**Chapter 1**

**Introduction**

Economic integration is a well-defined subject in the literature. As predicted in international trade theory, one trades first and primarily with one’s neighbors and, from empirical findings, we also learn that proximity is the main engine for trade between two economic entities (Combes, Mayer, and Thisse 2008). Balassa (1961) describes economic integration as a process that occurs between countries or territories in the same geographical area that facilitates the removal of barriers to the movement of goods, services, and capital in order to promote economic welfare and prosperity.

Rivera and Romer (1991) argue that in a world with two leading developed economies, economic integration can cause a steady increase in global growth. Starting from a position of isolation, closer integration can be achieved by increasing trade in goods or by increasing the flow of ideas. However, differences in endowments or technologies of the economies will induce allocation effects that shift resources between the two sectors in each country.

At the international level, Rodrik (2000) discusses the process of internationalization, seeing significant room for growth in international economic integration in the long term, as technological progress will both foster integration and remove some of the traditional obstacles to economic integration. It is also hard to envisage that a substantial part of the world’s population will want to relinquish the material benefits that an increasingly integrated world market can deliver. Hard-won citizenship rights are also unlikely to be given up easily, keeping pressure on politicians to remain accountable to the wishes of their electorate.

Regarding monetary integration, Mundell (1961) presents the