the selected sectors of tourism, agriculture, construction materials and fast moving consumer goods – in order to analyse¹ the possible trade relationships between Israel and Palestine and to assess their impact on both economies.

With this research PIBF aims to:

- Provide businesspeople of both communities with a tool for mid/long term business decisions that take into account possible scenarios of the economic relationships between Israel and Palestine.
- Analyse the effects that potential trade regimes might have on the respective economies and trade sectors, and identify fields and projects for immediate cooperation.
- Develop a private sector position which can influence decision makers in both countries to develop a sound economic

relationship between the two economies.

Trade Agreements

Trade agreements aim to eliminate or reduce trade barriers between national economies. In the case of the intertwined Israeli and Palestinian economies, the stakes are particularly high. The spectrum of potential scenarios is broad. Failure to reach an agreement would allow barriers to emerge without control, potentially drying out established business relationships. A cooperative agreement, (Customs Union or a Free Trade Agreement), would preserve existing trade opportunities and foster cooperation. Between them, lies the option to rely on the general rules of the WTO system.

We believe that any future trade regime should do three things:

- Preserve existing trade opportunities
- Foster new ones
- Promote cooperation

Our objective is to help identify, agree on and implement the best possible regime for people and businesses of both parties.

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¹ The research has been undertaken by a Consortia team composed by 20 Palestinian, Israeli and international experts and funded by the International Council of Swedish Industry (NIR).

FINDINGS & CONCLUSIONS

Trade Potential for Both Partners

After six years of conflict and less and less respect for the bilateral “Paris Protocol” trade regime, two perceptions appear to permeate our business communities: “Palestinian markets and businesses are no longer relevant for Israeli businesses.” and “The only viable solution for the Palestinian economy is the complete separation from Israel.”

Our research demonstrates that both perceptions are utterly wrong. A cooperative trade arrangement would generate enormous advantages for Palestinian businesses but as well for the Israeli economy.

This impact would be immediate and particularly high on certain sectors and subsectors such as tourism, fruits, vegetables, olive oil, garments, ITC, and others.

The numbers convey a clear message: For Palestine, revenues from tourism would potentially multiply by 30, those from agriculture by more than 20; overall export revenues would increase by a factor 18 in 10 years.

For Israel, the gains would also be very significant: around 250% in tourism, more than 100% in agriculture-related exports and 40% in overall exports earnings.

Job creation would be equally significant. Palestinian jobs will grow by 120%. Palestinian current unemployment would disappear. More than 25 % of that jobs will be generated by tourism.

Employment gains for Israel would represent 12% of the present workforce.

The annual results in the year 10 after an agreement can be projected as follows:

Sectors	Annual Gains / Losses Cooperative agreement ²	Palestine	Israel
Tourism	Exports loss/gain USD millions	2,090	7,400
	GDP loss/gain USD millions	1,580	5,600
	Employment (thousand jobs)	220	410
Agriculture	Exports loss/gain USD millions	2,530	3,010
	GDP loss/gain USD millions	1,720	1,820
Global impact	Exports loss/gain USD millions	7,300	27,000
	GDP loss/gain USD millions	12,000	28,000
	Employment (thousand jobs)	915	525

If a political solution and economic cooperation are agreed, both communities would further benefit not only from the reactivation of the Palestinian economy but from access to markets in the Middle East (especially the Gulf countries); Israeli exports would further (re)gain markets with a high sensitivity for human rights.

The current situation – “(almost) No Agreement”

In contrast, the recent past provides ample illustration of the real costs of the conflict. The asymmetry of both economies and trade has significantly increased during the last years.

Palestinian exports reached USD 732 million in 1999 decreasing to 500 million in 2005. Imports decreased by 9% to USD 2,4 billion

² The best scenario is compared to the “no-agreement” situation. 2005 is the reference. Conservative assumptions have been used for the model. Indirect impact is included. The calculation method is presented in Annex 2.

in 2005. Almost 74% of Palestinian imports come from Israel, and 90% of total Palestinian exports go to Israel.

The Palestinian economy has gone through a major economic crisis in the last years. Palestinian GDP (estimated at USD 4.5 billion in 2006) was 21 percent lower, in real terms, than it was in 1999. GDP per capita was less than USD 1,100, almost 40 percent lower than in 1999.³

The Israeli economy has recovered annual real growth of 5 % but only after 2004, following a decline in 2001-2002. Israeli GDP is projected to be USD 160 billion in 2007 and GDP per capita around USD 22,000.

Israeli producers exported USD 43 billion in 2006, up 19% from the previous year. Imports also grew to USD 48 billion. 66% of Israeli exports are manufactured goods, 65% of which go to the US and the EU. Imports from Palestine were close to 1%, and exports of goods were around 6.3%, the second biggest foreign market. But exports to Palestine in 2005 were still 30% below pre-Intifada figures, without considering energy prices.

The Palestinian economy depends highly on Israeli supplies. Exports to Israel and third countries are declining, due to the conflict, transportation and business impediments and declining competitiveness.

From No Agreement to No Trade

In this situation of (virtually) no agreement, the economic situation of the West Bank will further deteriorate. The completion of the West Bank wall/barrier will accelerate this trend towards a situation that may resemble that in Gaza today.

Gaza illustrates what a “No Agreement” scenario could look like, and even worse, as currently at least the duty free agreement still applies. In the case of separation in conflict, trade between Israel and Palestine would fall to minimum levels. It would be regulated exclusively by national measures. No

international disciplines would apply. No remedy would be provided for any treatment perceived as “unfair.” This scenario offers the lowest level of predictability and the highest risk for foreign and local producers.

The need of a sound Legal Framework for Doing Business

Although transitional, the Paris Protocol (PP)⁴ has been the first instrument to govern trade between Palestinian and Israelis. The PP recognized Palestine (WBG) as a separate customs territory that would operate in a customs union with Israel, controlled primarily by Israel.

The current trade framework is a mix of an imperfect customs union and Israeli unilateralism, driven by the liberalization of the Israeli economy, and applied to the largely unregulated Palestinian economy, with no choice for Palestine.

As a result of the lack of implementation of key elements of the PP and the severe infringements of its spirit and letter of the agreement which have taken place during the years of conflict (closure, unilateral physical barriers, etc.), the PP's applicability has been minimal.

The PP has been ineffective in guaranteeing trade rights to Palestinians, but it still applies as a matter of law and is the basis for the existing duty-free treatment for goods.

Even if the Palestinian legislative activity was intense between 1996 and 2005, the Palestinian territory is still governed by different laws that provide a contradictory legislative set which the judiciary cannot apply in an effective way. The Israeli legal framework is also complex, but more developed and coherent. There are also social and practical impediments for Israelis doing business in the Palestinian territories as well as for Palestinians in Israel.

Business transactions have been significantly reduced since 2000. Joint

³ World Bank and IMF estimates, see Annex 1.2.

⁴ Adopted in 1995 by the Government of Israel and the Palestine Liberation Organization as Protocol 5 of the Interim Agreement

activities are now limited to trade, with mutual investments has been reduced to almost nil.

This trend is reversible. This paper demonstrates that an appropriate trade arrangement would help Palestinian businesses increase their competitiveness in their own as well as in the global market. It further shows that trade with cooperation between both sides would lead to win-win mutual benefits for the Israeli and Palestinian economies.

Joint Interests

The Israeli and Palestinian business communities have identified key issues, that should be reflected in, and supported by, the future economic arrangements, namely:

- Normality, stability and the absence of conflict.
- Viable Palestinian statehood.
- Synergies and cooperation.

A "two state" solution implies agreement on political borders. A realistic short term goal should be to create a transitional trade regime based on cooperation and integration, leading to create independent economic relationships with third parties.

The basic Palestinian interests include:

- Viable economy.
- Economic sovereignty.
- Access to key physical, institutional and legal infrastructure.
- Integration into the regional and global economy (the EuroMed process, GAFTA, the WTO and preferential arrangements with key partners).
- Social stability.

We believe that Israel has potential to be one of most advanced economies in the world due to its economic structure and dynamics. Israeli interests can be summarized as follows:

- Palestinian economic recovery, as Palestine is still the second largest export market for Israel.

- No more discrimination of Palestinians businesses, as it runs counter to Israeli business interests.
- Access to Arab markets (Israeli ability to capture this opportunity depends on its political and economic relations with Palestine).
- Maximization of mutual benefits vis-à-vis the EU and the USA (cumulation, QIZ-style incentives, etc.).

The Agreement Scenarios: WTO, Customs Union, FTA Plus

In the case of a "two state agreement", which would imply a formal separation, 3 scenarios appear relevant and feasible:

Scenario A: Agreed separation with a low level of conflict.

WTO/Non-Discriminatory Trade Policy (NDTP).

Scenario B: Return to an Agreed & Improved Pre-Intifada Situation.

Improved Quasi-Customs Union.

Scenario C: Agreed political separation with Integration and Active Economic Cooperation.

Free Trade Arrangement Plus (FTA Plus).

WTO/NDTP

Under the system established through the World Trade Organization (WTO), Members grant each other market access on a non-discriminatory basis (MFN). WTO Members must also treat goods and services from other Members at least as well as they treat their own (National Treatment). WTO Members further agree on certain market access guarantees, i.e. maximum tariffs. The WTO system also imposes certain disciplines on exceptional trade measures (from anti-dumping to security measures), and domestic regulation measures, like

sanitary and phytosanitary measures and technical regulations and standards (TBTs).

WTO/NDTP as a minimum form of co-existence would offer the benefits of separation (policy freedom), but forego most of the benefits of cooperation.

FTA and CU Agreements

In a **Free Trade Area** (FTA) the goods nationally produced enter the other market free of customs duties and other charges. However, market entry requirements like technical standards and health and safety regulations are enforced at the point of entry into the market. Because a free trade agreement liberalizes trade in the nationally produced products of the parties, rules of origin play a major role in distinguishing national products from third party products. Trade relations with third parties remain a matter of the FTA partners' sovereign choice.

A **Customs Union** is a higher level of economic integration that includes all features of an FTA (liberalization of trade in local products between the parties), but adds a common customs tariff.

As a reflex of the harmonized external policy, a CU allows for the free circulation of goods, whether national or imported, between the parties. This makes the use of rules of origin, and hence their administration, less costly or even obsolete.

However, a CU tends to be dominated by the stronger partner, hence in this case Israel, not least because it may hamper agreements and trade with Arab countries.

The **main difference** between a Free Trade Area vis-à-vis a Customs Union is thus the lack of a common external tariff towards third party imports even though some harmonization of tariffs may be desirable to reduce smuggling and to ease bilateral border administration. Under an FTA, bilateral economic borders remain fully intact and may even gain in significance, given the need to distinguish originating from third

country goods. An FTA thus requires separate customs administrations for the parties to the FTA, even though harmonization, cooperation, and even some integration is desirable.

An important aspect is the possibility of separate trade policies *vis-à-vis* third parties. Being only in an FTA with Israel, but not a CU, would thus enable Palestine to gain and actively utilize its full Membership in GAFTA.

Hybrids between the basic models FTA and CU are possible. Additional "deeper integration" elements of cooperation and integration can be freely added to a basic FTA frame, e.g. cooperation between standards organizations, recognition of health certificates, joint supervision of banks, etc. Such an FTA with added features could be termed an "**FTA Plus**".

Impact of the different Trade Scenarios on the Sectors

This analysis includes comparative impact forecasts of the trade regime scenarios, based on 3 parameters for each sector and for Palestine and Israel globally:

- Contribution to the GDP.
- Contribution to exports.
- Contribution to employment.

Though figures should be indicative, they are important to visualize the medium-long-term outcome of a choice among possible scenarios.

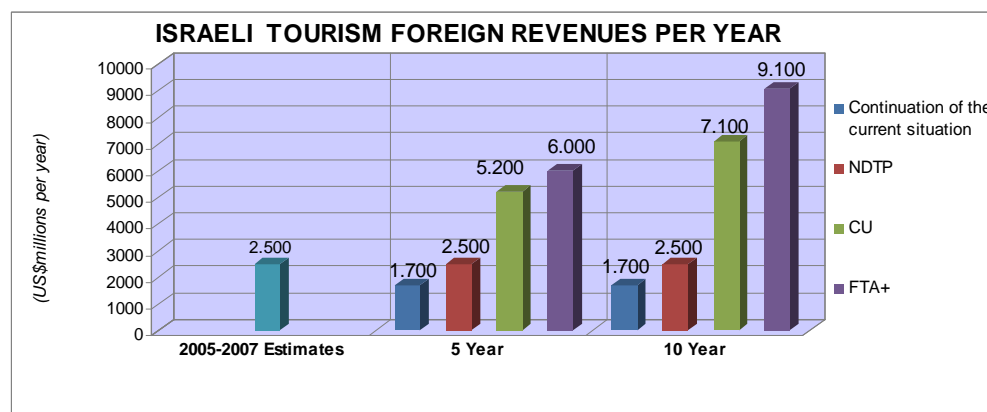
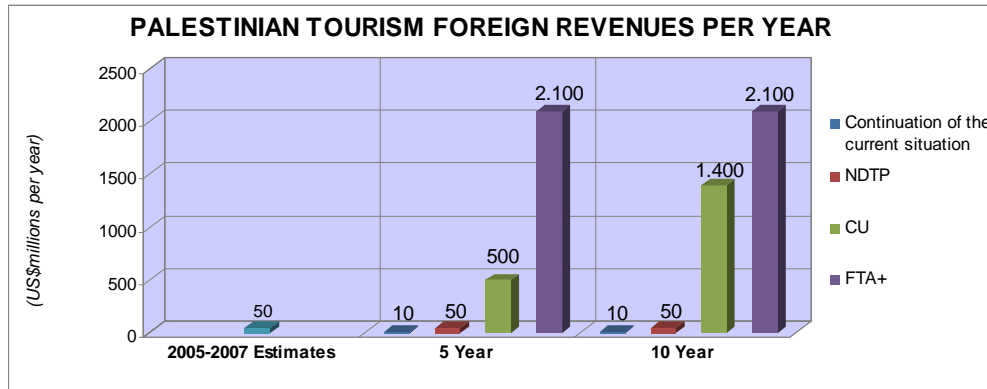
The continuation of the current situation has not been considered as an option, assuming that economic separation under declared hostility would lead to a very negative economic impact on both communities, comparable to the current Gaza scenario (where trade sanctions apply). Their impact has been assessed only as background.

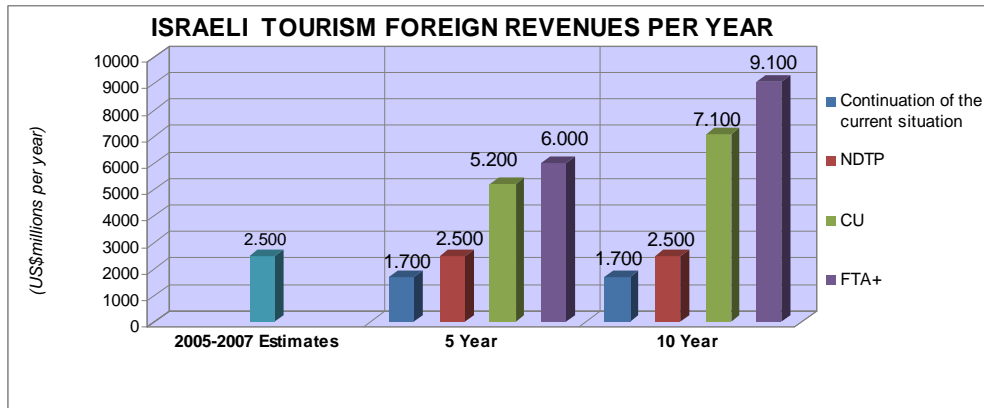
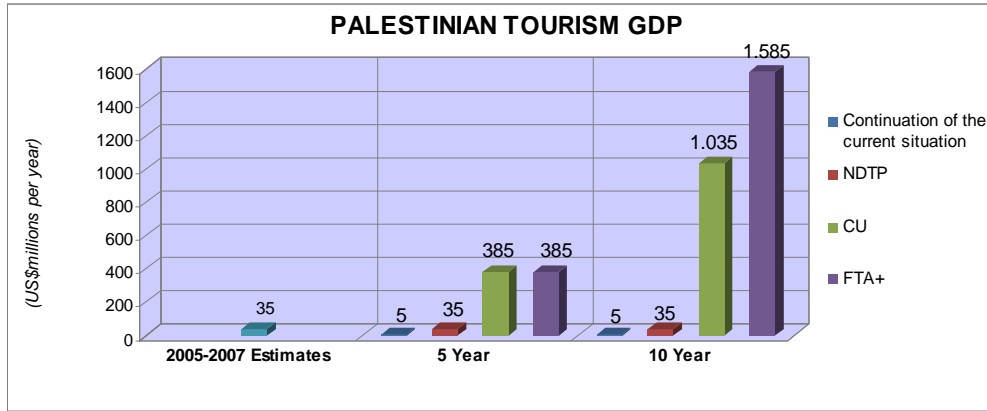
Tourism is the sector, in both economies, expected to gain immediately from any agreement.

Tourism Sector Impact Analysis (5-year projection)		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA PLUS
Palestine	Exports loss/gain (US \$ millions per year)	-40	Insignificant	450	2,050
	GDP loss/gain (US \$ millions per year)	-30		350	350
	Employment loss/ gain (thousand jobs)	-15		65	65
Israel	Exports loss/gain (US \$ millions per year)	-800	Insignificant	2,700	3,500
	GDP loss/gain (US \$ millions per year)	-600		2,000	2,500
	Employment loss/ gain (thousand jobs)	-60		140	175

The tourist assets of Israel and Palestine are exceptional, not least if seen in relation to the neighbouring countries. But tourism is sensitive to the political atmosphere and the security situation. The continuation of conflict would negatively affect the incipient reactivation of recent years.

Tourists in Palestine and Israel would reach 2 and 4 million per year within 5 years under cooperative environment and with diversification to non Christian tourism. Growth will continue until the 10th year.

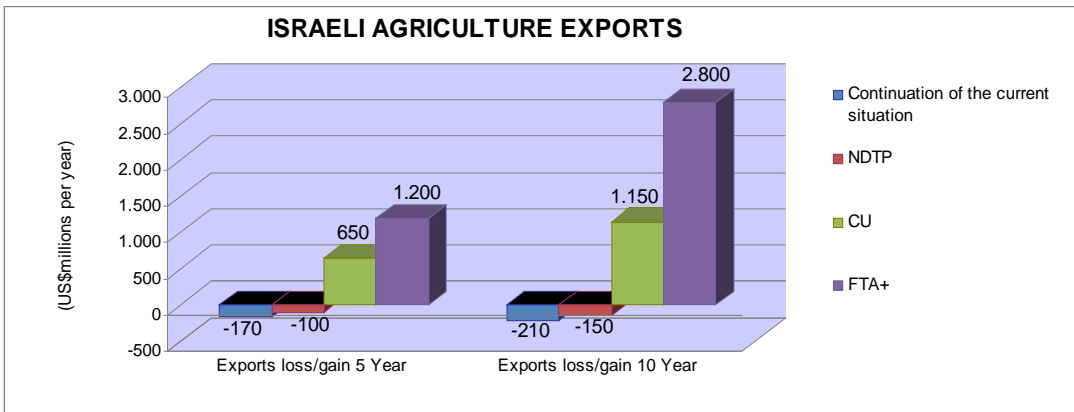
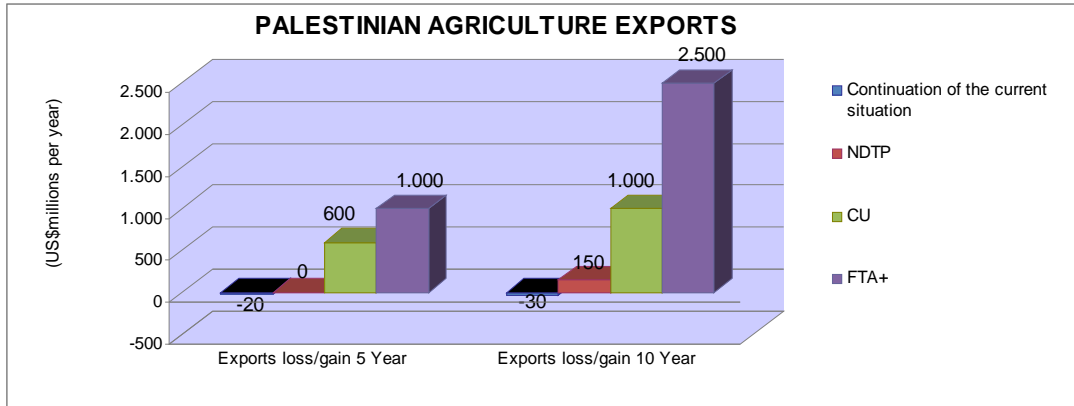




Considering the potential of cooperation in this field, it is vital to undertake joint marketing and strategic partnerships to benefit both sides from marketing of the “Holy Land product” in major tourist markets.

Because of its labour intensity and the indirect effects (one job creates two indirect jobs), employment would increase by 140,000 new jobs in Palestine and 350,000 in Israel by the 10th year.

Agricultural Sector Impact Analysis (5-year projection)		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA Plus
Palestine	Exports loss/gain (US \$ millions per year)	-20	Insignificant	600	1,000
	GDP loss/gain (US \$ millions per year)	-190	-100	500	700
Israel	Exports loss/gain (US \$ millions per year)	-170	-100	650	1,200
	GDP loss/gain (US \$ millions per year)	-100	-60	400	700



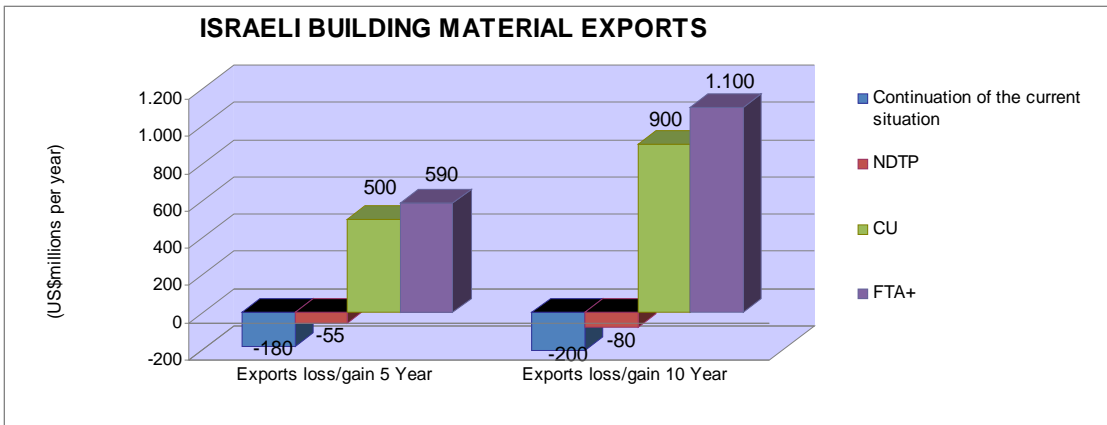
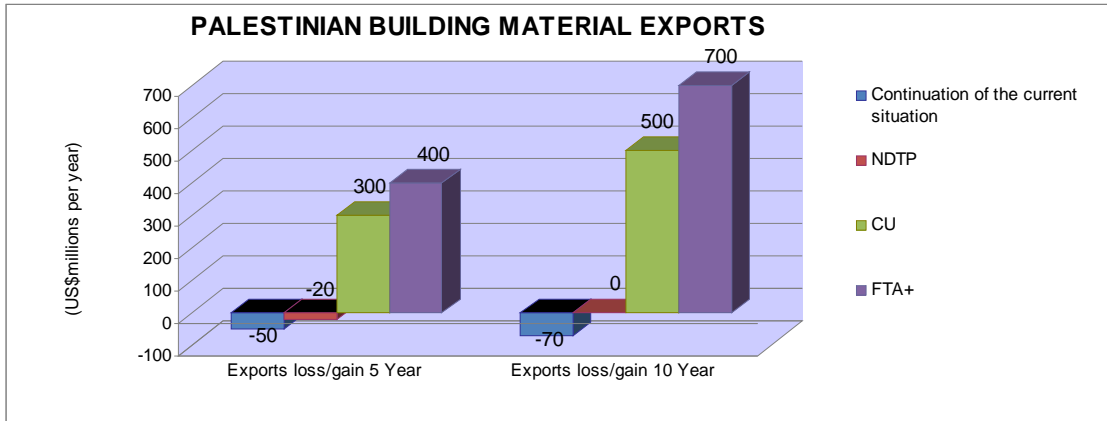
The reactivation of the Palestinian economy would have a direct impact on the domestic **agriculture** market and production and an increase of imports from Israel. Cooperation would also help to increase Palestinian exports to Israel and to the third markets. Special attention would be paid to the Arab Gulf markets in competition with Jordan and Egypt.

The continuation of the current situation would result in increased transaction costs,

markets stagnation and a decline in cooperation.

The FTA+ could envisage transitional agreements, joint testing procedures, mutual recognition and multiple other elements of cooperation. Example could be the joint export of high value flowers and vegetables to European, Arab and other markets, cooperation in the olive oil sector or the joint development and delivery of agriculture- related services.

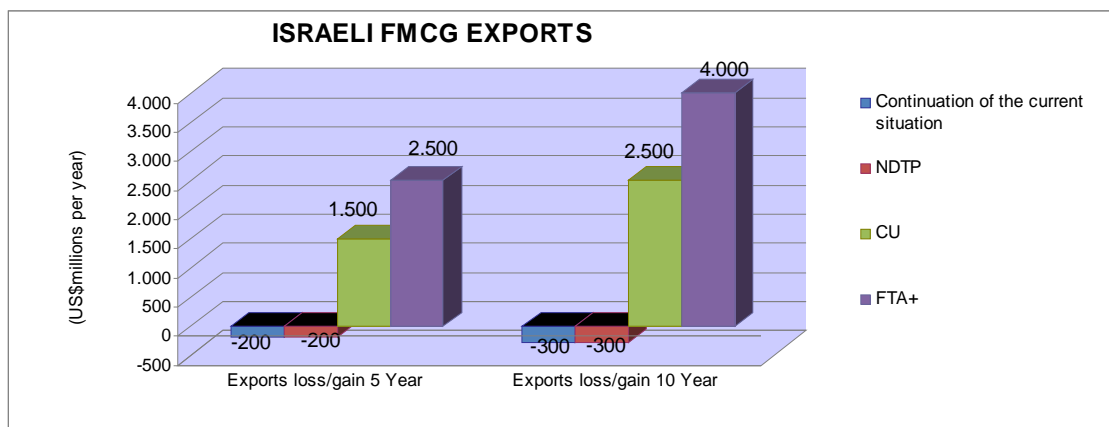
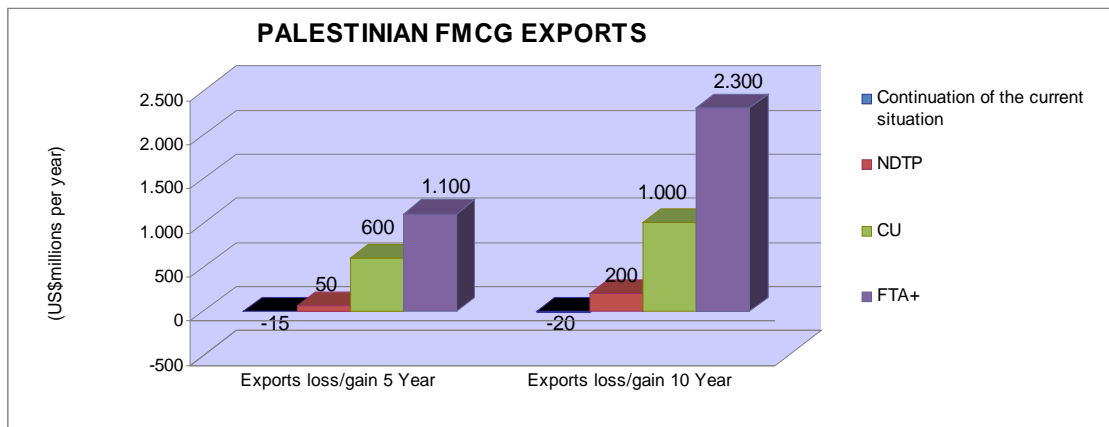
Building Material Sector Impact Analysis (5-year projection)		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA Plus
Palestine	Exports loss/gain (US \$ millions per year)	-50	-20	300	400
	GDP loss/gain (US \$ millions per year)	-120	-100	350	400
Israel	Exports loss/gain (US \$ millions per year)	-180	-55	500	590
	GDP loss/gain (US \$ millions per year)	-110	-35	300	350



Because of Palestinian dependency on the Israeli producers, the continuation of the current situation would lead to a severe shortage in critical **construction**-industry inputs, hurting Palestinian construction activities. An FTA+, by contrast, would allow both economies to reap substantial exports

gains from cooperation in production and marketing to other third country markets, and especially the Arab markets. In the case of stone & marble, Palestinian & Israeli producers would be able to cooperate in more aggressive marketing in the USA and other high-value markets.

FMCG Sector Impact Analysis (5-year projection)		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA Plus
Palestine	Exports loss/gain (US \$ millions per year)	-15	50	600	1,100
	GDP loss/gain (US \$ millions per year)	-200	-150	800	1,200
Israel	Exports loss/gain (US \$ millions per year)	-200	-200	1,500	2,500
	GDP loss/gain (US \$ millions per year)	-120	-120	900	1,500



The negative effects of a continuation of the current situation result primarily from a decrease in the production capabilities of Palestinian **FMCG** industries and an increase in production costs.

Under a cooperation scenario, by contrast, Palestinian and Israeli producers would take profit from the anticipated improvement in Palestinian living standards and the resulting growth in consumption. In an FTA+ scenario, cooperation in marketing and production would allow both communities to bring premium products to markets on

competitive terms. Palestine's GAFTA membership would enable joint products to enter Arab markets.

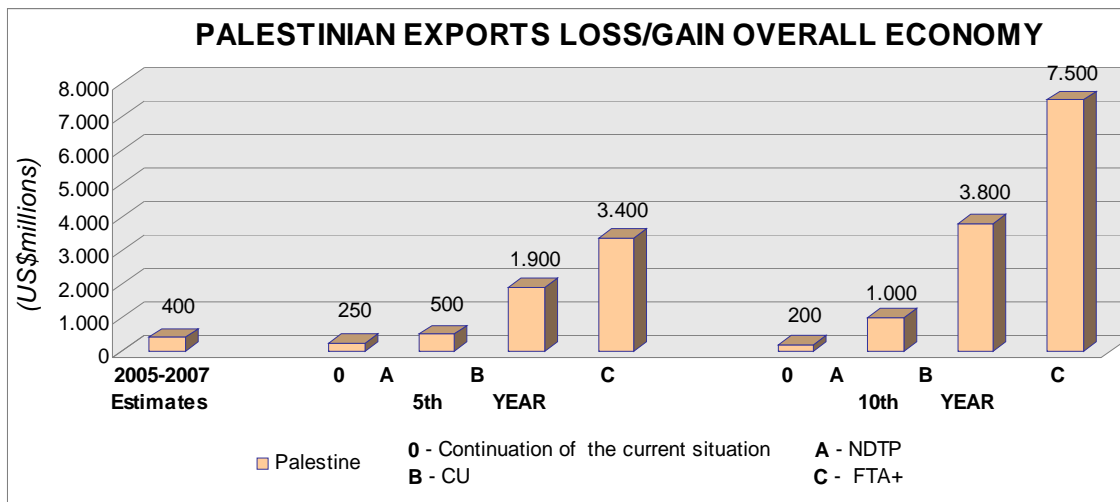
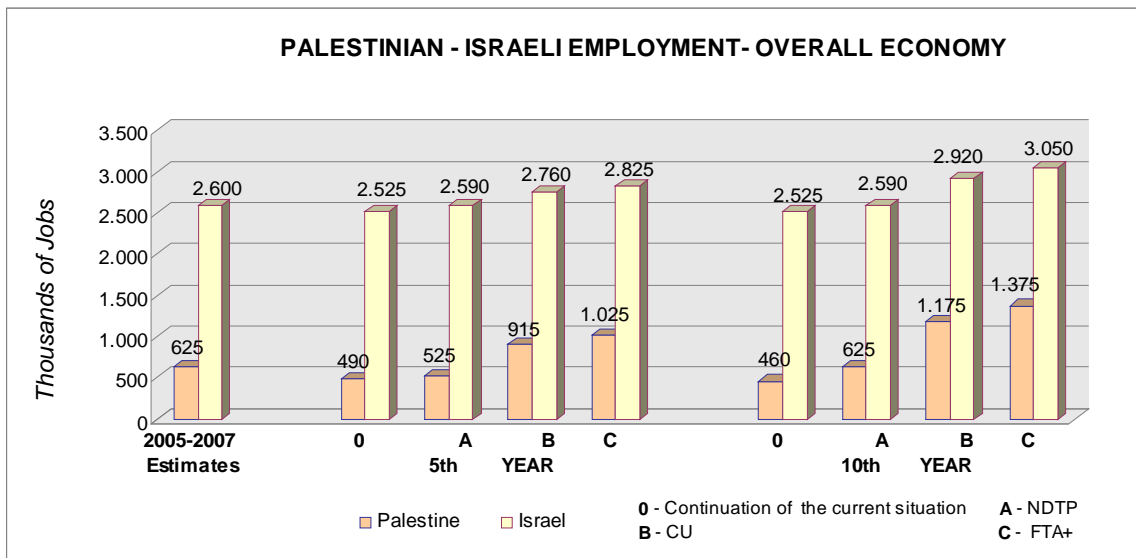
Palestinian-Israeli cooperation should focus on export-oriented food-processing and on production being directed towards the Israeli market.

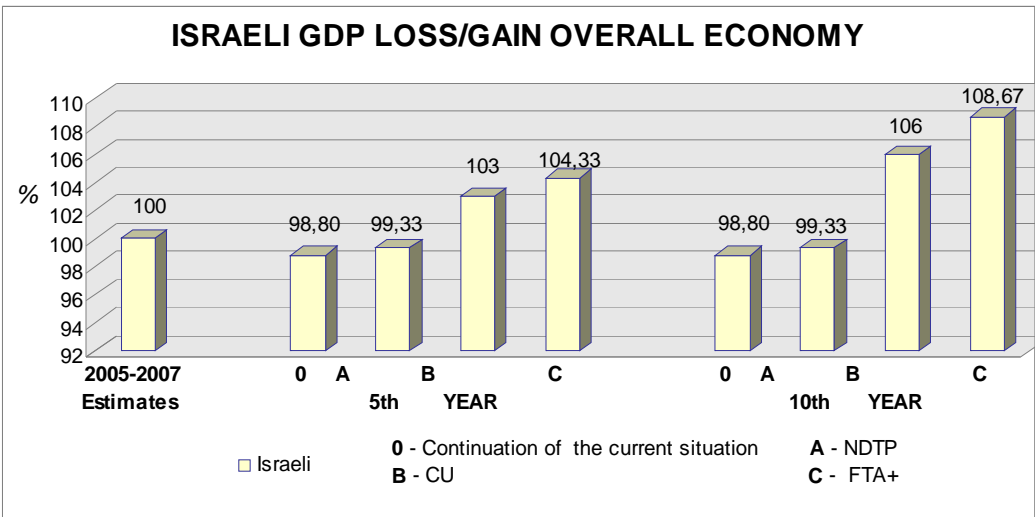
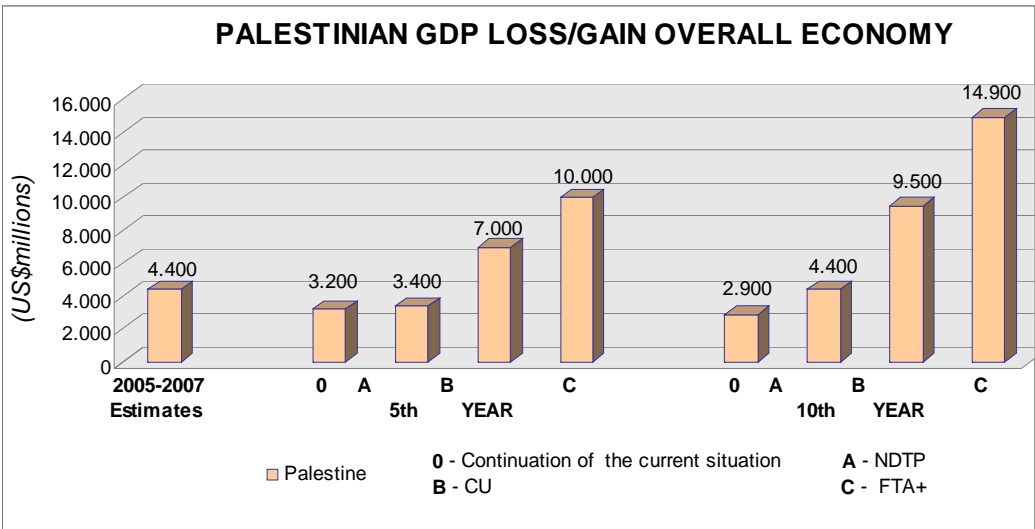
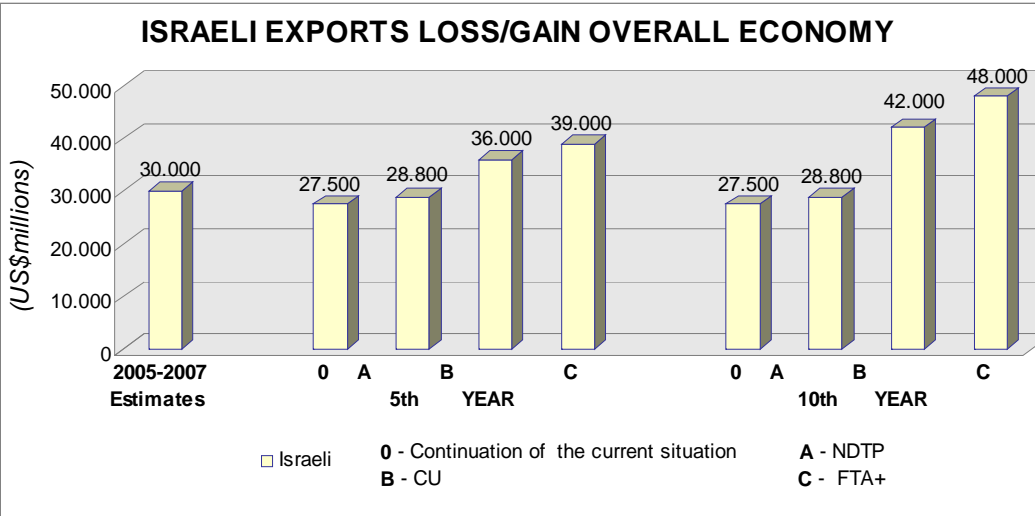
Impact of the alternative agreements on the global economy

Considering the analysed main sectors and other subsectors, we have estimated the overall impact on the global economies:

Overall Impact Analysis (5-year projection)		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved CU	C: FTA +
Palestine	Exports loss/gain (US \$ millions per year)	-150	100	1,500	3,000
	GDP loss/gain (US \$ millions per year)	-1,200	-1,000	2,600	5,600
	Employment loss/ gain (thousand jobs)	-135	-100	290	400

Overall Impact Analysis (5-year projection)		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved CU	C: FTA +
Israel	Exports loss/gain (US \$ millions per year)	-2,500	-1,200	6,000	9,000
	GDP loss/gain (US \$ millions per year)	-1,800	-1,000	4,500	6,500
	Employment loss/ gain (thousand jobs)	-75	-10	160	225





Scenario A: NDTP/WTO

The main implication for Palestine would be a gradual long term decline in GDP per capita. Palestinians exporters would continue to face movement restrictions, uncertainty and prohibitive transactions costs. For Israel, the main consequence will be a withdrawal of Israeli businesses from the Palestinian market, losing a great economic and business potential.

Scenario B: Customs Union

The freedom of movement for Palestinian goods and business people between Palestine and Israel would return, and the accessibility of third-country markets for Palestinian importers and exporters would substantially improve. Israel would benefit from the increase in Palestinian income to achieve an overall export gain of USD 12 billion per annum in 10 years.

Scenario C: FTA+

Fast economic growth and improved living conditions would confirm the resilience of the Palestinian economy. It should achieve an annual real GDP per capita growth rate of 11.5% over the first 5 years of the forecast period. One of Palestine's most important advantages, as a GAFTA member, would be its free access to the large, fast growing Arab markets. Israel export gains are projected to reach USD 18 billion per year in 10 years.

RECOMMENDATIONS

The recommended Trade Arrangement

“FTA Plus” looks as the most promising option as it is set to combine:

- (1) the **benefits of separation** (policy freedom: GAFTA access, matching trade and economic policy to national interests, minimize interdependencies that might generate risks, etc.).

- (2) the **benefits of cooperation** (institutional and legislative harmonization and cooperation, free trade).

An “FTA Plus” Agreement would further:

- (3) comply with WTO requirements on preferential agreements (so would a CU arrangement), and
- (4) fit into Euro-Med and other FTA contexts, not least providing an opportunity to exploit the pan Euro-Med cumulation of origin.

The “FTA Plus” arrangement would have a significant effect on mutual trade in the respective goods. In addition to the harmonization of SPS/TBT⁵, measures like adherence to the European standards by both Palestine and Israel, would have significant facilitating effects.

Another possible feature would be a package of mutual services that would facilitate movement of goods across borders, such as customs administrations for each other where logistically useful, or mutual assistance in the collection / clearance of Value Added Tax. Further steps could be the integration/ cooperation of other authorities or the harmonization / synchronization of customs procedures.

Measures in the area of services could include, for example, the recognition of qualifications (e.g. doctors, engineers), licensing (e.g. courier), supervisory measures (e.g. banking supervision); or administrative cooperation like a harmonized tour guide register and car insurance regulations facilitating coverage of both markets.

An “FTA Plus” would open up the door to more intensified institutional cooperation, examples of which are intellectual property administration, anti-dumping activity, and health and pest control procedures. A further key element can be a binding and effective dispute settlement mechanism, with direct domestic enforcement

⁵ Sanitary and Phytosanitary/Technical Barriers to Trade.

mechanisms similar to those under NAFTA, whereby national courts have built in authority to deal with trade disputes.

Other issues relevant to trade, like investment promotion, competition regulation or government procurement, could be included.

We conclude that the most desirable and most likely scenario is an “FTA Plus”, including both goods and services.

The following are recommended “Plus” components:

- Shared food safety infrastructure (laboratories) and mutual recognition of safety standards and inspection certificates.
- Harmonization of safety standards for construction equipment and other machinery.
- Mutual recognition of professional qualifications and specific business licenses, such as tour guide licenses, nurse exams, truck drivers, engineers’ qualifications, car insurance licenses, etc.
- Cooperation and (better) IT-interfacing of customs and tax authorities.
- Harmonization of external customs tariffs where possible (notwithstanding the right of each party to set its own).
- Far-reaching liberalization and integration in suitable specific sectors (e.g. mobile telephony).
- Merging of supervisory authorities (e.g. telecoms regulator).

These functions are relatively non-sensitive to political / security-related tension.

Opportunities for Joint Ventures and Cooperation

About 20 cooperation opportunities in the fields of tourism, agriculture, construction and fast moving consumer goods have been identified to develop new markets and products, reduce costs and share risks through partnership initiatives.

Palestinian-Israeli business cooperation is a prerequisite for a successful implementation of the recommended future trade regime; matching economic interests of both sides will establish an environment that will encourage joint ventures and cooperation as a virtuous circle.

In the tourism sector, the joint marketing of the Holy Land concept in Germany has been identified as a pilot cooperation project.

Agriculture offers a wide range of joint business opportunities for cooperation: export of flowers and vegetables to European, Arab and other markets, Palestinian production of labour intensive vegetables for the Israeli food industry, the olive oil sector, Palestinian “Boutique” and “Specialty” agricultural projects, development and delivery of agriculture-related services etc. Cooperation with Israel would enable Palestinian agriculture to enjoy the Israeli know-how and marketing experience in these fields.

Other areas include marketing of building materials in their domestic and third party markets. Under an FTA +, Israel would have opportunities of additional exports to third parties.

Finally, future cooperation in the FMCG sector would generate benefits to Israeli and Palestinian food industries. Possible projects include: dairy and export-oriented food-processing projects in the Jordan Valley and the areas of Hebron and Jenin, near crossing points with Israel.

Recommended Transitional measures

Notwithstanding the much-needed focus on long term perspectives and implications, it is important, and possibly essential even for the negotiation of a sustainable agreement, to address the need for both immediate and transitional measures on the way towards economic final status arrangements.

We therefore recommend the urgent implementation of immediate and transitional measures in the framework of

the existing PP in order to promote cooperation rapidly and overcome current obstacles to both business communities, such as:

- Guarantee secured movement and access for everybody.
- Creation of autonomous Palestinian exit/entry points for goods, services and people.
- Removal of obstacles to trade within the West Bank and Gaza and full use of existing infrastructures.
- Stop to all discrimination at airports, seaports and in all administrative processes.
- Regulated labour access to both labour markets.
- Establishment of a territorial link between West Bank and Gaza.

- Full reciprocal information sharing between customs and tax authorities on relevant matters. Harmonization wherever possible.
- Full information sharing between ministries/agencies and standardizing bodies dealing on standards, technical regulations, health & safety regulation, etc. Adoption of systems of mutual recognition and harmonization wherever possible.
- Review of the PP's goods lists A1, A2 and B to address Palestinian trade issues with third parties (Arab countries in particular).
- Re-vitalization of the Joint Economic Committee as an institutional vehicle to resume constructive working relations, review pending issues and pave the way for a future FTA +.

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Glossary of Key Terms Relating to International Trade and Trade Agreements.

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AHLC	Ad-Loc Liaison Committee
BOP	Balance of Payments
CU	Custom Union
DCO	District Coordination Office
EU	European Union
EUROMED	Euro-Mediterranean Partnership (Barcelona Process)
FDI	Foreign Direct Investment
FTA	Free Trade Area
GAFTA	Greater Arab Free Trade Area
GATS	General Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
GoI	Government of Israel
IDF	Israel Defense Forces
IMF	International Monetary Fund
JEC	Joint Economic Committee
LDCs	Least developed countries
MAS	Palestine Economic Policy Research Institute
MEFTA	Middle East Free Trade Area
MENA	Middle East and North Africa
MFN	Most Favoured Nation
MNE	Ministry of National Economy
MRA	Mutual Recognition Agreement
NDTP	Non-Discriminatory Trade Policy
NTB	Non-Tariff Barriers
PA	Palestine Authority
PCBS	Palestinian Central Bureau of Statistics
PLC	Palestinian Legislative Council
PLO	Palestine Liberation Organization
PNA	Palestine National Authority
PP	Paris Protocol
RoO	Rules of Origin
SPS	Sanitary and Phytosanitary Measures
TBT	Technical Barriers to Trade
TOR	Terms of Reference
TRIPS	Trade-related aspects of intellectual property rights
UNCTAD	United Nations Conference on Trade and Development
WB	World Bank
WBG	West Bank and Gaza
WTO	World Trade Organization

I. Introduction

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The future relationship between Israel and Palestine will only be stable, prosperous and peaceful if economic relations are put on a solid footing. Businesses, the essential drivers of economic development, hold the key to making the future work for both sides.

Palestinian and Israeli negotiators are currently discussing options for future economic arrangements between the two parties, from the possibility of reaching no agreement at all to the possibility of continuing the present customs union, from basing relations on normal “most-favoured nation” principles (WTO) to a Free Trade Agreement.

Palestinian and Israeli businesses want to understand what a future *without any agreement* between Israel and Palestine would mean for them, as much as they need to understand what the different *scenarios for a possible future economic agreement* may mean. Only if they know this, they can formulate their interests in a way that will enable their negotiators to negotiate the best possible arrangement.

At the same time, however, businesses also hold the key to (most of) that knowledge. No abstract economic projection has given them what only they themselves can and have to provide, namely the *business perspective* on the possible scenarios. Only businesspeople themselves can tell with any degree of certainty what they will, or may, do under any given scenario.

Therefore this Research has been designed, structured and reviewed by the Palestine International Business Forum (PIBF) composed by key businesses leaders from Palestine and Israel, in the framework of the dialogue and cooperation between the two business communities to promote economic development in Palestine and enhance economic cooperation between the Palestinian and Israel business communities..

PIBF has selected four representative sectors for an in-depth analysis of the impact of the different trade arrangements on business in both sides (agriculture & agribusiness, tourism, construction and building materials and fast moving consumer goods)

As a working tool for business leaders the paper explains the scenarios, their background, their contexts (historical and international) e) and their impact on the selected sectors to provide a basis for informed discussions with and among businesspeople. This information together with the basic legal, economic and political information on the scenarios aims to provide a key reference for businesses and negotiators on both sides as well as for possible future actions to enhance economic relations between the two sides.

The assignment has been financed by the International Council of Swedish Industry (NIR) and has been undertaken by TAS Europrojects, Brussels, that has mobilized a pool of highly experienced Palestinian, Israeli and international experts, all familiar with the challenges and the issues featuring the two economies.

II. The Existing Trade Regime and their implementation: a mandate for change

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2.1 Conceptual Parameters and Limitations of the Paris Protocol Regime

2.1.1 Background

The Paris Protocol (“PP”)⁶ was designed as the provisional regime to govern the Palestinian – Israeli economic relationship during the up-to-five-year Interim Period. The PP represented an important step forward by initially recognizing Palestine (West Bank & Gaza Strip, “WBG”) as a separate customs territory that would operate in a CU with Israel under its control. While their effective power remained unequal, their nominal economic equality was recognized. The PP gave WBG some policy space to manage its internal market, and the potential to diversify its trading partners, recognizing the historical ties between the WBG’s and the Arab and Islamic markets, severed due to the Israeli occupation.

The PP intended to ensure the free movement of goods between Israel and WBG under the premise of a union between the two markets with no economic borders. The PP also addressed the free movement of labor, recognizing the dependence of the WBG economy on the Israeli labor market. The PP included measures which would serve the fiscal needs of WBG in terms of revenue collection (tax and customs duties) to ensure operations of the Palestinian National Authority (“PNA”) until WBG customs could handle customs clearance independently, by assigning those responsibilities to Israeli customs. This decision led to the adoption of trade arrangements – bilateral and with third parties – consistent with Israeli interests but not necessarily with those of the WBG economy.

The PP has no effective enforcement mechanism. Implementation has been based on the goodwill of the parties. The Joint Economic Committee (“JEC”), which was supposed to review and solving pending issues as well as propose amendments, should have been the last resort and only mechanism to settle disputes. As a political body deciding by consensus (and hence effectively not deciding in critical cases) it never succeeded in serving this function.

The PP still applies as a matter of law, but some crucial components have not been implemented largely due to the Israeli government political choice, pressure of interest groups, or/and the guise of security requirements. As a result of this lack of implementation, the severe infringement of the spirit and the letter of the PP, the changes that have taken place in the last six years (closure, unilateral construction of physical barriers to the movement of goods and people, the establishment of commercial crossings, the withholding of WBG revenues by Israeli customs, etc.), and the transitory nature of the PP, no longer satisfying either side’s needs, the actual possible applicability or implementation of the PP is today highly limited.

⁶ adopted in 1995 by Israel and the Palestine Liberation Organization (“PLO”) as Protocol 5 of the Gaza-Jerico Agreement.

2.1.2 Current State of Applicability – From Integration to Separation

In view of the occupation, with no Palestinian state, the architects of the PP and the Oslo process avoided in 1993-4 the issue of political sovereignty (statehood, borders, withdrawal, settlements removal, etc.) relying on a vague concept of Palestinian economic sovereignty. They constructed an interim agreement framework where the two societies would coexist initially under Israeli controlled external borders, no internal borders and a link between the West Bank and Gaza, slowly moving towards the creation of a Palestinian state, through Palestinian control of external borders, the creation of safe passages, and then permanent status negotiations with demarcated borders and a permanent territorial link. This transitional framework promised the Palestinians high living standards and time to build their internal capacity to operate the necessary state institutions.

The PP framework was supposed to end no later than May 1999, when a permanent status agreement would be reached. In the pre-2000 negotiations, the dominant joint expectation was a continuation of close economic ties between Israel and WBG, and close cooperation in the form of a Customs Union “CU” or a new Free Trade Arrangement “FTA”. This new scenario would facilitate the growth of both economies, while leaving room for cooperation and integration. This assumption shaped the perspectives and interests of businesses on both sides.

Instead of more integration, the post-2000 period saw the progressive disruption of economic cooperation. Meaningful political engagement came to a standstill, and many measures taken no longer respected the applicable agreements, particularly the PP. Continued hostilities were raised to justify these measures, which meanwhile had a detrimental effect on the economy and the population. The nature and severity of the closures and other measures created an economic regime far from integration. The unilateral creation of de-facto economic borders (the separation wall/barrier) brought 'imposed separation', the worst of options, inconsistent with the PP's objective of free movement of goods and people and causing enormous economic losses, particularly to WBG as the weaker economy.

The reasons behind the non-implementation of the PP were straightforward: the emergence of the Israeli unilateral policy of intensive security measures, separation and disengagement and the continued hostilities. Security considerations, as always, were allowed to prevail over trade at all junctures.

As a result, business became increasingly difficult for Palestinians. Survival became the dominant short-term goal of Palestinian businesses. Israeli businesses discontinued their investments in the Palestinian economy. As reliance on Palestinian labour became difficult, and politically undesirable, third country labour gradually replaced Palestinian labour.

This had some effect on long-term business perspectives. As mutual reliance became more difficult, business started looking outwards for different alternatives. Israelis found Jordanian and Thai textile suppliers and Filipinos as workers. Palestinians, businesses and workers, found little compensation for the lost business with Israel. Some, service providers in particular, “discovered” the Arab markets. As a result, the prospect of a close future political-economic cooperation with Israel gradually lost attractiveness.

Business on both sides became used to the daily reality of economic separation, expressed in the “Gaza Disengagement” and the West Bank Wall / Separation Barrier. The effect on business perspectives has been dramatic, with many Palestinian businesses focusing strictly on short term survival alternatives.

2.1.3 The Palestinian and Israeli Economies in an (almost) “No Agreement” situation

As a consequence of the conflict and the virtual “no-agreement”, the Palestinian economy has gone through an economic crisis for the last 7 years. Palestinian GDP (USD 4.5 billion in 2006) was 21% lower, in real terms, than in 1999; and real GDP per capita was 40% lower than in 1999.⁷

The Israeli economy however, after a decline in real GDP in 2001-2002, has experienced an annual growth of 5%. Israeli GDP is expected to reach USD 160 billion in 2007 and GDP per capita USD 22,000 (20 times Palestinian GDP per capita). Israel’s external trade totalled USD 95 billion in 2006 (goods only, of which USD 47 million were exports), 30 times Palestinian external trade.⁸

An analysis of Palestinian exports to Israel shows a continuous decline, in real and market share terms, since the 1980s, from 2.5 to 3.5% of total Israeli non-diamond goods imports in the 1st half of the 1980s (until the First Intifada in 1987), to 1.5% in the 2nd half of the 1990s (prior to the Second Intifada), and 1% in 2000-2005.

Palestinian exports to Israel in 2005 amounted to USD500-550 million, including USD400 to 450 million in exports of goods and USD50 to 100 million in services.⁹ Palestinian exports of goods to Israel have represented 95% of total Palestinian exports in pre-Intifada years and 90% since 2002. The leading sectors in goods exports to Israel are: fresh vegetables, stone and building industry products, and textile and garments (mainly sub-contracting for Israeli firms). Other important sectors include: wood products and furniture, iron and steel, aluminium products, plastic products and footwear.^{10 11}

Israeli exports to Palestine in 2005 amounted to USD 2.5 to 2.7 billion, including USD 2.2 to 2.5 billion in goods exports and USD 200 to 300 million in services, reflecting a recovery to almost pre-Intifada levels (see Annex Table 2.3)¹² A substantial part of this recovery, however, is due to higher prices of petroleum products, gas and electricity. If these items are deducted, Israeli exports to Palestine in 2005 were still 30% below pre-Intifada figures (Annex Table 2.3).

Israeli-made products represented 2/3 of pre-Intifada Israeli total goods exports to Palestine (amounting to US\$ 1.1 to 1.2 billion annually in 1998-2000), including inputs, intermediary products, equipment, and machinery (1/3 were re-exports, petroleum products, gas and electricity).

⁷ World Bank and IMF estimates, annexe table 2.1

⁸ Israel Central Bureau of Statistics (ICBS); not including trade with Palestine which is not registered in Israeli external trade statistics

⁹ Not including remittances of Palestinian workers in Israel.

¹⁰ See detailed analysis by sector and sub-sector in Annex Table 2.4

¹¹ Sources: Peres Center and Paltrade, *The Untapped potential*, p. 25-27, 34-35; Annex Table 24; Annex II

¹² These estimates include unreported and unrecorded agricultural and other exports.

The historical evidence shows that the level of Israeli exports to Palestine is determined by the overall level of economic activity and household incomes in Palestine. Until the first Intifada in 1987, the Palestinian market received 12% of total Israeli non-diamond exports. The first Intifada was followed by a decline to 6 to 7% in 1988-1990. In 1991-1998, under conditions of a certain stability and less violence, this share was 8 to 9%. The second Intifada was followed by a 5% fall in 2002. The relative tranquillity in 2003-2005 resulted in a 6 to 6.5% increase in 2004-2005.¹³ In spite of this historical decline, Palestine is still the 2nd largest market for Israeli goods exports, after the USA.

The decline in market share in 2004-2005, compared to the period prior to the first Intifada, is equivalent to USD 2.5 to 3 billion in annual exports. Though market conditions changed over these 20-year period, this indicates the magnitude of lost Israeli exports to Palestine. It also reflects the economic growth and purchasing power lost by the Palestinian economy due to violent conflict, political instability and restrictive security measures. Our analysis in Chapter 4 below shows that the potential for Israel, in terms of economic cooperation with Palestine, under conditions of increased security and stability, may far exceed this lost export potential.

2.2 Economic Impact of a Continued (almost) “No Agreement” Situation

2.2.1 Assuming the Worst: Features of a “No Agreement” Continuation

We must assume that the current economic separation will be accentuated, if the declared hostility between Israel and Palestine continues in any form. In broad terms, we would expect the following developments:

Political and security situation: Palestine and Israel will treat each other as hostile entities; there will be prolonged periods of violence; mutual formal or informal bans on economic relations and business cooperation, except for humanitarian issues.

Movement and access: closure of Israel-controlled crossings; harsher internal closure regime in the West Bank; stricter limitations to move Palestinian goods through Israel; no access of Israeli goods into Palestine; no tourists between Israel and Palestine.

Trade regime: Israel and/or Palestine could, and might at some point likely, terminate the PP¹⁴. The effect would be dramatic. Trade barriers (tariffs and NTBs) would rise to MFN levels – i.e. for many goods to the point of making imports economically impossible. In the absence of *any* agreement on preferential trade, trade between Israel and Palestine would be regulated exclusively by measures adopted by national legislators, regulators or administrators. No international disciplines apply, and no remedies are available for alleged “unfair” treatments. While national traders may have recourse under *national* legal systems against such measures, foreign goods and services enjoy no similar legal protection under international law. An important aspect of this scenario, aside from the risk for foreign producers and the protection for local producers, is that cumulation of origin between Israeli and Palestinian producers under the EuroMed system is not possible, as this requires at least a FTA between cumulation partners.

¹³ All percentages are out of Israel's non-diamond goods exports

¹⁴ Signed as a "transitional" agreement for a limited period, its current legal status is not clear.

Non-trade economic regime: Abolition or suspension of the Israeli-Palestinian clearance system; suspension of banking relations, etc. The international economic relations of both parties would be negatively affected. Palestine would face a significant decline in external aid. A growing negative sentiment would affect Israel's exports to major markets, in addition to the negative impact on local financial markets and the domestic economic environment.

2.2.2 What does this mean for Business ?

The "No Agreement" situation provides unlimited policy space for both governments with respect to tariffs. This would make bilateral trade very unpredictable for businesses, and it may be easier for local businesses to obtain protection. Trade barriers, including NTBs, could be raised to make imports economically impossible, without available remedies.

"No Agreement" would sooner or later increase the trade transaction costs beyond economic efficiencies and slow or prevent the entry of goods into their respective markets. Eventually, it could imply, for Palestine, the loss of its largest export market, and for Israel, the loss of its second largest export market. No minor consequences for either.

Finally, the continuation of "No Agreement" would materialize the opportunity cost of not capturing the business opportunities offered by mutual cooperation.¹⁵

2.2.3 Estimating the Impact on both Economies¹⁶

Implications for Palestine

This situation would eventually affect all aspects of the Palestinian economy, perhaps to the point of resembling the immediate effects of the Intifada. A 2006 World Bank analysis portrayed the following forecast for the Palestinian economy: Palestinian GDP per capita would decline in 2006 by about 30% to US\$ 800, unemployment will jump to 40%, and the number of people below the poverty line will grow to 2/3 of the population.

This scenario took place in Gaza in 2007, after Hamas gained effective control. As shown in a joint PalTrade-PFI survey, 80% of industrial businesses and 60% of construction businesses stopped operations, exports and imports stopped almost completely and the cash-based agricultural sector faced devastation. The impact of the border closures on the Gazan economy reflected its dependency on the importation of inputs from Israel to sustain local production in agriculture, industry and construction.

The above described picture illustrates the effect that "No Agreement" would have on the Palestinian economy, especially since by 2008 all trade between the West Bank and Israel or through Israel will be channeled through controlled crossings, and

¹⁵ See *The Untapped Potential...*

¹⁶ Based on detailed analysis presented in the Annex II, Sector Study Working Paper

the economic impact of border closures in the West Bank will be similar to the effect of similar measures in Gaza.

Based on past crisis experience¹⁷, we would expect the Palestinian economy to decline steeply in the first period and then gradually over the longer term with occasional upticks. This will translate into a cumulative real term drop of about 1/3 in Palestinian GDP, from US\$ 4.5 billion today to less than US\$ 3 billion in 10 years. GDP per capita, which fell from US\$ 1,900 in 1999 to US\$ 1,100 in 2007, would reach US\$ 700 in 5 years, and US\$ 550 in 10 years. This would make Palestine the poorest Arab country, with a GDP per capita lower than Yemen's or Sudan's¹⁸. The economy would lose 165,000 jobs, a 25% drop in the current number of jobs, bringing the unemployment rate to about 45%. Exports would decrease to 2002 levels, the worst year of the intifada, and continue to decline to half its current level of US\$ 400 million (see Summary Table 1, p. 20 below).

Implications for Israel

The direct effects of "No Agreement" on the Israeli economy would be less significant than on the Palestinian economy, but not insignificant.

The most obvious implication would be **the loss of a large part of Israeli exports** in the short term, as a result of border closures. In the longer term, protectionism and a decline in demand will together further decrease them. **Substantial tourism revenues** would also be lost.

Several branches of Israel's industry depending heavily on sub-contracting Palestinian businesses would suffer substantial losses. The garment and furniture industries would be particularly affected. Hundreds of small and medium size Israeli garment businesses depend on Palestinian sewing plants. These are characterized by very short time responses to market changing requests, forcing production in small series, and requiring quick design and production cycles. About 90% of the garment sector production in Gaza, and 76% of the furniture production, was exported to Israel. Since sewing accounts to up to 15% of the total value of a finished garment, the Israeli added value (design, cutting, locally-produced inputs, marketing and services is double or triple the Palestinian value added).

Israel's **direct loss** of export revenues may amount to about US\$ 2.5 billion, lost GDP may be estimated at US\$ 1.8 billion (Summary Table 1), and 75,000 jobs may disappear¹⁹

The indirect implications of "No Agreement" would have a more profound impact on Israel's economy. The growing negative sentiment in some of its major export markets, as well as on its domestic economy, including its financial markets, will translate into losses in export revenues and GDP. These losses are difficult to

¹⁷ The conflict period following the Intifada (4th quarter of 2000, 2001 and 2002), the 1st half of 2006 (Israeli and international response to the Hamas government), and the situation in Gaza since mid-2007

¹⁸ Most of the decline is projected to be in the West Bank, as closures will contribute to push its economy down, closer to the level of Gaza.

¹⁹ The equivalent of 5% of current exports (goods and services, excluding diamonds), 2% of GDP and 2.5% to the unemployment rate.

estimate, but, judging from the 2001-2002 experience, the "net" annual impact could represent 2% of exports and 0.5 to 1% of GDP, equivalent to lost export annual revenues of US\$ 7 to 8 billion at the end of 10 years, and annual GDP losses of US\$ 10 to 15 billion.

Finally, "No Agreement" would prevent the Israeli business community from capturing the opportunities offered by cooperation, as described in the CU and FTA Plus scenarios below.

2.3 New Opportunities and Risks in the International Context: WTO, EuroMed and GAFTA

2.3.1 Background

Several international and *regional* integration initiatives will affect the future relations between Israel and Palestine. The following is a listing of those initiatives, outlining their possible influence on the Palestinian – Israeli economic relationship.

2.3.2 The World Trade Organization (WTO)²⁰

The WTO is the backbone of the world trading system. Rather than a strong organization it is a highly developed legal system of multilateral trade rules, whose aim is to facilitate international trade by guaranteeing non-discrimination and agreed market access levels, avoiding unfair use of trade measures for political aims and creating a framework of reliability, predictability, transparency and the rule of law.

Key operating concepts are market access commitments (tariff ceilings for goods, specific commitments for services) and non-discrimination through MFN and National Treatment principles (see Annex). Specific disciplines focused on avoiding protectionist abuse, cover TBT, SPS, subsidies, anti-dumping and other issues. The WTO offers its members a *binding* dispute settlement process.

As a member of WTO, Israel is bound to apply its provisions. Palestine is expected to become a member in the mid-term future, after participating as an observer in the 2005 WTO Hong Kong Ministerial Meeting.

Membership should benefit Palestine in many ways, not least by providing an international institutional and legal reference for any future trade agreement with Israel. It will also, perhaps even more importantly, provide a reliable basis for its trade with the 150 other WTO Members.

2.3.3 The EuroMed (“Barcelona”) Process

Known as “a child of the Oslo Process”, the EuroMed Process initiated 1995 in Barcelona is based on the idea of peaceful regional relations, aiming (among multiple other initiatives) at the establishment of a free trade area encompassing all members, including Arab countries and Israel. Both Israel and Palestine are founding members of the Euro-Med process.

The EuroMed process is structured around the EU in the centre and the EuroMed partners around, linked to the EU by bilateral Association Agreements (a “Hub &

²⁰ For a more detailed overview of the WTO see Annex 3 and/or www.wto.org.

Spokes” structure), that aims to develop by 2010 into a Euro Mediterranean Free Trade Area for goods. The current agreements, like all FTAs, offer opportunities for businesses but at the same time constrain these through strict rules of origin. Cumulation of origin, currently bilateral between each of Israel and Palestine and the EU, is therefore a key component of the EuroMed process. Under the “Palermo Protocol” rules that are currently being introduced, diagonal cumulation will permit complementation of production to increase market penetration and share (Pan-Euro-Mediterranean cumulation).

In addition to facilitated trade in goods, ongoing negotiations under the Euro-Med process, including Israel and Palestine, aim to generate an FTA for services and investment by 2015. Other negotiations under the Euro-Med process aim to establish a stronger dispute settlement mechanism, initially complementing and ultimately replacing similar mechanisms in bilateral association agreements.

These developments are very important for Palestine and Israel. If the Euro-Med process proceeds as foreseen, by 2015 Palestinian-Israeli bilateral trade will be covered by regional FTAs for goods, services and investment, including a dispute settlement mechanism. While this presupposes some bilateral negotiations, much may be predetermined by existing rules in bilateral deals with the EU. This suggests that Israel and Palestine will eventually need to establish an FTA for goods with Euro-Med Rules of Origin, extended to services, incorporating each other's concessions to the EU – provided they want to benefit from the vast opportunities of this new economic space which, not least, will include Europe..

2.3.4 The “Greater Arab Free Trade Area” (GAFTA)

GAFTA is a free trade area under the League of Arab States. Some very positive experiences in Arab countries have created incentives for its expansion. It is expected that all Arab states will have zero tariffs towards each other's products by the end of 2007. Negotiations are ongoing to include services under the scope of GAFTA, with a view to achieving harmonization with the provisions on services negotiated in the EuroMed process.

Palestine at present has a peculiar member status. Its goods have, initially, duty free access to Arab markets, but it is exempt from offering GAFTA partners reciprocal market access, given that its external borders are still *de facto* controlled by Israel and its tariff policy is established by the PP.

Full GAFTA membership however, should be expected under a future scenario involving Palestinian statehood. This will lead to legally secured and significant market access to Arab markets, which could support cooperation between Palestinians and Israelis.

At least under present political circumstances however, Palestine membership in GAFTA will probably be incompatible with a CU between Palestine and Israel. Even though the clear present objective of many Arab states is to exclude purely Israeli goods from Arab market access, the present non-reciprocal duty free access to Palestinian products is unlikely to last.

This may change radically if an overall political agreement to the Palestinian problem is achieved and the Israeli-Palestinian long conflict finally ends. In such a scenario Israeli market access to Arab markets, *de facto* or *de jure*, may become a reality.

2.3.5 Other Preferential Trade Arrangements

The Israel-US Free Trade Agreement provides full access of Israeli goods to the U.S. market, making the U.S. the largest market for Israel. The Palestine–US Free Trade arrangements are based on the Israel–U.S. agreement. It would have to further developed if the CU were replaced by another agreement. While offering free market access in principle, this arrangement has virtually not benefited the Palestinian economy due to a number of internal and external reasons.

The potential to benefit from an effective U.S. – Palestine free trade arrangement in cooperation with Israel could, however, materialize if the goal of concluding MEFTA, introduced by the U.S. to achieve regional cooperation, were achieved.

Israel and Palestine further have free trade agreements with EFTA states, Canada and Turkey, similar in nature, which would *inter alia* facilitate cooperation in targeting those markets for Palestinian products.

2.4 Palestinian and Israeli Private Sector Interest in a Trade Regime

2.4.1 Joint Israeli-Palestinian Interests

The Israeli and Palestinian business communities have identified a number of issues that must be addressed for their relationship to the business environment:

- **Normality, stability and the Absence of Conflict.** A peaceful, stable environment is needed, where the political impact on the economy is minimal and where planning is possible, without the risks and costs of violent circumstances.
- **Palestinian Statehood.** The prevailing opinion seems to be that economic normalcy will only come with Palestinian statehood.
- **Synergies and cooperation.** Both business communities expect to be able to create synergies to reap the fruits of cooperation through trade, investment and joint projects. Both economies are currently intertwined at many levels, and disruption would cause transaction and opportunity costs for both. Specifically, there is mutual interest in the regulation of trade and business, including:
 - the harmonization and mutual recognition of product and service standards, technical regulations, sanitary and phytosanitary measures, control, inspection and conformity assessment procedures and certificates;
 - pooling regulatory and administrative resources (leading to lower fees and time savings), e.g. laboratories, testing, certification;
 - the harmonization of supervisory measures (e.g. in banking);
 - the cooperation of supervisory authorities (e.g. joint insurance supervision);

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- the cooperation of competition authorities (general and specific, e.g. telecoms);
 - the harmonization of foreign trade policies and measures (e.g. tariffs, NTBs) to regional levels.

Both sides generally agree that the most feasible political compromise is a viable "two-state" solution, including the following components:

- A Palestinian state should have the power to define its economic objectives and strategies and to implement them within the parameters of a bilateral agreement;
- Economic cooperation will be conducted in mutual good faith;
- A clear agreement on borders, including a final decision on Jerusalem and the Israeli settlements;
- A Palestinian state should have full economic jurisdiction, implying trade, labour and other regulatory activities, over its external borders with Jordan, Egypt and Israel;
- A Palestinian state should have territorial continuity within the West Bank and effective communications with Gaza.

A "two state" solution implies agreement on political borders. The realistic short term goal should be to create a transitional trade regime based on cooperation and integration, leading eventually to the freedom to create independent, bilateral economic relationships with third parties.

2.4.2 Palestinian Interests

Against a background of virtual economic breakdown, the Palestinian interests are both basic and fundamental. They can be summarized as follows:

- **Viable economy.** Given the small size of the Palestinian market, the private sector may create employment by opening up to the world through bilateral, regional and multilateral trade agreements. This assumes that there is Palestinian control over external borders with Israel, Jordan and Egypt, and that trade agreements are effectively implemented.
- **Economic sovereignty.** Control and facilitation of exports and imports requires sovereignty over economic borders.
- **Key physical, institutional and legal infrastructure.** Palestinian businesses need reliable access to trade infrastructure such as airports, seaport roads network, electricity grid, water desalination and others. The same applies to institutions and legal components such as land and other registries.
- **Integration into the regional and global economy.** Palestinian businesses need exposure to global markets in order to develop competitiveness. The strong connection to Israel leaves Palestinian businesses vulnerable and dependent. They have a vital interest in integrating into key international systems, like the EuroMed process, GAFTA, the WTO and preferential arrangements with key partners.

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- **Social stability.** Economic recovery and development will depend on social stability, which in turn requires stable and sound social security systems.

2.4.3 Israeli Interests

The economy of Israel is large, if compared to the Palestinian, with a sizeable internal market and growing export markets. Israel's GDP is 40 times larger than Palestine's, and its exports, including goods and services, are 100 times larger than Palestine's.

Israel has undergone a profound economic and external trade liberalization in the last 20 years, reflected in the build-up of significant trade volumes with all major international markets (except Arab markets). Many leading businesses have become multinational players, with global production and marketing systems. The global sales volume of certain Israeli-based multinationals is far larger than their sales in the internal Israeli market and their Israeli-origin exports combined.²¹ In certain industries like high-tech, advanced electronics and agriculture, Israel has become an important global player.

The US is the largest single market for Israeli exports, accounting for 1/4 of its exports, while the EU is the largest trading bloc, accounting for 1/3 of Israeli exports. Israel has successfully diversified its exports in recent years, particularly to China, India and Turkey.

Israeli policy towards trade with Palestine however, retained its "traditional" characteristics of looking at the Palestinian market as a captive market for Israeli exports and limiting the access of Palestinian exports into the Israeli internal market. Influenced by the political situation, Israeli trade with the Arab world is practically non-existent, except for small volumes with Jordan and Egypt.

Against this background, Israeli interests can be summarized as follows:

- **Hoping for Palestinian Recovery.** However severe the disruption, however, Palestine is still the second largest export market for Israel. A recovery of the Palestinian economy would represent an increase in Israeli exports. The factors behind Israeli exports to Palestine however, have been profoundly transformed. The technological changes and enhanced competitiveness of the Israeli industry over the last 20 years have created a new situation regarding the Palestinian market.
- **Confidence in own competitiveness.** A large part of the Israeli industry today is confident in its ability to compete in the Palestinian market with local producers and foreign competitors. This is especially true in relation to inputs, intermediate products and equipment for agriculture, industry and construction, which already constitute a significant part of Israeli exports to Palestine.
- **Against continued discrimination...** Many Israeli businesses are beginning to realise that a continuation of the practices that try to preserve a de-facto regime that discriminate against Palestinian exports to Israel and

²¹ This global activity is not reflected in Israeli national accounts or in Israeli export figures, although it is a very important ingredient of Israel's economic strength.

create advantageous conditions for Israeli exporters to Palestine, is no longer feasible and actually counter to Israeli interests.

- **...or for continued discrimination.** There is however, a part of the Israeli business community interested in the preservation of the "old regime", considering the protection against Palestinian imports and the preservation of their advantages in the Palestinian market as vital to their survival.
- **Access to Arab Markets.** Likely the most important Israeli economic interest in the Palestinian context lies in the potential impact on Israeli–Palestinian relations of Israel’s export potential to Arab markets, in particular the Gulf countries. The Israeli ability to capture this opportunity depends on its political and economic relations with Palestine. Cooperation with Palestine may be the best way for Israel to access Arab markets.
- Other elements to be considered include the coordination of Palestinian – Israeli future trade agreements with regional arrangements, as well as with Israeli existing and future free trade arrangements, to maximize mutual benefits vis-à-vis third parties (accumulation arrangements, QIZ-style incentives for joint Israeli – Palestinian production, etc.).

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III. Scenarios of Potential Trade Arrangements

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This section addresses the rationales, functions and basic mechanics of trade agreements. It further lays out the main parameters of three potential scenarios for future trade regimes between Israel and Palestine, namely (A) WTO/NDTP, (B) Customs Union and (C) “FTA Plus.” For Palestinian and Israeli businesses and policymakers, as well as their international partners, it is very important to be fully aware of these parameters and differences in order to identify opportunities and risks, and hence formulate their interests and positions, with respect to each scenario.

3.1 Overview: Trade Agreements and their Basic Elements and Mechanics

Trade agreements aim to gradually lower or eliminate trade barriers between national economies. They represent steps towards the integration of markets, designed to realize certain benefits of this integration for both parties to the agreement. The objective of all trade agreements on goods is to provide mutual preferential market access to the nationally produced goods of each party, reducing or eliminating tariffs and quantitative restrictions, the main trade barriers.

The effective access of goods to other markets is also, and often significantly, affected by non-tariff barriers (NTBs), including sanitary and phytosanitary measures (i.e. health measures), national standards and technical regulations, environmental measures, cultural measures and licensing procedures. Trade agreements address NTBs by incorporating provisions on legislative, regulatory and administrative issues that work to discipline the use of trade-affecting national measures while preserving the needed policy space to address relevant national concerns, in particular non-trade concerns such as national security, environmental protection or consumer safety.

Trade agreements vary significantly in this respect. Some eliminate virtually all NTBs, others very few of them. The tools to eliminate or reduce NTBs include the harmonization of standards, sanitary and other measures, the recognition of all or some of the other party’s measures; and/or regulatory and/or administrative cooperation, including forms of integration like joint standards organizations or environmental protection agencies.

Most trade agreements have non-discrimination provisions, particularly Most Favoured Nation (“MFN”) and National Treatment (“NT”), market access, transparency (publication, notification, information points) and rule of law (local and international dispute settlement).

To the extent that trade agreements also cover services, the approach to the above issues is broadly similar to that used for goods, with some important variations. Because services are regulated almost exclusively at the domestic level, with no or very few actual “border” measures applied, agreements on services focus strongly

on domestic regulations, roughly comparable to issues raised by NTBs with respect to goods. Actual market access is often granted on the basis of specifically negotiated lists of commitments specifically defining which services and “modes of supply” are acceptable.

Many modern trade agreements address a number of other issues that affect businesses, including investment (rights of investors), competition law (control of cartels, abuse of dominant market power, right to interconnect with local network operators) and protection of intellectual property rights (patents, trademarks and geographical indications).

Trade agreements aim to discipline governmental action affecting trade. In order to be effectively implemented and to have a significant impact on "real-life" economic and trade relations, and on the business environment as a whole, they need to operate in a favourable political and overall economic context. This has been exemplified clearly by the erratic and partial implementation of the Paris Protocol.

The design and implementation of trade agreements in the Palestinian-Israeli context must take into account a number of important factors, including:

- Movement and access arrangements and security procedures, which should reflect the real level of freedom of movement for goods and people for Israeli, Palestinian and third-party nationals;
- The political stability and security situation inside Palestine, and between Palestine and Israel;
- Israeli and Palestinian government policies towards business cooperation and investment (negative, passive or pro-active);
- The level of donor's financial and economic support to the Palestinian economy and to Israeli-Palestinian economic cooperation, including incentives for trade and/or investments.

The impact analysis of the economic and trade scenarios in Section 4 will take into consideration the above factors, evaluating whether they confirm the theoretical impact of the trade regime.

3.2 Relevant Trade Scenarios

Palestine and Israel are separating politically. The question is to what extent they will separate, or cooperate, economically. The answer depends on the skill and will of their negotiators. All scenarios, including “no agreement”, a Free Trade Agreement (FTA) and a Customs Union, are a priori possible.

A “no agreement” scenario – the absence of *any* trade agreement between the two parties – would mean that trade could be unilaterally regulated at will by each party. Among other consequences, there would be no tariff preferences and discrimination would be legal. This scenario is not only undesirable but also unlikely, as it is widely anticipated that both parties will agree to at least WTO rules.

At the other end of the range of possible scenarios lies near-full integration in the form of a customs union that would imply fully free trade between the parties and a harmonized policy *vis-à-vis* third parties.

Between these extremes lie the more likely scenarios of a bilateral relationship on the basis of WTO rules (Non-Discriminatory Trade Policy), a “bare” Free Trade Agreement (FTA), or an enhanced “FTA plus” with additional elements of cooperation and a customs union along the lines of the Paris Protocol.

Scenario A: Agreed Separation within the Framework of the WTO

In this scenario, Israel and Palestine would apply a non-discriminatory trade policy to each other. Upon Palestine’s accession to the WTO they would further benefit from the application of the whole range of WTO rules. Israel and Palestine would treat each other as they treat other non-preferential trading partners. Preferential “third” trading partners, such as the European Union and EFTA, for both Israel and Palestine, would be treated better. This scenario appears as a realistic alternative if Palestine and Israel cannot reach a preferential agreement.

Key Features

Under the system established by the World Trade Organization (WTO) and its treaties (GATT, GATS, TRIPS and others), Members grant each other market access on a non-discriminatory basis (MFN principle). For all trade in goods, and agreed services sectors, members must also apply the “National Treatment” (“NT”) principle, i.e. treat goods and services from other members at least as well as they treat their own.

WTO members agree to certain market access guarantees, i.e. maximum tariffs and protection measures on services in their negotiated national “schedules.” Trade between WTO members is not “free”, as tariffs and other limitations, within the limits agreed, apply.

The WTO system also imposes disciplines on the use of exceptional measures, including remedies like anti-dumping, environmental measures, security measures, and typical domestic regulation measures like sanitary and phytosanitary measures (protection of human, animal and plant health and safety) and technical regulations and standards (TBTs). These disciplines, while important, remain relatively broad and leave significant room for national policies. They encourage, but do not require, cooperation. As a result, NTBs between WTO members, while broadly regulated, remain significant. Importantly, the WTO system is reinforced by a binding and very effective dispute settlement mechanism.

WTO principles can also be applied outside of WTO membership. Such a “Non-Discriminatory Trade Policy” (“NDTP”) applies MFN and, possibly, NT principles. Even if Palestine and Israel do not reach a more extensive agreement, they may apply a NDTP as long as Palestine is not a WTO Member.

Under WTO/NDTP, the preferences given by Palestine to Israel would be the same as those given by Palestine to third countries. When and if Palestine becomes a

WTO member, under the MFN, these preferences would necessarily have to be the same.

The WTO offers higher models of integration among groups of its Members, provided they reach a high level of actual integration in goods and/or services trade. These models are the Free Trade Area (FTA) and the Customs Union (CU).

While the WTO/NDTP scenario is possible, the cumulation of origin between Israeli and Palestinian producers under the Pan-EuroMediterranean System of cumulation would not be possible, as this requires at least a FTA between cumulation partners.

What Does this Mean? Some Examples & Reflections

Under the WTO/NDTP, trade between Palestine and Israel would be subject to the tariff levels adopted by each for trade partners with no preferential trade arrangements. Israeli trade with Palestine, which amounted to around 2.1 billion USD in 2005, would then be subject to Palestinian tariff rates and duties, at a level that remains to be seen.

Israeli existing tariff rates would apply to imports of Palestinian goods, ranging from 400 to 500 million USD annually. In 2005, these rates amounted to an average of 5.1% for industrial goods, while agricultural products, including processed foods, were subject to a tariff average of 32.9%. The all-inclusive average tariff was 8.9%²². It is clear that for certain Palestinian goods the loss of their current “preference margin” would mean the loss of a significant competitive advantage they currently have in the Israeli market *vis-à-vis* third country products.

Under a WTO scenario, product standards for Palestinian window frames in Israel or for Israeli construction machinery in Palestine are subject (only) to the WTO’s TBT Agreement. Unless specifically agreed in addition, there would be no mutual recognition of standards and technical regulations; products from one side would be subject to potential delays and multi-level inspections when entering the other market. These would be more pronounced with regard to health & safety inspections of food products, which however would at least be controlled by the WTO’s SPS Agreement. (Both TBT and SPS Agreements would not apply under a simple NDTP policy outside of WTO Membership.)

The WTO however, encourages institutional cooperation, mutual recognition of standards and health requirements, and other forms of cooperation, provided other WTO members are given the chance to benefit from similar cooperation if they are in a similar situation. It would then be *possible* for Palestinians and Israelis, even if they do not conclude a comprehensive trade agreement, to arrive at specific cooperation arrangements under this scenario, for example a mutual recognition agreement (“MRA”) on food safety standards for milk products, or a coordinated regulation and supervision of car insurance providers.

Although a WTO/NDTP regime would regulate trade, it would result in a significant reduction of bilateral trade benefits *vis-à-vis* the current situation, in particular the loss of the “preference margins.” Palestinian and Israeli goods and services would

²² These numbers emanate from the WTO Secretariat’s Report prepared in the context of the 2006 Trade Policy Review of Israel.

compete in their respective other's market with goods from the rest of the world on an equal footing.

Scenario B: Quasi-Customs Union - Return to an Agreed and Improved Pre-Intifada Situation

This scenario envisages a situation where Israel and Palestine allow the free flow of goods and services between them and maintain a common external customs tariff for all or most goods. Under this scenario, it is possible, but not necessary, that goods from third countries also benefit from that almost free flow between the parties.

This situation resembles in many ways the present practice, as the Paris Protocol did in fact establish a quasi-customs union between Israel and Palestine, albeit under far-reaching de facto Israeli control.

Key Features

A Customs Union ("CU") is an economic integration model which includes all the features of an FTA (liberalization of trade in local products and/or services between the parties – see Scenario C), but adds elements of a common external trade policy, including most importantly a common customs tariff. Import taxation and regulation are harmonized between the two sides.

As a reflection of this harmonized external policy, it is much easier to allow for the free circulation of goods, whether national or imported, between the parties to the CU. This, in turn, makes the use of rules of origin, and their administration, much less important and costly. They can even be completely eliminated if, as is often the case, the common external trade policy harmonizes all rules of origin.

While a CU usually allows its members the right to retain some NTBs, CUs tend to work towards the progressive elimination of NTBs, to the extent that this is the intention of the parties. One of the most advanced examples of such CU is the European Community ("EC"). But even within the EC certain SPS and TBT measures still apply.

What Does this Mean? Some Examples & Reflections

A CU between Israel and Palestine would be the closest to the pre-Intifada situation. It would mean that both maintain a harmonized external tariff, with both national products and imported goods flowing free between the two economies.

It would further mean that NTBs such as different product standards, health regulations and related inspections *might* be kept to a minimum. It is however conceivable to maintain a CU with high NTBs.

The need for a common external trade policy however, would also mean that Palestine and Israel would have to agree on external tariffs. This would make it much harder, if not impossible, for Palestine to conclude separate FTAs with third parties, for example by joining GAFTA as a full member. In other words: living in a

CU with Israel, while clearly beneficial for bilateral trade, may affect trade with third parties negatively.

Additional “Political” Elements Assumed

For purposes of the impact analysis in Section 4 we envisage an improved quasi-customs union on the basis of the Paris Protocol. We assume a certain reduction of the de facto Israeli control and implementation. We further assume that this scenario will include the following additional factors:

- Movement and access arrangements and security procedures providing for an orderly and undisturbed movement of goods, businesspeople and tourists between Israel, Palestine and third-party countries;
- A relatively stable political and security situation inside Palestine, and between Palestine and Israel;
- Actively encouraging Israeli and Palestinian governmental policies towards business cooperation and investment;
- Donors financial support in the amount of US\$ 1-1.5 billion per annum, over a 10-year minimum period (a slight increase compared to the level of support during the Intifada period), directed to infrastructure and other development programs.

This scenario also envisages a gradual return to a pre-Intifada situation in all other aspects of economic life.

Scenario C: “FTA Plus” – FTA with Deeper Integration, Active Economic Cooperation and Donor Support

This scenario envisages an Israeli - Palestinian agreement on the duty free treatment of mutually originating goods and services, but not of third party goods or service (FTA for goods and services).

It further envisages that Palestine and Israel agree that this FTA is enhanced (“FTA plus”) through “deep integration” components like cooperation on health, tax, standardization, competition and bank supervision authorities, harmonization and recognition of product standards and professional qualifications of service providers and institutional arrangements such as joint committees and dispute settlement.

Key Features of a Free Trade Agreement

Like a CU, an FTA is an economic integration agreement. In a free trade area, the majority if not all, of the goods nationally produced (based on agreed rules of origin) enter the other market exempt of any customs duties or charges of equivalent impact. However, other entry requirements like technical standards and health and safety regulations of the importing market remain usually in place.

The main difference between a FTA and a CU is the lack of a common external tariff on third party imports. An FTA does not require the partners to harmonize their external trade policy towards third parties. Partners however, remain free to negotiate trade agreements, including tariffs, with third parties. Third country products then cannot flow freely between the FTA partners, because otherwise

imports from third countries could enter the combined market via the partner with the lower tariff. For the same reason, some harmonization of tariffs may be desirable to reduce the likelihood of smuggling and to ease bilateral border administration.

Because free trade areas liberalize trade in the nationally produced products of the parties, but do not affect their respective trade with third parties, rules of origin play a major role distinguishing national from third party products. In their absence, third party products could benefit from preferences through simple transactions (e.g. mixing) or just transshipment arrangements, nullifying the purpose of the free trade area. The flipside however, is the administrative burden for producers, traders and administrations associated with rules of origin.

Under an FTA, bilateral economic borders remain intact, becoming important to avoid non-originating goods from entering the territory under the guise of originating goods. The FTA therefore, requires in principle separate customs administrations by the parties, even though harmonization, cooperation and some integration are possible and desirable. Most importantly, the FTA allows each party to have completely separate trade policies vis-à-vis third parties. Having an FTA with Israel, instead of a CU, would, for example, enable Palestine to become a full Member of GAFTA.

Adding Elements: Features of an “FTA Plus”

With the WTO minimum requirements of covering “substantially all trade” satisfied, parties to an FTA or CU are free to take further measures towards integration and cooperation (sometimes referred to as “deep” or “deeper integration”).

There are many alternatives of deeper integration agreements (e.g. an FTA with a partly harmonized external tariff, e.g. on all industrial but not agricultural goods). Similarly, additional elements of cooperation and integration can be added with minor requirements imposed by WTO rules (e.g. cooperation between standards organizations, general recognition of health certificates, joint supervision of banks and insurances, joint telecoms regulation, harmonized immigration policy for certain specialists from third countries, etc).

Technically these variations will usually be FTAs with added features, or “FTA plus,” leaving out the harmonization of external trade policies characteristic for CUs. *Which elements* of “deep integration” are added to an FTA is a matter for negotiations.

What does this mean? Examples & Reflections

An FTA between Palestine and Israel would maintain the potential for duty free trade of local goods such as agricultural produce, if accompanied by the right certification of origin. But goods imported to Palestine from third countries via Israel would not enter duty free.

Such third party products would not be freely traded in an FTA, contrary to a CU. It is estimated that presently about one third of Palestinian imports (500 to 600 million USD per year) “from Israel” are actually third party products. Provided the FTA arrangements were to lead to more effective origin examination by Palestinian customs, these imports would generate customs revenue for the Palestinian treasury, instead of the Israeli treasury, as is the present case.

It should be noted however, that this would be an indirect effect of the presumably increased border presence of customs under an FTA. Also under a CU (including under the Paris Protocol) imports should be monitored and customs revenue distributed according to the destination principle.

It is also important to note that under an FTA, specific rules of origin will likely be applicable. This not only means administrative burdens for businesses, which will have to prove the origin of their goods and production inputs and/or value added in order to benefit from duty-free treatment. It also means that some Palestinian and Israeli products that are currently crossing the border duty free would not qualify as originating in either economy under normal rules of origin (because the transformation or value-added is not significant enough), and would no longer qualify for preferential treatment and be subject to MFN duties. (To facilitate the continued sub-contracting of services from one side to the other, a system of temporary entry of products would thus have to be devised to provide for cases like the sub-contracting of textile and sewing of Israeli ready wear in Palestinian factories and workshops.)

An FTA can be designed to permit diagonal cumulation between Palestinian, Israeli and European products aimed at entry to the European market (and subject to certain conditions with American products under the concept of *Qualified Industrial Zones*), allowing for the utilization of input materials within certain percentages from Palestinian and Israeli products to be exported to European (or American) markets duty free.

For Palestine, the benefits of an FTA would include the freedom to enter into preferential trade agreements, which Israel is not party to, such as the Greater Arab Free Trade Area (GAFTA) or the Agadir Group (Egypt, Jordan, Tunis and Morocco), an FTA designed to allow for cumulation of origin (i.e., sourcing inputs from various partners within the group) for preferential export to the EU under EuroMed cumulation rules.

“FTA Plus” Components: Examples & Reflections

A number of “FTA Plus” components can be envisaged, including the following:

- **NTBs in TBT and SPS:** “FTA Plus” features are generally desirable in the context of NTBs like standards or sanitary and phytosanitary measures. An example would be the mutual recognition of conformity testing certificates issued by standards institutes or testing laboratories. A recognized Palestinian laboratory could certify the conformity of Palestinian products with Israeli standards, and these certificates would be recognized by the Israeli authorities, making further testing at the time of importation into Israel unnecessary, and vice versa. Similarly, the standards themselves could be harmonized (for example by both sides adopting European standards) or, in the case of national standards, mutually recognized as sufficient.
- **Administrative Cooperation and Coordination on Trade in Goods:** Mutual services which would facilitate movement of goods across borders, such as customs administration for each other where logistically useful, the harmonization / synchronization of customs procedures, mutual assistance in the collection / clearance of VAT and others.

- **Harmonization, Recognition and Administrative Cooperation in Services Regulation:** Measures could include the recognition of qualifications (e.g. doctors, engineers), licensing (e.g. courier services), supervisory measures (e.g. banking supervision), or administrative cooperation such as a joint or harmonized tour guide registry and joint insurance regulation, necessary for car insurance if cars cross borders.
- **Cooperation in “Trade-Related Areas:”** Institutional cooperation including intellectual property administration, anti-dumping regulations, and health and pest control procedures.
- **Dispute Settlement:** A national court based mechanism, possibly with enforcement components similar to NAFTA’s, to deal with disputes between trading partners.
- **Cooperation in Other Non-trade Areas:** Investment, competition regulation, sectoral regulation, government procurement, and others.
- **Labour:** While every agreement is different, a standard FTA would not normally include provisions on the movement of labour between markets. Access of Palestinian labour to the Israeli market would have to be negotiated, if not covered by provisions on services.

An “FTA Plus” approach offers further integration while maintaining key features of autonomy *vis-à-vis* a CU, most importantly the freedom of each side to manage relations with third parties, allowing Palestine to design its own foreign trade policy, including for example Membership in GAFTA.

Additional “Political” Elements Assumed

For purposes of the impact analysis in Chapter 4, we assume that an “FTA plus” scenario would include the following factors:

- Movement and access arrangements and security procedures which will enable orderly movement of goods, businesspeople and tourists between Israel, Palestine and third party countries;
- Relatively stable political and security situation inside Palestine and between Palestine and Israel;
- Actively encouraging Israeli and Palestinian governmental policies towards business cooperation and investment;
- A high level of donor financial support, directed towards infrastructure and other development programs.

.....

IV. Impact Analysis of the Trade and Economic Regime Scenarios – Overview And Sector Study

.....

The objective of this section²³, is to assist Palestinians and Israelis in defining their planning and business choices through: (1) a qualitative and quantitative analysis of the impact of trade regime scenarios on their future economic development and specific sectors; and (2) factual evidence of these impacts on cooperation and key projects.

The quantitative analysis is summarized in comparative forecasts with respect to 3 parameters: (1) value added contribution to GDP; (2) contribution to exports, and (3) contribution to employment. The purpose of these forecasts is to illuminate the long-term implications of different trade regime scenarios.

4.1 Impact Analysis of the Trade and Economic Regime Scenarios – Overview and Cross-Sector

4.1.1 Scenario A: Economic Separation under Non-Discriminatory Trade Policy (NDTP/WTO)

This is a "more of the same" situation, evolving into a "low intensity hostile separation", with international involvement. The current quasi-customs union gradually dies, and is replaced by a NDTP/WTO regime²⁴ with the following characteristics:

Political and security factors: continuation of the political stalemate, political instability, daily violence, hostile atmosphere and negative governmental policies towards business cooperation.

Movement and access factors: The "closure regime" will continue in the West Bank²⁵. The Fence/Wall has been practically completed and all trade between the West Bank and Israel will go through 6 crossings that should be operational by 2008, making the economic impact of border closures much harsher. When these crossings become formal custom-borders, an additional layer of custom-related checks and bureaucracy will be added.

Trade factors: Palestine and Israel would lose their rights to preferential treatment, and would be obligated by WTO regulations to raise mutual tariffs and other barriers to the MFN level (the same that applies to all other non-preferred trading partners). The historical evidence supports scepticism with respect to the mutual adherence to WTO regulations.

²³ The detailed Sector Impact Analysis is presented in Annex II.

²⁴ For a detailed analysis of the trade-related aspects of the NDTP/WTO scenario, see Chapter 3

²⁵ Widened to Gaza as well.

Non-trade factors: The clearance system and banking relations could be suspended or terminated. Donor financial support would be reduced.

Implications for Palestine

Palestinian exporters would continue to face movement restrictions, uncertainty and prohibitive costs of transportation to Israel and third countries. This negative impact would be compounded by (1) trade movement through 6 controlled crossings, and the anticipated closures; (2) additional custom-related crossing obstacles; and (3) a new set of trade-related barriers as Palestinian exports would not enjoy free access to Israel any more.

Palestinian exports would decline substantially, and the economy would experience a downturn, adversely affecting employment. The cumulative impact of an economic decline would be substantial over time. By the end of the 10-year forecast period, Palestinian export revenues would be 2/3 of the current level, GDP would be ¾ of today's and 15-20% of the current jobs would be lost (Summary Table 1, p. 20 below).

Implications for Israel

The withdrawal of Israeli businesses from the Palestinian market that started with the Intifada would accelerate, as the purchasing power of the Palestinians would dwindle and transaction costs and security risks would increase. The importance of Palestine as a trading partner would diminish, with no substantial immediate damages to Israel, as their businesses are expected to develop market alternatives quickly.

Israel would lose however, a substantial economic opportunity. Lost exports may amount to USD 1,2 billion annually, and lost GDP to USD 1 billion, with the impact on employment expected to be minimal (Summary Table 1)²⁶

4.1.2 Scenario B: Customs Union - Return to pre-Intifada Situation

A CU includes all features of a FTA (liberalization of trade in products and/or services between the parties), adding a common external trade policy, particularly a common customs tariff and harmonized import regulations.²⁷

This more balanced CU would bring Palestinian economic development and Palestinian-Israeli economic relations back to the pre-Intifada status, as originally contemplated by the PP, with the following characteristics:

²⁶ Based on detailed analysis presented in the Sector Impact Study Working Paper

²⁷ For a detailed analysis of the trade-related aspects of this scenario, see Chapter 3

Political and security factors: relatively stable political and security situation inside Palestine and between Palestine and Israel; encouraging governmental policies towards business cooperation; positive international and regional atmosphere.

Movement and access factors: gradual dismantling of the "closure regime"; movement and access arrangements and security procedures for an orderly movement of goods, businesspeople and tourists between Israel, Palestine and third-party countries.

Trade factors: continuation of free trade between Israel and Palestine; improved access of Palestinian products to the Israeli market, more trading opportunities for Palestinian and joint products in third-party markets.

Non-trade factors: USD 1 to 1,5 billion donor financial support to Palestine over a 10-year period, for infrastructure and economic development programs; trade incentives for export of Palestinian and Palestinian-Israeli products to third-party markets; donor-backed "soft programs" on trade between Israel, Palestine and third-parties, investment incentives and others. CU constraints may limit the effect on trade with third parties of these incentives.

Implications for Palestine

This scenario would result in a gradual return of freedom of movement for Palestinian goods and businessperson between Palestine and Israel, and a gradual dismantling of all "internal closures" inside the West Bank, enabling the Palestinian economy to return to normal operations. Palestinian economic growth would be export-directed, with an immediate increase in local market activity, hopefully leading to double-digit annual GDP growth rates.

The accessibility of Palestinian importers and exporters to third-country markets would improve, enhancing Palestinian trade with third-country markets, especially Arab markets.

Considering the weakness of Palestinian productive sectors and the CU obstacles to trade with third countries, Palestine should be able to tap only a fraction of its export potential to US, European or Arab markets. Palestine however, should gradually gain a broader access to the Israeli market, where the largest increase in Palestinian exports would be seen.

The Palestinian economy should have high GDP growth rates in the first period of economic recovery, regaining its pre-Intifada real GDP per capita in about 7 years. Palestinian exports should grow almost ten-fold during the ten-year forecast period, its GDP should double and jobs should grow by 90 percent (Summary Table 1, p. 20 below).

Implications for Israel

Israel's exports to Palestine rise and fall with the Palestinian GDP. As this is expected to continue, a Palestinian economy recovery should generate an increase in Israeli exports.

The CU regime however, would limit the ability of the Israeli and Palestinian business communities to capture business opportunities created by cooperation with US, EU or Arab trading partners.

Israel is projected to increase exports of goods and services, excluding diamonds, by 20 to 25% in 10 years (USD 12 billion annually), GDP should grow by 5-6% (USD 9 billion) and 320,000 jobs would be created (12% increase).

4.1.3 Scenario C: FTA Plus - Active Economic Cooperation and Donor Support

An FTA is the result of an economic integration agreement allowing national goods to enter the other market exempt of any customs duties. The main difference between an FTA and a CU is the absence of a common external tariff on third party imports. The following factors will be present:

Political and security factors: same as for the CU scenario.

Movement and access factors: same as for the CU scenario (although under the FTA Plus scenario there will be custom borders between Israel and Palestine)²⁸.

Trade factors: an FTA will allow Israeli and Palestinian products to enter the other market exempt of custom duties, as under the CU regime. The difference is that an FTA would give Palestine preferential trade agreements to which Israel is not party, such as GAFTA. An FTA would also open the possibility of diagonal accumulation between Palestinian, Israeli and European products.²⁹

An effective FTA must have substantial "Plus" elements, including agreements on sectors like agriculture or tourism, issues like the use of shared water resources, the environment, transportation, impediments to exchange of services, agreements with third-party markets like QIZ-style arrangements with the US and other markets, special arrangements for export-oriented free zones, special economic development zones (the Jordan valley), special-status industrial estates (as has been discussed with Turkey), and others.

Non-trade factors: same as for the CU scenario.

²⁸ Physical border-crossings, and security checks are expected to be there anyway.

²⁹ For a detailed analysis of the key features of the FTA scenario, see Chapter 3

Implications for Palestine

The Palestinian historical economic performance shows remarkable strength whenever the political situation allowed for economic growth. This was evident throughout the 1990s (see Annex Tables 4.1, 4.2), as relative political stabilization and eased security restrictions resulted in a Palestinian annual economic real growth of 11% (1997-1999 average).

The conflict with Israel is the factor with the strongest impact on Palestinian economic development. Long-term real GDP growth data show the impact of the first Intifada (1988-1989, Annex Table 4.1), the violent period of 1996 (Annex Table 4.1), and the second Intifada (Annex Table 1.1).

A positive security and political atmosphere should result in fast Palestinian economic growth, including the mobilization of unutilized production capabilities: 300,000 unemployed working age people, plus 50,000 entrants yearly, ready to capture work opportunities, and high unused production capacity in industry and construction.

Additional growth-inducing factors are expected to contribute to high rates of real GDP growth in the first period of a return to orderly economic life, including Palestine's membership to GAFTA.

Jordan is a good example. As shown in Annex Table 4.4, under GAFTA, Jordan has tripled its exports to Arab markets between 2000 and 2006. More recently, these exports have grown between 25 to 30% annually. This Jordanian success strongly indicates the potential for Palestinian regional export growth. The combination of Palestinian GAFTA membership and its access to Israeli technology and production capabilities can place Palestinian exporters in a competitive position with respect to other regional players.

Under this scenario, in 5 years the Palestinian economy should regain its pre-Intifada real GDP per capita and continue to grow at a high rate for the following 5 years. Our projection at the end of the 10-year forecast period indicates a Palestinian GDP of USD 15 billion and GDP per capita of around USD 2,300 (Summary Table below).

Is such an optimistic forecast feasible?

The growth goals of this scenario are similar to what Jordan has achieved. Moreover, even under optimistic assumptions, Palestinian GDP per capita at the end of the 10-year forecast period, will still be 20% below the 2007 level of the Jordanian GDP per capita, and probably some 40-50% below its level in 2017. Palestinian annual exports should increase by USD 7 billion by the end of our 10-year forecast period, and the number of new jobs around 750,000, a 120% increase with respect to current employment (Summary Table 1 below).

Implications for Israel

Israel annual exports should increase by USD 18 billion in 10 years (1/3 over present levels, excluding diamonds), its GDP should grow by US\$ 12 billion (8% over the present level), and 450,000 new jobs should be created (17% over the present level).

Summary Table 1: Overall Impact Analysis. Year 10. ³⁰

		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA PLUS
Palestine	Exports loss/gain (US \$ millions) per year	-200	600	3,400	7,100
	GDP loss/gain (US \$ millions) per year	-1,500	Insignificant	5,100	10,500
	Employment loss/ gain (thousand jobs) per year	-165	Insignificant	550	750
Israel	Exports loss/gain (US \$ millions) per year	-2,500	-1,200	12,000	18,000
	GDP loss/gain (US \$ millions) per year	-1,800	-1,000	9,000	13,000
	Employment loss/ gain (thousand jobs) per year	-75	-10	320	450

4.2 Impact Analysis by Sector

4.2.1 Tourism

Implications for Palestine

The past 7 years were devastating for the Palestinian tourism sector. Revenues (exports) were practically zero in 2001-2004, and although there are signs of a recovery since 2005, revenues and tourist arrivals in 2005-2006 represented 20% of their 2000 level.

Continuation of current situation

Given the sensitivity of this sector to the political atmosphere, security situation and movement restriction, a continuation of the current situation would take the sector back to the level of activity in 2001-2002 (i.e. tourist numbers would be no more than a few tens of thousands per year and revenues would be almost zero), and eventually ruin the sector).

³⁰ The 5 years projection is presented in the Executive Summary.

Scenario A: NDTP / WTO

The long-term implications of this scenario would include a slow deterioration of this sector. The quantitative 10-year projection of this process is in Summary Table 2 below.

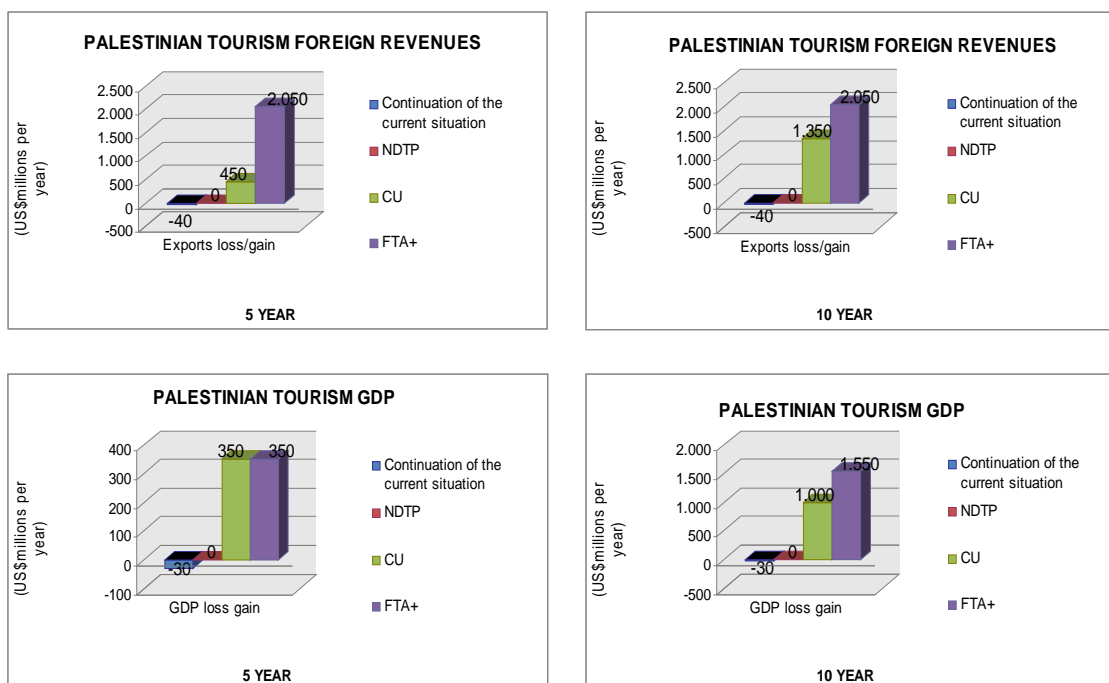
Scenario B and C: Improved Customs Union and FTA Plus

These would include the following characteristics: movement restrictions would be replaced by a free and orderly movement of tourists in Palestine and between Palestine and Israel; Palestine would become a safe and independent tourist destination; the average length of stay and spending of visitors would show an increase; travel destinations and points of interest would diversify beyond the strong dependency today on the Christian market; the Palestinian tourism infrastructure would be rehabilitated and developed; a partnership with the Israeli tourism sector would develop to market a broader “Holy Land” product.

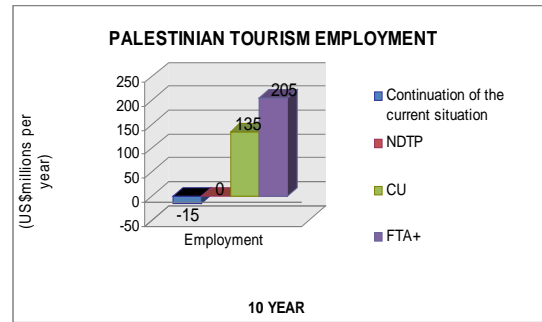
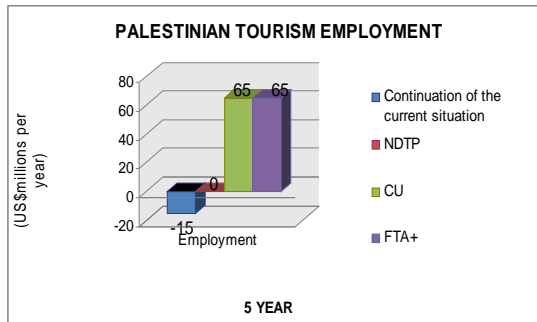
Our projections for the Palestinian tourism sector under scenario B are:

- The number of tourists would recover to pre-Intifada levels of 1 million by the 5th year of the forecast period, continuing to grow steadily until reaching 2 million by the 10th year.
- The average length of stay and spending of visitors will increase to USD 500 per tourist by the 5th year (double the 2000 level, but 40% of the 2005 Israeli level), and USD 700 by the 10th year (50% of the 2005 Israeli level).

There would be an increase in tourism revenues from USD 50 million annually, to USD 1.4 billion in 10 years; 135,000 jobs would be created (45,000 direct jobs and 2 new indirect jobs for each direct one); and GDP would grow by USD 1 billion (Summary Table 2 below).³¹



³¹ See the detailed analysis in the Sector Study Working Paper



Scenario C (FTA Plus) would enable the Palestinian tourism industry to tap more aggressively non-Christian markets (business and conferences, tour packages for Jordan and Egypt, Muslim pilgrimage and visiting friends and relatives or leisure travelling).

The half-ruined Palestinian tourism infrastructure would limit the recovery. Our forecast for the first 5 years is basically the same as for scenario B.

The quantitative forecast for scenario C by the 10th year would include: 3 million tourists per year, an increase in annual revenues from USD 50 million to USD 2.1 billion; 200,000 direct and indirect jobs created and a GDP increase of USD 1.5 billion (Summary Table 2).

Is this forecasts too optimistic?

Jordan is again a good example. A total of 6 million tourists will have visited Jordan in 2007³². Our forecast for scenario C is that after 10 years of "normal life", a total of 3 million tourists will have visited Palestine.

Implications for Israel

Israel was visited by 1.8 to 1.9 million tourists in 2005-2006. Over 2 million may visit the country in 2007. In the 2nd half of the 1990s, before the Intifada, the annual number of tourists ranged from 2.2 to 2.7 million. Annual tourism income in recent years has been around USD 2.5 billion.

Continuation of the current situation

The historical evidence shows that the Israeli tourism industry is quite sensitive to the political atmosphere and the security situation. The Intifada at the end of September 2000 caused a 72% decrease in the number of tourists.

Under this scenario, the recovery that tourism has experienced since 2003 would be reversed, and the number of tourists would fall to 1.2 to 1.5 million annually through the 10 year forecast period, with the following economic consequences:

- USD 800 million in annual export income losses³³.
- 60,000 jobs lost³⁴.

³² Of which one half are day-trippers; and around one quarter of a million Israelis (mainly Arab Israelis).

³³ Computed as per the Israeli average income of US\$ 1,300 per tourist (2005 figures)

- USD 600 in annual GDP losses³⁵.

Scenario A: NDTP / WTO

The Israeli tourism industry would not be substantially affected, continuing its present course of around 2 million tourists per year, with occasional falls at times of violent conflicts.

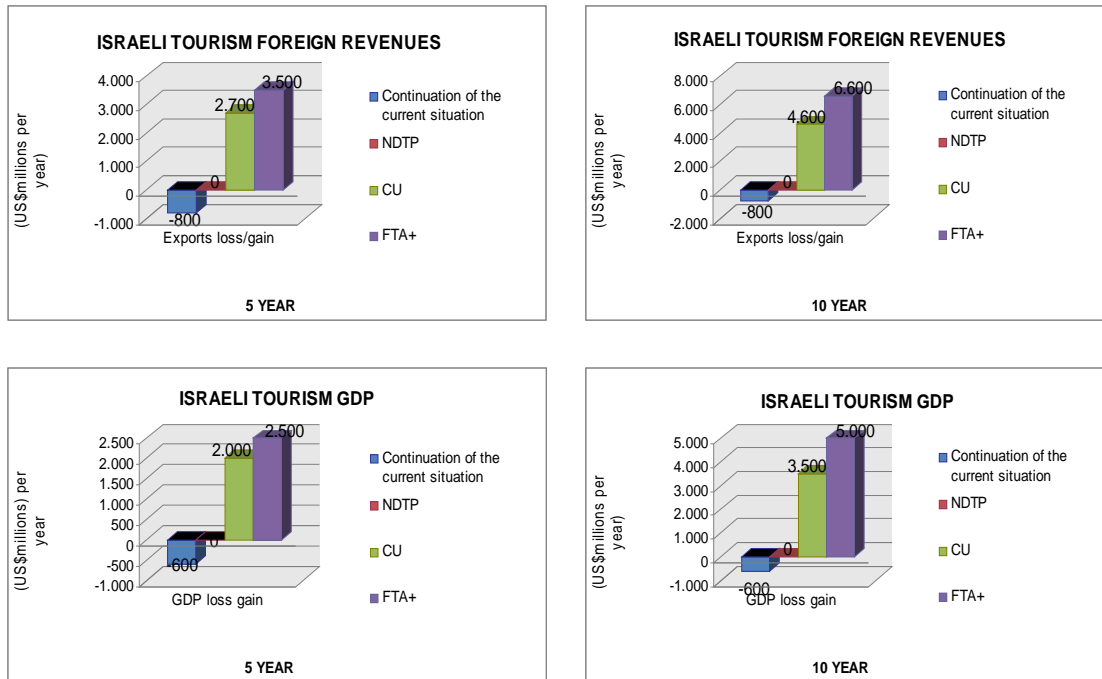
Scenarios B and C: Improved CU and FTA Plus

The positive atmosphere which these scenarios would represent for Israel (and Palestine), as a tourist destination would make a big difference for the Israeli tourism sector.

Scenario B (Improved CU regime)

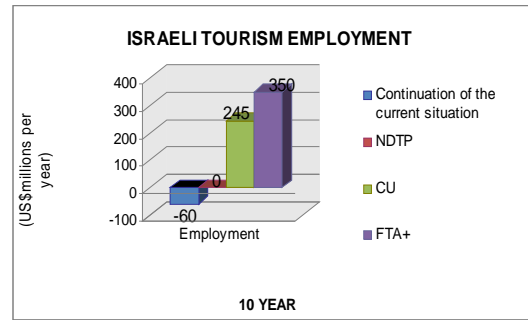
Israel would recover its pre-Intifada 3 million annual tourist visits in about 3 years. The target of 5 million visits would be achievable during the 2nd half of the 10 year forecast period, particularly if a strategic partnership with the Palestinian tourism sector is implemented to develop a “Holy Land” tourism project.

An **FTA Plus Scenario (Scenario C)** would be the most encouraging alternative from a business perspective, particularly considering the stronger flow of non-Christian tourism into Palestine.



³⁴ 20,000 direct jobs in tourism, and additional loss of around 40,000 indirect jobs.

³⁵ Based on the 2005 data as to the value added content in Israeli tourism revenues.



Our projections for the Israeli tourism sector **under scenarios B and C** are:

- Under scenario B, the number of tourists would recover to the pre-Intifada level of 3 million in 3 years, rising to 4 million by the 5th year, and 5 to 6 million by the 10th year.
- Scenario C would lead to stronger growth, reflected in a tourist visit number of 4 to 5 million by the 5th year and 7 million by the 10th year.

Summary Table 2: Tourism Sector Impact Analysis. Year 10.³⁶

		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA PLUS
Palestine	Exports loss/gain (US \$ millions) per year	-40	Insignificant	1,350	2,050
	GDP loss/gain (US \$ millions) per year	-30	Insignificant	1,000	1,550
	Employment loss/ gain (thousand jobs) per year	-15	Insignificant	135	205
Israel	Exports loss/gain (US \$ millions) per year	-800	Insignificant	4,600	6,600
	GDP loss/gain (US \$ millions) per year	-600	Insignificant	3,500	5,000
	Employment loss/ gain (thousand jobs) per year	-60	Insignificant	245	350

Our 10-year forecast would be as follows:

- Increase in annual tourism revenues (from the present USD 2.5 billion), to USD 4.6 billion under scenario B, and USD 6.6 billion under scenario C.
- Creation of 245,000 jobs under scenario B, and 350,000 under scenario C.
- GDP annual increase of USD 3.5 billion under scenario B, and USD 5 billion under scenario C.

³⁶ The 5 years projection is presented in the Executive Summary.

4.2.2 Agriculture

Implications for Palestine

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Continuation of the current situation

Agricultural GDP would decline more steeply than national GDP, because of its dependence on Israeli-made and Israeli-imported inputs. Agricultural inputs (mainly from Israel), constitute over 55% of the value of agricultural production, and in some areas 70 to 75%. Agricultural production would be seriously affected by the shortage of these critical inputs.

This has actually materialized in Gaza since its takeover by Hamas. The PalTrade survey of 12 July 2007 estimated that if cultivation supplies (fertilizers, pesticides, etc.) are not available, there will be a 50 percent fall in the quantity and quality of plant product. The effect on the Palestinian livestock sector would be severe, since all animal feed and other critical inputs come from or through Israel.

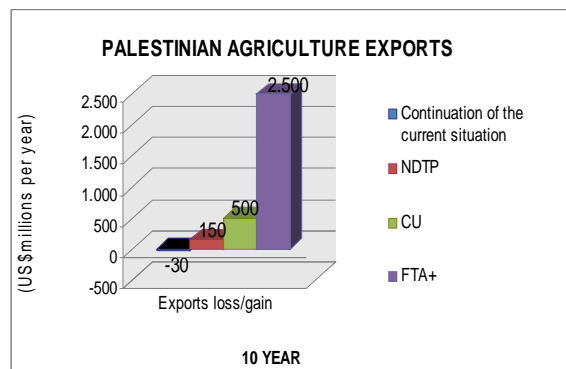
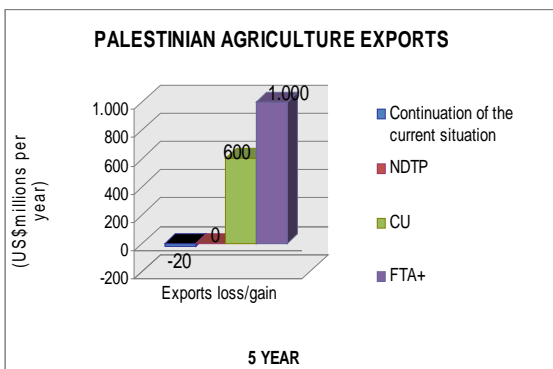
The estimated GDP loss would be about USD 220 million annually by the end of the 10-year forecast period. Agricultural exports are also expected to fall more steeply than the general fall in exports, bringing them from USD 50 to USD 20 million by the 10th year.

The impact on Palestinian employment would be moderate, since a large part of employment in this sector includes unpaid family members and part time workers.

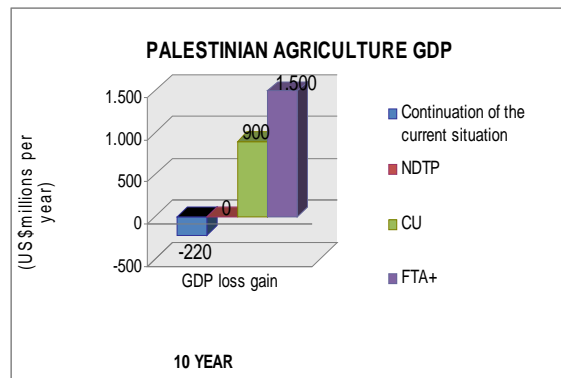
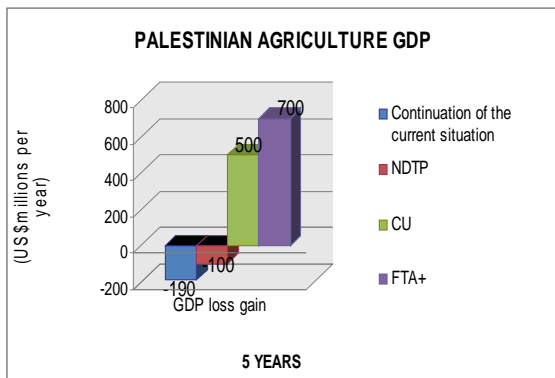
Scenario A: NDTP / WTO

Palestinian exports to Israel would experience an even more substantial decline than in the previous scenario, but exports to other markets may compensate for this decline. The impact on domestic economic performance would be more moderate than in the previous scenario.

Palestinian export-revenue losses would amount to 60% by the end of the 10-year forecast period, but the GDP fall would be in line with the overall Palestinian GDP decline (20 to 25%, Summary Table 3 below).



³⁷ Based on detailed analysis presented in the Sector Study Working Paper



Scenarios B and C: Improved CU and FTA Plus

Scenario B: Palestine and Israel would be able to set in motion a broad set of mutually advantageous trade and business activities, in agriculture and agriculture-related fields;

Scenario C: Palestine and Israel would have a number of business opportunities in fields like high-value vegetable, flower and fruit exports to European and other markets. Their cumulative benefit for Palestine could be estimated as follows: exports (and import substitution) increase of USD 1 billion by the 10th year of the forecast period, and a GDP increase of USD 900 million by the 10th year.

The **FTA Plus Scenario** would enable Palestine and Israel to benefit from other business opportunities with respect to third-country markets, especially Arab markets. Their cumulative benefit for Palestine could be estimated as follows: exports (and import substitution) increase of USD 2.5 billion by the 10th year of the forecast period, and GDP increase of USD 1.5 billion.³⁸

Implications for Israel

Prior to the Intifada, Israeli exports of agricultural products to Palestine totalled USD 200 to 250 million, about ¼ bigger of total Israeli agricultural exports. Agricultural exports to Palestine between 1999 and 2005 fell to about USD 150 million. In certain agricultural sub-sectors however, Palestine is still the largest Israeli export market (e.g. live animals, dairy products, and certain categories of fruit).

The export of inputs, intermediate products, and equipment (or "inputs") is more important for Israel. Exports of Israeli-made inputs to Palestine almost doubled in value in 1999 compared to agricultural products, estimated at USD 350 to 400 million. By 2005, exports of Israeli-made inputs decreased to around USD 250 billion.

Continuation of the current situation

Israeli exports of finished agricultural products to Palestine would show different declines. Basic products like milk and meat would be less affected than others like fruits. Exports of Israeli-made agricultural inputs would decline in line with Palestinian agricultural GDP.

³⁸ See detailed analysis in the Sector Study Working Paper.

The impact on Israeli GDP is estimated on an average ratio of 60% value added assumed for all Israeli-made lost exports to Palestine (excluding re-exports). We expect agricultural export losses to amount to USD 210 million annually by the 10th year, and GDP losses of USD 125 million annually by the 10th year.

Scenario A: NDTP / WTO

Israeli exports of finished agricultural products to Palestine should experience a steep decline. The decline in exports of inputs for Palestinian agriculture should be smaller, compared to the previous scenario.

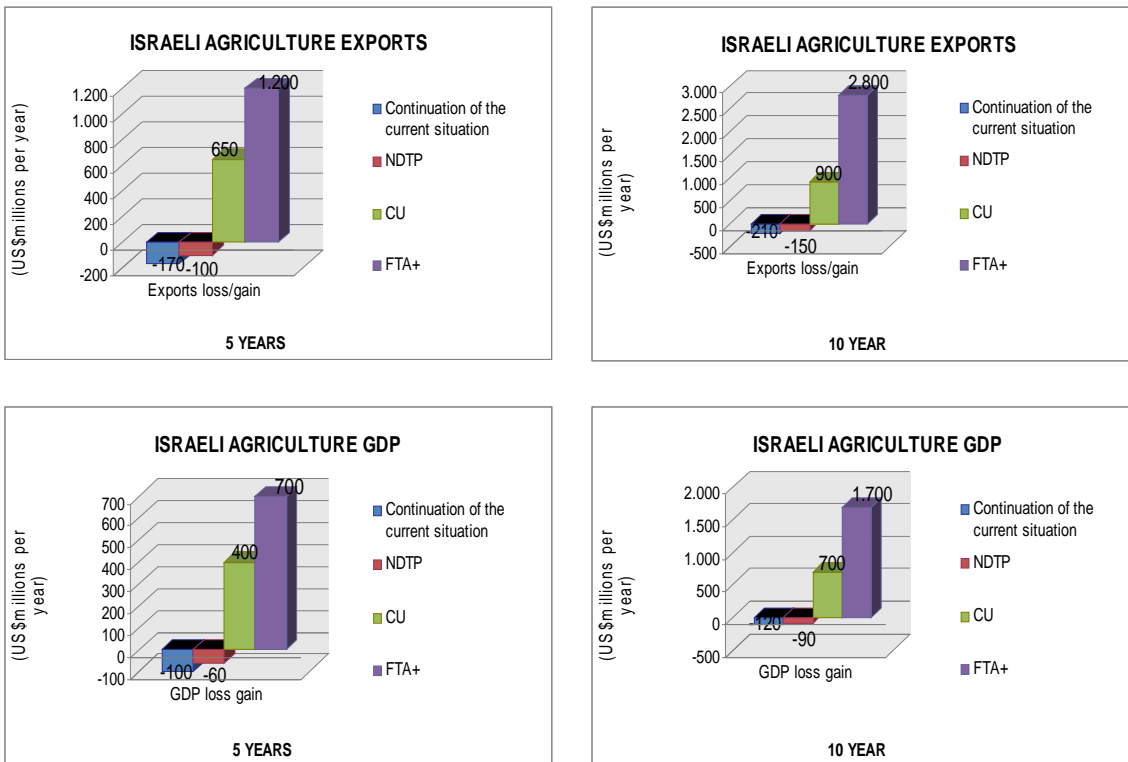
We estimate the Israeli agricultural export revenue losses at USD 150 million annually by the 10th year; and GDP losses at USD 90 million annually (Summary Table 3 below).

Scenario B: Improved CU

Israel and Palestine could develop mutually advantageous trade and business activities in agriculture and agriculture-related fields.

Israeli businesses could benefit from the development of Palestinian agriculture through partnerships, supplying inputs, intermediary products and equipment and exporting agricultural products and inputs to Arab markets developed jointly with Palestinian partners.

The benefit for Israel could include export increases of USD 1.15 billion by the 10th year and GDP increases of USD 700 million.



Scenario C: FTA Plus

This would enable Israel and Palestine to take advantage jointly of business opportunities in additional sectors and third country markets, particularly Arab markets.

The benefit for Israel could include export increases of USD 2.8 billion by the 10th year and GDP increases of USD 1.7 billion.

Summary Table 3: Agricultural Sector Impact Analysis. Year 10.³⁹

		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA Plus
Palestine	Exports loss/gain (US \$ millions) per year	-30	150	1,000	2,500
	GDP loss/gain (US \$ millions) per year	-220	Insignificant	900	1,500
Israel	Exports loss/gain (US \$ millions) per year	-210	-150	1,150	2,800
	GDP loss/gain (US \$ millions) per year	-120	-90	700	1,700

4.2.3 Building Materials

Implications for Palestine

The Palestinian construction industry has been characterized by fluctuations that strongly reflected the performance of the economy. Total expenditure on building, about USD 1 billion in 1999, fell 75% by 2001, fluctuating between USD 400 to 800 billion in 2002-2006.

The stone and marble sub-sector is one of the most significant industries in Palestine. Other major sub-sectors include structural metal products and metal intermediary products for building, concrete and cement, paint, carpentry, veneer sheets and construction wood works.

The Palestinian stone and marble industry is highly interwoven into the Israeli construction industry. Other Palestinian building industries also depend on the Israeli construction industry, as a market for their production, or as a source of their inputs. Pre-Intifada building exports to Israel (including related services) amounted to 1/3 of Palestinian exports to Israel.

Continuation of the current situation

The impact on Palestine would be very negative, given the sensitivity of this sector to the fluctuations of the Palestinian economy and its dependency on the Israeli market. Gaza-style closures would likely cause a drastic decline in Palestinian exports of building materials and severe shortages in critical construction inputs. This has materialized in Gaza since its takeover by Hamas. The PalTrade survey of

³⁹ The 5 years projection is presented in the Executive Summary.

12 July 2007 found that in July 2007 the number of employees in the construction industry in Gaza was 80% lower than in January 2007.

We estimate that this situation could cause a 50% decline in Palestine exports of building materials, followed by further declines in subsequent years.

Domestic expenditure on building should fall from 60% to 70% (from a 2004-2006 average) and remain at that level through the 10-year forecast period, causing building sector GDP losses of over 50% by the 10th year.

Our 10-year forecast would then be as follows: annual export losses of USD 70 million and GDP losses of USD 150 million by the 10th year of the forecast period.

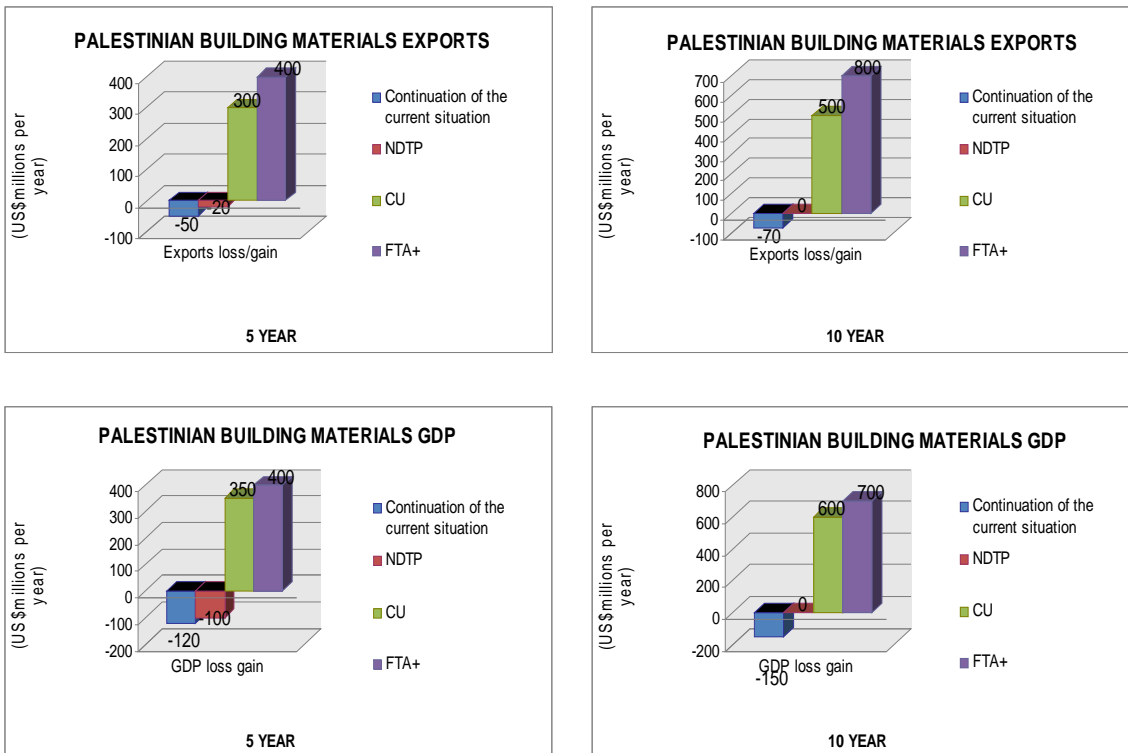
Scenario A: NDTP / WTO

The decline in Palestinian exports of building materials, mainly stone and marble, to Israel is expected to be more moderate than for other sectors. Palestinian annual export revenue losses would amount to USD 30 million, and GDP losses to USD 60 million by the 10th year of the forecast period (Summary Table 4 below).

Scenario B: Improved CU

On the basis of past experience, construction should be a leading sector in a Palestinian economic recovery.

Domestic construction activity should reach pre-Intifada levels by the 1st or 2nd year (registering 60% to 70% growth). **Exports to Israel** should grow faster, considering the easier access that stone, marble and other building materials should have to Israel.



This scenario would enable Palestinian and Israeli producers to cooperate in marketing stone products to the US and other high-value markets, meeting the growing demand for high quality stone in world markets.

Our 10-year forecast would then be as follows: annual export increases of USD 500 million, and GDP increases of USD 600 million by the 10th year of the forecast period.

Scenario C: FTA Plus

Palestine and Israel could cooperate to produce, market and sell to third-country markets, especially Arab markets, focusing on premium building products, like advanced systems to these huge markets (total annual investment in construction in the 6 Gulf countries in the coming decade is estimated at US\$ 30 to 40 billion).

Our 10 year forecast would then be as follows: annual export increases of USD 800 million, and GDP increases of USD 700 million by the 10th year of the forecast period.

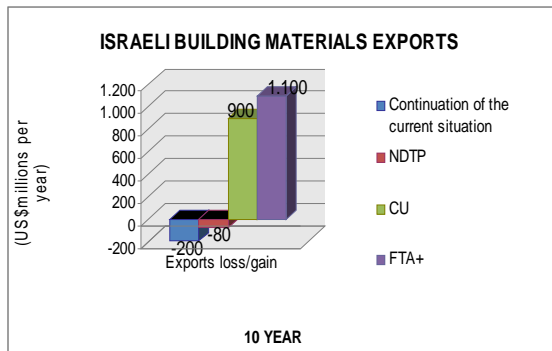
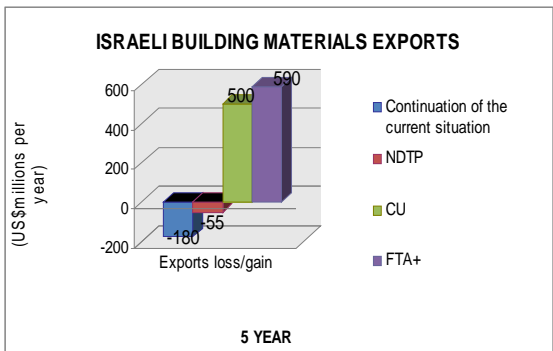
Implications for Israel

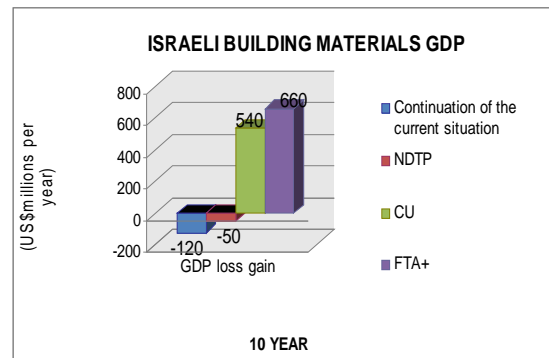
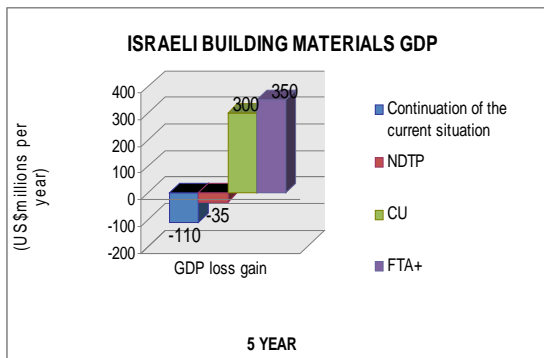
The building material sector includes a variety of sub-sectors that supply all kind of inputs, intermediary products, systems, equipment and services to the construction industry. Though many of the basic building industry products are local or regional (low value per ton, long range transportation costs relatively high), Israel's high value products are increasingly gaining export markets, with volumes estimated at USD 1.5 billion.

Pre-Intifada total Israeli building material sector exports to Palestine (including cement, stone and other building materials, metal, wood and plastic, and related services) were estimated at over USD500 million, approximately 20% of total Israeli exports to the Palestine.

The dependency of the Palestinian construction sector on Israeli inputs is reflected in the substantial Israeli value added to Palestinian construction. Excluding labour and stone costs, Israeli value added is larger than Palestinian value added in respect to the total value of production in the Palestinian construction sector.

The level of economic activity in Palestine has significant effects on the volume of Israeli exports to Palestine of construction industry inputs. Israeli exports of these products in 2005 were 35% lower than in pre-Intifada years.





Continuation of the current situation

Exports of Israeli construction inputs would decline in line with the Palestinian construction sector GDP. Taking total Israeli exports of USD 300 million in the Base Year, we would expect a decline of 2/3 by the 10th year, representing a USD 200 million loss. The impact on Israeli GDP is estimated on the basis of a 60% added value ratio, representing USD 120 million by the 10th year.

Scenario A: NDTP / WTO

The decline in Israeli exports would be proportionately lower than for Palestine, amounting to USD 80 million and GDP losses of USD 50 million by the 10th year.

Scenario B: Improved CU

Israel could benefit from cooperating with Palestine to export to third countries, in addition to benefits from a rise in the export of construction inputs to Palestine, which should grow in line with the Palestinian construction GDP. These benefits for Israel could represent export increases of USD 900 million and GDP increases of USD 540 million by the 10th year of the forecast period.

Scenario C: FTA Plus

Israel could benefit, jointly with Palestine, from substantial export gains from cooperation in production, marketing and selling to third-country markets, especially the Arab markets. This could represent export increases of USD 1.1 billion and GDP increases of USD 660 million by the 10th year of the forecast period.

Summary Table 4: Building Material Sector Impact Analysis. Year 10. ⁴⁰

		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA Plus
Palestine	Exports loss/gain (US \$ millions) per year	-70	Insignificant	500	700
	GDP loss/gain (US \$ millions) per year	-150	Insignificant	600	700
Israel	Exports loss/gain (US \$ millions) per year	-200	-80	900	1,100
	GDP loss/gain (US \$ millions) per year	-120	-50	540	660

⁴⁰ The 5 years projection is presented in the Executive Summary.

4.2.4 Fast Moving Consumption Goods

Fast Moving Consumer Goods (FMCG) are daily-consumed products that have a quick turnover and sell in large numbers at a relatively low cost. This includes food, drinks, soap, cosmetics, teeth cleaning products, shaving products and detergents.

Implications for Palestine

Palestinian FMCG exports to Israel are insignificant in contrast to the importance of the Palestinian market for Israeli FMCG exports. However Israel remains an important potential export market for Palestinian FMCG industries.

Continuation of the current situation

The impact on Palestinian FMCG exports would be marginal, but the impact on the domestic market and industrial production would be significant. This scenario would have negative sector impact due to an expected steep decline in household incomes and a corresponding reduction in local demand for food industry products, and to the dependency on Israeli inputs, which, by becoming less available, would lower production capabilities of local FMCG industries and increase production costs.

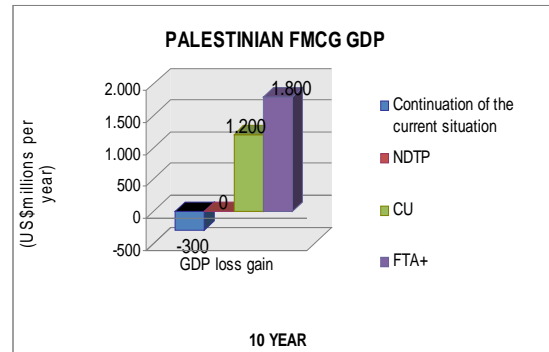
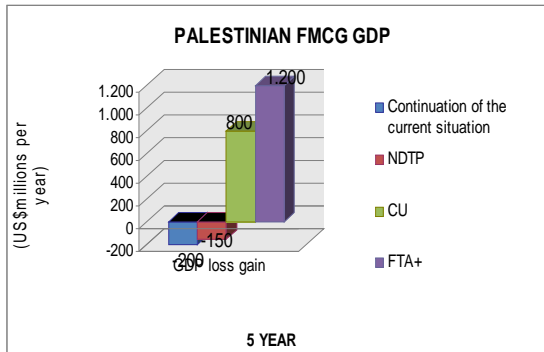
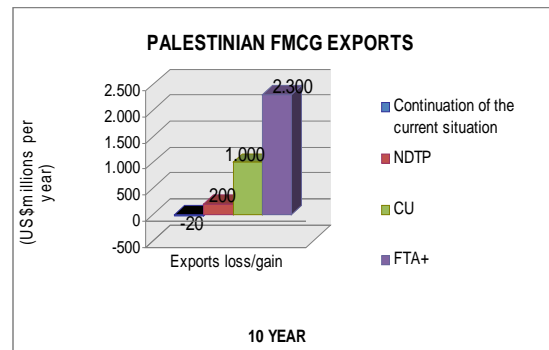
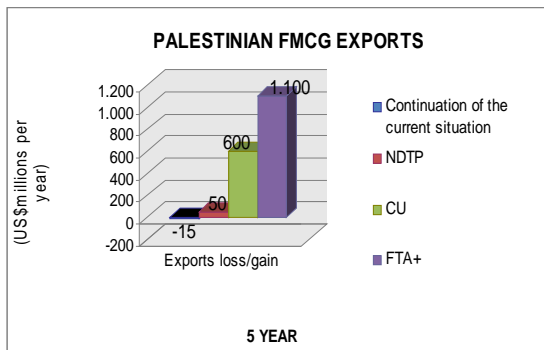
Our 10-year forecast would be as follows: export losses of about USD 15 million annually and GDP losses of about USD 300 million by the 10th year of the forecast period.

Scenario A: NDTP / WTO

We would anticipate annual export losses of about USD 15 million. GDP would fall in line with national GDP (between 20% to 25%, Summary Table 5 below).

Scenario B: Improved CU

We would anticipate a substantial increase in local demand for food industry products. The challenge for the Palestinian FMCG industry would be to compete with imports from foreign suppliers. Cooperation with the Israeli industry would enable Palestinian FMCG producers to rely on Israeli technological and logistical advantages to develop a similar capacity in Palestine. Cooperation would open **the Israeli market** to Palestinian FMCG products, including already existing local and international marketing channels. Israeli producers could lower production costs, particularly in labour intensive activities, and enhance their competitiveness in the local market against foreign suppliers.



The extent of the benefits from this cooperation depend on Palestinian economic activity. The Palestinian market should generate new annual sales for Palestinian and Israeli food industries combined of USD 2 billion over the 10-year forecast period. The Israeli local market may generate equivalent export and import substitution benefits of USD 0.5 to 1 billion for Palestinian and joint food industry products. Our 10-year forecast would be as follows: annual export increases of USD 1 billion, and GDP increases of USD 1.2 billion by the 10th year of the forecast period.

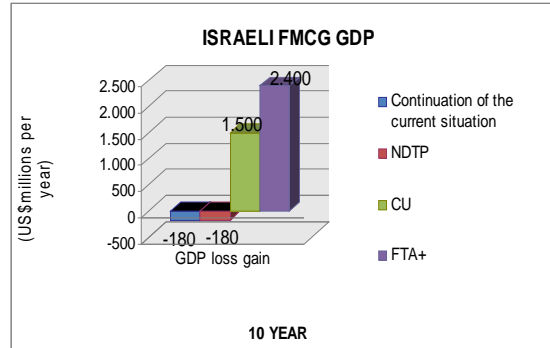
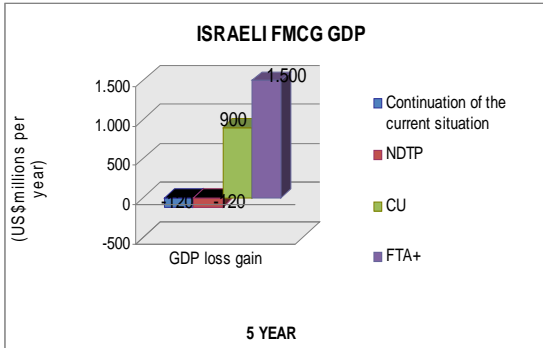
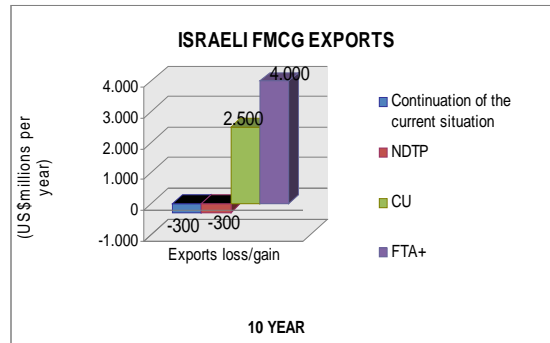
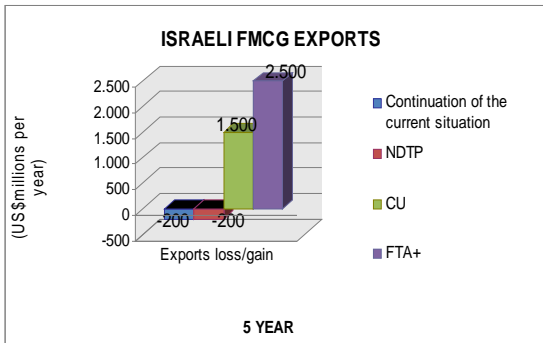
Scenario C: FTA Plus

This would open opportunities in Arab markets, where there is strong demand for high-quality food products. Cooperation in production and marketing would enable Palestinian and Israeli suppliers to sell premium products to these markets at competitive prices. Such cooperation would benefit from: (1) Palestinian membership to GAFTA, providing duty-free access to GAFTA to joint products; and (2) the proximity of production sites, reducing transportation costs and enhancing the comparative advantage of Palestinian-Israeli products.

Our 10-year forecast would be as follows: annual export increases of USD 2.3 billion and GDP increases of USD 1.8 billion by the 10th year of the forecast period.

Implications for Israel

Until the first Intifada in 1987, the Palestinian market represented a significant share of Israeli food industry sales. The Intifada started a continuous decline of Israeli food sales to the Palestinian market. The second Intifada forced many Israeli companies to cease their activities in the Palestinian market altogether.



Israeli exports of food products to Palestine are exceptionally sensitive to the Palestinian economic and security situation, especially in non-basic foods. The Israeli Food Industries Association estimated that exports of food products to Palestine dropped 60% in the early years of the second Intifada, and then jumped up 50%.

As growth potential in the Israeli FMCG market is limited, leading Israeli food and non-food FMCG companies are gradually shifting to export oriented growth strategies, and Palestine is a high priority target under these strategies.

Continuation of the current situation

Three categories of FMCG companies must be differentiated: (1) suppliers of basic food products (i.e. drinking milk, low price soft drinks, etc.), which would be less significantly affected; (2) suppliers of non-basic FMCG products, including a variety of food and other FMCG products whose sales to Palestine would fall substantially; and (3) suppliers of raw materials, other inputs and semi-finished products to Palestinian food and other FMCG industries, which would also see a significant reduction in sales.

Our 10-year forecast would be as follows: annual export losses of USD 300 million and GDP losses of USD 180 million by the 10th year of the forecast period.

Scenario A: NDTP / WTO

The projected impact of this scenario should be moderate: annual export losses of USD 150 million and GDP losses of USD 90 million by the 10th year of the forecast period (Summary Table 5 below).

Scenario B: Improved CU

Palestine would remain the most important export market for Israeli food products. Israeli and Palestinian exporters would benefit from the cooperation described in the impact analysis for Palestine. Our 10-year forecast would be as follows: annual export increases of USD 2.5 billion and GDP increases of USD 1.5 billion by the 10th year of the forecast period.

Scenario C: FTA Plus

This would open opportunities beyond those mentioned under Scenario C, because Israeli-Palestinian cooperation in the production and marketing of food products would provide access to large and growing Arab markets.

Our 10-year forecast would be as follows: annual export increases of USD 4 billion, and GDP increases of USD 2.4 billion by the 10th year of the forecast period.

Summary Table 5: FMCG Sector Impact Analysis. Year 10. ⁴¹

		Continuation Current Situation	SCENARIOS		
			A: NDTP/WTO	B: Improved Custom Union	C: FTA Plus
Palestine	Exports loss/gain (US \$ millions) per year	-20	200	1,000	2,300
	GDP loss/gain (US \$ millions) per year	-300	Insignificant	1,200	1,800
Israel	Exports loss/gain (US \$ millions) per year	-300	-300	2,500	4,000
	GDP loss/gain (US \$ millions) per year	-180	-180	1,500	2,400

⁴¹ The 5 years projection is presented in the Executive Summary.

V. A REFERENCE SCENARIO: THE LIKELY/DESIRABLE FUTURE TRADE REGIME

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5. A REFERENCE SCENARIO: THE LIKELY/DESIRABLE FUTURE TRADE REGIME

This section aims to provide a sketch, and brief evaluation, of what appears to be the most desirable - and, provided serious negotiations happen: most likely-future scenario, namely a “FTA Plus”. This sketch is a risky guesswork, as it is, of course, impossible to predict the outcome of negotiations. With this caveat in mind, it appears useful to engage in such a projection to assist businesses, negotiators, policymakers and other stakeholders in shaping their perspectives for the way ahead.

5.1 The Desirability and Likelihood of an “FTA Plus” Regime

An FTA/“FTA Plus” is a desirable future trade arrangement between Palestine and Israel because it ensures a desirable level of economic integration between the parties while allowing them autonomy in the conduct of trade with third parties. An FTA/“FTA Plus” is also a likely future trade regime between the parties because it satisfies both the WTO conditions for preferential trade arrangements and those of the Pan-Euro-Mediterranean cumulation of origin, a cornerstone of future trade and economic cooperation in the region.

Desirability: There are two main reasons that make an FTA/“FTA Plus” a desirable future trade regime between Palestine and Israel. First, an FTA/“FTA Plus” is an economic integration agreement that allows most nationally produced products (and services in so far as the agreement addresses services trade) to enter the market of the other party to the FTA/“FTA Plus” duty free. An FTA/“FTA Plus” therefore ensures the free flow of trade in originating products between Palestine and Israel.

Second, FTA/“FTA Plus” does not pose a requirement on the parties to the FTA to harmonize their external tariff policy towards third party imports. For Palestine, this would mean autonomy to enter into trade arrangements with third parties with whom Israel may not necessarily have trade relations. Even if Israel has trade relations with such third parties, the optimal conditions for trade relations may not necessarily be the same. This is particularly relevant in the context of Palestine’s integration with the Arab world under the GAFTA, the Agadir Group or other bilateral or regional trade arrangements with Arab or Islamic countries. Further, it is important to recognize that notwithstanding the benefits of harmonization *some* differentiation in external tariffs between Israel and Palestine may be beneficial, as the different levels of development between the parties may let them benefit from the flexibility of employing different tariff levels in particular in respect to certain special or sensitive products.

Likelihood: It is imaginable that Palestinian and Israeli negotiators will not be able to agree on comprehensive new parameters for a future trade regime. In that case,

the most likely default options appear to be a WTO/NDTP scenario (this would not require them to negotiate; they could just accept their (future) multilateral obligations under the WTO) or a de facto continuation of the Paris Protocol regime, more or less implemented (this may be the result of a tacit agreement not to do anything, which would leave the Paris Protocol applicable in principle). This option, however, appears rather unstable, and hence provisional, as neither party appears willing to actually remain in a customs union.

Provided Palestine and Israel do succeed in holding serious negotiations about their future trade regime, however, it is reasonable to presume that this arrangement will likely be in the form of an FTA to satisfy WTO requirements for preferential trade agreements under GATT Article XXIV and fulfil EuroMed requirements for the cumulation or origin.

WTO rules recognize the desirability of trading partners to establish close economic integration in the form of customs unions and free trade areas and grant each other treatment that is even more favorable than that granted to other WTO members (MFN) in order to enhance and facilitate trade among their markets. However WTO rules try to balance the opportunities of trade creation that arise from enhanced trade relations between parties and the risks of trade diversion with third parties through requiring to the parties to liberalize substantially all the trade between them and not to raise tariffs or non-tariff barriers to trade vis à vis third parties. Both requirements are currently fulfilled by Israel and Palestine.

Past experience, current relations and the general political outlook, however, suggests that a customs union between Palestine and Israel is a rather unlikely scenario for the future as it requires enhanced – and somewhat active – economic, institutional and political cooperation, harmonized trade and tariff policies and deeper economic integration between the rather ‘unequal’ trade partners. It is reasonable therefore to assume that the more likely scenario that satisfies the parties existing and future WTO commitment is an FTA, or “FTA Plus.”

In addition, the European requirements for diagonal cumulation of origin under the Euro-Med system of cumulation necessitate the parties in the cumulation process to be members of (at least) an FTA and to have identical rules of origin. An FTA/“FTA Plus” between Palestine and Israel would therefore allow Palestinian and Israeli producers to benefit from the EuroMed cumulation rules in their production processes.

5.2 “FTA Plus” – Why and How?

Given the current integration and interdependence of the Palestinian and Israeli economies, there is an obvious significant degree of mutual business interest in a high degree of integration and cooperation in any future trade regime. At the same time, a customs union appears highly unlikely as a long-term option due to its various constraining effects. This suggests that an “FTA Plus” will best satisfy the parties’ needs.

What could be the “plus” elements? The new generation of FTAs recently negotiated provides some guidance for this. These FTAs often entail additional components to optimize the economic and institutional between the parties to the FTA, facilitate

trade and create the necessary framework for resolving disputes in addition to widening the scope of the agreement. These additional elements, often referred to as “FTA Plus,” may include, for example, the following elements:

- mutual recognition of standards, technical and health safety regulations, testing and certification
- institutional cooperation in matters such as competition regulation
- labour movement regulating the movement of labours from either side into the labour market of the other side
- transit between the two sides facilitating the transit of goods from and to third parties over the territory of the other party
- border control and customs co-operation arrangements– important in order to ensure that rules of origin do not become an unnecessary barrier to trade
- investment protection arrangements, establishing rules for investments by one side in the economy of the other side and the protection of such investments and investors
- dispute settlement procedures and remedies –the key to ensuring the reliability and predictability of the trade relations based on rules, rights and obligations.

In essence, thus, “FTA Plus” looks as the most promising option because it combines

- the **benefits of separation** (policy freedom: access to GAFTA, fine-tuning of trade and economic policy to national interests, minimize interdependencies that might generate risks, etc.) with
- the **benefits of cooperation** (institutional and legislative harmonization and cooperation, free trade) while
- **satisfying WTO requirements** for preferential agreements (so does a CU arrangement), and
- **fitting into Euro-Med and other FTA contexts** providing an opportunity to exploit the pan Euro-Med cumulation of origin.

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VI. Fields of Cooperation and Potential Projects

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6.1 Tourism

Both Israel and Palestine share the interest of taking advantage of the unique position of the "Holy Land" for the development of religious, historically oriented and sightseeing tourism. Under conditions of political stability (such as envisaged under Scenarios B and C), Israeli-Palestinian cooperation in marketing and product development can make the "Holy Land" a major world-class tourism attraction.

According to Israeli tourism sector estimates, the overall joint tourism potential of Israel is around 7-8 million tourists per annum; of which, 5-6 million would be religious, historically oriented and sightseeing tourists, and 2-3 million in other segments.

In addition, tourism sector leaders point to the vast potential of the two domestic-tourism markets. The magnitude of Israeli domestic hotel-use is around 12 million hotel night per annum. For comparison one should note that the total figure of nights spent by the 9 million tourist who visited Egypt in 2006 was 90 million (only 7.5 times the Israeli domestic market). The untapped potential of the domestic Palestinian market is huge as well (on certain days of the Ramadan, for example, Jerusalem hosts hundreds of thousands of Muslim visitors).

A major critical field of cooperation is in marketing of the Joint product of Holy Land in the major tourism markets. Studies have shown that the image of Israel as a dangerous and unpleasant destination costs Israel 2-3 million tourist visits per year. The best and most effective way to accomplish such a "repair" is through cooperation in marketing and image building in the major tourism markets.

In order to practically promote cooperation in this vital field, it is suggested that a specific market be chosen as a pilot for such a joint image-building and marketing operation (e.g. the German market), which should be backed by an appropriate European partner. Once such a pilot proves its value, and a model for successful cooperation is established, it can be duplicated on a larger scale to other tourism markets.

6.2 Agriculture

As mentioned above, **Scenario B** would enable mutually advantageous cooperation in various agriculture-related fields, such as:

- Development of high-value vegetable, flower and fruit exports to European and other markets in cooperation with Israeli companies; this would be based on the following strengths: (1) The professional capabilities and expertise of Palestinian farmers; (2) Palestinian relatively low labor costs; (3) Israeli advanced agricultural know-how and logistical services; (4) Israeli access to European and other high-value Western markets; and (5)

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- Palestinian access to fast developing high-value Gulf and other Arab markets.
 - Palestinian-Israeli Cooperation in other fields of advanced Agro-Business, for the local Palestinian and Israeli markets, and for export to third markets
 - Palestinian Production of Labor Intensive Vegetables for the Israeli Food Industry
 - Revival and Development of Citrus Production in Gaza with Treated Waste Water
 - Olive Oil Export from the West Bank to Israel and Other Markets
 - Palestinian "Boutique" and "Specialty" Agricultural Projects, such as organic crops, production of honey, specialty grape products, and many more
 - Cooperation in agriculture-related logistical, extension, water-treatment and other services
 - Regulated employment of limited number of Palestinian workers in Israeli agriculture, under new mutually agreed arrangements.

Scenario C (FTA Plus) would enable Palestine and Israel to take advantage of a second tier of business opportunities; most importantly, this scenario would unleash, for the Palestinian and Israeli agro-business communities, the large potential of cooperation and joint business development vis-à-vis third-country markets, and especially the Arab Gulf markets.

Arab Gulf countries (including Saudi Arabia) have developed into huge markets for agricultural products, which consume fast-growing quantities of imported fruits, vegetables, and other agricultural products, and serve as an important international marketplace for flowers and other agricultural products as well. Saudi Arabia alone imported, in 2005, agricultural products at a total value of over US\$6 billion (most of it non-basic products).

The combined advantage of the free access of Palestine (as a member to GAFTA), and the quality-edge of Israeli growers would enable: (1) gradual development of diversified agro-business based on export from Palestine to these markets, in cooperation with Israeli growers; and (2) marketing of Israeli production surpluses to these markets, combined with Palestinian exports.

A vital project necessary for supporting these vast opportunities is a logistical and agricultural-support center, which needs to be developed near the east-bound Palestinian border-crossing, namely in the area of Jericho.

In summary: under Scenario B (Customs Union) Palestinian-Israeli cooperation is expected to expand far beyond the specific fields and activities mentioned above, in plant production and marketing, in various livestock sub-sectors, and many other agriculture-related fields, activities and services. The cumulative effect would be gradual transformation of the Palestinian agricultural sector at large, from low-value, low-quality local market oriented agriculture, to high-quality and high price export oriented agri-business. **Scenario C (FTA Plus)** would inject more power into this process.

In order to practically promote cooperation in agriculture, it is suggested to choose some of the following projects for immediate promotion:

- An export-directed flower or vegetable growing project in the West Bank (based on Gaza experience, and serving as a model project).
- An olive-growing and olive-oil production upgrading model project.
- An organic farm model project in the Jordan valley.
- A logistical and agricultural-support center project, either by one of the major Israeli-Palestinian West-Bank crossings, or in the area of Jericho.

6.3 Building Materials

Palestinian-Israeli cooperation in this field needs to concentrate mainly on marketing, in the respective domestic markets, and jointly in third-party markets.

Such cooperation may start in the export of stone and marble to third-party markets. The demand for high quality stone is on the rise in the US and in other markets, and sales of Israeli and Palestinian stone to these markets has increased significantly. This is due to the product's unique quality, which meets the current trend to incorporate stone in design, coupled with processing techniques (including distinctive masonry) that result in unique products.

More generally, business cooperation (and donor support) in this field should focus on enhancing accessibility and supporting marketing of Palestinian and Israeli suppliers in the other party's market and jointly in export markets, including, inter alia:

- Programs that will offer incentives and professional support for the marketing of Palestinian construction industry products in Israel: construction-material marketing centers in Israeli trade-centers and within trade compounds near the major Palestinian – Israeli border-crossings
- Incentives to Israeli – Palestinians joint-ventures in the construction-materials sector – either for the Israeli and Palestinian domestic markets, or for exports
- Specific export-promotion programs for certain well-chosen sub-sectors, such as the stone & marble sub-sector; sophisticated electronic systems for the construction industry; etc.

6.4 Fast Moving Consumption Goods

Israeli-Palestinian cooperation in production and marketing to the local Israeli and Palestinian markets, as well as Western and Arab markets, would generate significant benefits to both Israeli and Palestinian food and other FMCG industries.

Industrial Estates, near the major Palestinian – Israeli border-crossings can serve as focal points for the development of West-oriented and Israeli market-oriented FMCG industries; while An Arab-World-directed industrial estate in Jericho or another nearby Jordan valley location (with good accessibility to the Allenby Bridge) will serve Palestinian and joint Arab-World-oriented FMCG and other industries.

The establishment and development of such industrial estates would be greatly advanced by the assignment of a specific "international sponsor" to each of these estates. The sponsor will be a specific government that has expressed interest in a certain zone (like Turkey in Tarkumia and Jennin, and Japan in the Jordan Valley). This international sponsor will help "its adopted" specific estate financially, as well as in safeguarding its special status and conditions vis-à-vis the Palestinian and Israeli authorities, and will assist the managing company of the estate to bring in leading international companies.

Among the incentives for international (as well as Israeli and Palestinian companies to open production facilities in these estates will be duty free access to the US and the EU under Israeli Free Trade Area agreements, as well as duty free access to Gulf and other Arab markets under the umbrella of Palestinian membership in the Arab Free Trade Area Agreement

Trade and service compounds, near the above-mentioned industrial estates and border-crossings would facilitate bilateral trade. Some of these compounds would concentrate mainly on wholesale trade, while others would be based on a mixed wholesale and retail trade model.

In the pre-Intifada period (and even more so in the 1980s) Israeli-Palestinian border-trade was a big business. It included (1) large informal weekend shopping; (2) extensive trade between the West Bank and the Israeli-Arab population; (3) a wide range of service trade such as, car repair, personal and medical services (i.e. dentist services), recreational services (i.e. Palestinians coming to Israeli beaches); and more.

Most of this border trade was informal and un-recorded. Certain Israeli estimates put its pre-Intifada revenues at US\$300-500 million per annum. Under conditions as envisaged under Scenario B and C, this trade could be gradually revived in such Israeli-Palestinian trade and service compounds that would be developed near some of the new Palestinian-Israeli passages.

Three such industrial estates (in Jennin, Tarkumia, and the Jordan Valley can be put into immediate implementation, under the "sponsorship" of powerful international sponsors that have already "adopted" these locations (Turkey and Japan). Moreover, all three locations are well positioned for fast development of adjacent trade and service centers.

Among possible FMCG production projects which can be immediately advanced (by Palestinian and Israeli industrial groups which expressed concrete readiness to invest in such industrial estates, under appropriate conditions):

- Dairy and other export-oriented food-processing projects in the Jordan valley
- Food processing projects in Tarkumai and Jenin (targeting Israeli market).
- Logistic facilities for the proper handling of food products and perishable agricultural inputs for the food industry in the above-mentioned estates, and at the border-crossings, such as cooling chain facilities, etc.

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VII. The Transition to the Future Normality: Immediate Issues And Transitional Measures

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This section aims to address the issue of transitional arrangements on the way to any future long-term regime. While the focus of this project is on developing a viable long-term option, sustainable and forward-looking transitional arrangements are of key importance for businesses and may well “make or break” an overall deal.

The time required to build an economic and trade agreement will depend mainly on the approach and complexity of the agreement envisaged as well as on progress towards formulating and implementing the autonomous trade laws and regulations needed to implement it. Palestinian and Israeli citizens and businesses, however, have no time to lose. It is therefore imperative to consider and implement both (general) immediate issues and (targeted) transitional measures, as appropriate.

The measures to be adopted for a transitional period obviously depend on the specific type of economic/trade agreement envisaged. For example, work towards an FTA will require different transitional arrangements from work towards an agreement (or a solution without a specific agreement, except the WTO framework) based on the NDTP/MFN principles. Similarly, the manner in which the Paris Protocol is phased out will vary according to the approach chosen.

At the same time, however, a number of elements are likely to be common to all. They relate in particular to the core issues of movement & access, security measures, rapid dispute settlement and transit arrangements. Under all options discussed above, these issues require particular attention, since the achievement of legal, security, third-party dispute settlement (under third-country monitoring) and secure transit arrangements will be of paramount importance. As a first priority, these issues should be fully prepared for immediate negotiations.

It is crucial to emphasize that this needs to be done in parallel with the development of the long-term vision reflected in the target trade scenario. Only then can it be assured that temporary measures do not turn out to be wasteful dead ends.

7.1 Immediate Issues Independent of the Future Regime

The following measures appear to be both necessary and feasible (politically and technically) and should be addressed as a matter of immediate priority:

- **Straightforward movement and access issues.** Day-to-day, plainly unnecessary impediments to the movement of goods, services, people and money into and out of the Palestinian Territory can and should be removed immediately. The minimal results of the *Agreement on Movement and Access* of November 2005 should and could be implemented in full (see Box), taking into account Israel's (but also Palestinians') legitimate security concerns where

applicable. The numbers are sobering. Hundreds of checkpoints and countless other restrictions (permits or no permits) mean a – often prohibitive – cost on doing business in and with Palestine. Few foreign markets, few foreign investors and less and less Palestinian workers, service providers, businesspeople, investors and consumers themselves are able to sustain such premium costs of doing business in Palestine. The result is brain drain, capital flight and economic devastation.

- **Stop to all discrimination at airports, seaports and in all administrative processes.** Palestinian businesses, goods, and businesspeople are routinely treated differently in Israel than their Israeli, Western and third party counterparts. This is sometimes due to conscious (including legislative) choices, but in most cases simply the result of engrained and tolerated practice and attitude. This can and should be changed. (The same may apply on the Palestinian side, even if evidence and opportunity is scant.)

Box: Key Aspects of the 2005 Agreement on Movement and Access (AMA) of November 2005 ⁴²

- **Access for all Palestinians to all parts of the West Bank.** The AMA provides for a reduction “to the maximum extent possible” of obstacles to movement within the West Bank.
- The Agreement stipulated that a minimal **link between Gaza and the West Bank** in the form of truck and bus convoys would be instituted..⁴³
- Opening and operationalizing the **Rafah crossing point**.
- The issue of Rafah is worsened by the non-implementation of Israel’s commitments regarding the operation of the **Kerem Shalom terminal**.
- Regarding **passages between Gaza and Israel such as Karni** the AMA stipulates in no uncertain terms that “*The passages will operate continuously*”, specifying minimum numbers of truckloads per day.⁴⁴
- Finally, the Agreement envisages the reopening of **Gaza’s airport** and the building of a **seaport**.⁴⁵

⁴² The agreement was signed before Hamas took over control in Gaza by force. While this does affect certain assumptions in the short run, the basic tenets – basic requirements for Palestinian economic recovery and development – remain the same. It must at the same time be recognized that Israel did not implement most of the agreement even before Hamas’ election victory in January 2006.

⁴³ It should not be forgotten that this “link” was a minimal, drop-on-a-hot-stone measure, a far cry from the “safe passage” provided for in several agreements in place and *in force* between the parties, all equally sponsored by the International Community and all equally unimplemented by Israel.

⁴⁴ These numbers were never met by Israel, neither before nor after the Palestinian elections of January 2006, and neither before nor after the Hamas takeover of power in Gaza.

⁴⁵ Israel at no point in time made any effort to engage in the envisaged talks on the airport, nor to give donors the needed assurances for the seaport – including the assurance not to destroy it.

7.2 Transitional Measures on the Way to the Future Regime

The concrete transitional steps to be taken on the way to a future trade regime obviously depend on the regime chosen as the target. However certain elements of cooperation may be common to the most likely scenarios, from “WTO/NDTP” to “FTA plus.” Transitional steps towards such elements of cooperation could include the following:

- Enhancing **institutional cooperation** wherever possible, establishing / moving towards equality of goods/services/businesspeople on both sides. This could include:
 - Full reciprocal information sharing between customs and tax authorities on relevant matters. Harmonization and cooperation where possible.
 - Full reciprocal information sharing and cooperation of standardizing bodies, ministries/agencies dealing with technical regulations, health & safety regulation incl. food safety etc. Continued harmonization and cooperation wherever possible.
 - Proactive cooperation of regulators, e.g. in telecoms, energy and water regulation.
- Notwithstanding the need for cooperation, there is also – and simultaneously – a need for systematic **institutional and substantive separation**, or disentanglement, in certain areas, precisely to prepare for a functioning working relationship between functioning separate entities in the future. This concerns, for example, the administration of customs and taxes.
- (Re)establishment / enhancement of **systems of mutual recognition and harmonization** of standards, SPS measures etc. At present many standards, technical regulations, etc. are recognized, *de jure* and/or *de facto*. This facilitates mutual business relationships and avoids needless waste. Israel and Palestine should make a conscious and concerted effort to secure this practice as much as possible; where necessary, legalize and canonize it; and where possible, expand and consolidate it. It is of key importance to avoid needless disruption because of separation in these areas.

On the broader political front, the following appear to be important steps towards a functioning agreement-based “normal” trade relation in the future:

- **Creation of autonomous Palestinian exit/entry points for goods, services and people.** Under *any* separation scenario Israel obviously cannot continue to manage trade borders between Palestine and the rest of the world. This is true irrespective of the security situation, legitimate security concerns and security measures. It would be useful to implement Palestinian control and autonomy as early as possible. Models for Israeli security oversight exist (*inter alia* in the Paris Protocol, even if crude) and could be implemented on a transitional basis to build confidence.
- **Removal of obstacles to trade within the West Bank (and Gaza) and full use of existing infrastructure.** It is obvious that a normalized Palestinian economy as Israel’s counterpart and cooperation partner will, first and foremost, have to rely on normalized internal economic conditions.

Checkpoints, roadblocks, barriers and earth mounds are not part of a normal internal trade infrastructure, nor are walls/fences within a continuous economic territory.

- **Territorial Link between West Bank and Gaza.** A physical, reliable long-term territorial link between West Bank and Gaza should be established without delay to create full and unhindered territorial continuity for the Palestinian economy.

7.3 Making Use of Existing Structures and Concepts – The Paris Protocol as a Toolbox

Notwithstanding the weaknesses and poor implementation of the Paris Protocol, Palestinians and Israelis should not overlook its current function and potential. First, the Paris Protocol, despite all its shortcomings, is the only agreement currently in place, and hence the only legal framework to rely on for businesses and administrators from each side. Even a badly implemented Paris Protocol is still better than no agreement at all. It is the basis for the currently duty-free bilateral trade, as well as for the customs and tax cooperation, now more or less restored. Palestinian and Israeli business therefore have an interest to keep the Paris Protocol operational unless and until it is replaced by a future –better – agreement.

Second, despite all its shortcomings, the Paris Protocol does contain a number of mechanisms that can serve to implement the goals and steps contemplated above. In this sense the Paris Protocol represents a highly useful “*toolbox*” which Palestinians and Israelis should use, not discard, while working on a future regime. The implementation of (at least) key parts of the Paris Protocol can thus serve as a useful transitional measure.

As a pragmatic approach, businesses should thus work towards, and demand, such implementation, not (only) because the Paris Protocol is currently applicable treaty law (which it is), but because of specific desirable and available functionalities it offers.

Such highly usable functionalities (beyond **duty-free** access for goods, liberalization of certain **services**, **non-discrimination** and other straightforward elements of liberal trade) include, for example, the following:

- The **review of goods lists A1, A2 and B** to address Palestinian trade issues in relations to third parties (Arabs in particular) while the quasi-Customs Union is still in place. This would also assist in preparing for effective Palestinian economic autonomy.
- **Making use of the Joint Economic Committee** as tool for a constructive working relationship on issues such as SPS/TBT cooperation and others (see list above)

7.4 Measures in Relation to Third Parties

Palestinians and Israelis should further make optimal use of existing processes and developments beyond their bilateral relationship, not least as a measure to support the transition towards an economic final status. These measures include the

continued and where possible enhanced negotiation by both Israel and Palestine towards their respective further integration into regional and global systems. A particular focus should be on the WTO and EuroMed fora.

Both Parties: WTO and EuroMed

Global trade integration under the WTO offers reliable and stable mechanisms that may not only assist in relations with third party trading partners, but also in the design and implementation of a future agreement-based trade relation. The WTO thus provides *inter alia* a good forum for a significant part of the bilateral issues and concerns. This means that both parties have an interest in pushing forward Palestine’s application for Membership in the WTO.

This applies even more to the EuroMed (“Barcelona”) process. Israel and Palestine, both active members of the process, would be well advised to continue and intensify their efforts in this forum. Existing and evolving EuroMed rules on trade in goods, including for example rules of origin under the Palermo Protocol, provide ready-to-use elements that can assist in building the future bilateral regime. This will allow the parties to take such elements out of the purely bilateral equation and will thus simplify and focus negotiations.

The same is true for current negotiations on trade in services and investment. While both Israel and Palestine at present are negotiating bilaterally, respectively, with the EU, it is clear that any result (specific commitments to allow market access for foreign services – examples: foreign tourist guides, banks, telecoms companies; commitments regarding foreign investments) carries with it the potential to be used in other EuroMed relationships as well, including the bilateral Israeli-Palestinian one. Again, the EuroMed process thereby can provide a testing ground and crystallization point that may directly and indirectly assist in building the bilateral regime.

As indicated earlier, the EuroMed process proceeds under the stated ambition to establish a regional free trade area for both goods and services throughout the Euro-Mediterranean space. This effectively sets the minimum standards for their future bilateral relationship, which thus would entail free trade.

Specifically: Palestinian Relations with Third Parties

Palestine should further work as a matter of priority on the development and consolidation of frameworks for trade with and through other countries. Making such links progressively more reliable will deliver tangible value to Palestinian businesses (and their Israeli business partners). It will thereby strengthen Palestine on its way towards economic viability, and hence – not least – its ability to act as a fully operational counterpart for Israel. Key demands here include the following:

- Technical agreements with third parties, in particular high-standard transit arrangements (incl. matters of practice) with neighbours Jordan and Egypt
- Active, forward-looking Palestinian participation in all GAFTA negotiations, including in particular those on trade in services.

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Annexes:

Annex I: Working Paper on Trade Policy - Detailed Analysis of the different Trade arrangement Scenarios.

Exhibit 1.1: Current Obstacles to Palestinian and Palestinian-Israeli Trade

Exhibit 1.2 The WTO/World Trading System in a Nutshell.

Exhibit 1.3 Two Important International Trade “Theaters” for Palestine and Israel.

The EuroMed (“Barcelona”) Process and the Planned EuroMed Free Trade Area – An Overview

The Greater Arab Free Trade Area – An Overview

Annex II: Sector Study Working Paper – Impact Analysis of the Trade Scenarios.

Exhibit 2.1: Palestinian Sector Profiles: Tourism, Agriculture, Construction materials and FMCG.

Exhibit 2.2: Basic Trade analysis of Israeli Exports.

Exhibit 2.3: Basic Trade analysis of Palestinian Exports to Israel

Annex III: Research Methodology and Consultative Meeting Notes.

Exhibit 3.1: List of business people who participated in the Consultation process

Exhibit 3.2: Consultative Briefing Paper on Future Palestinian – Israeli Trade Scenarios.

Exhibit 3.3: Meeting notes of the Consultative process.

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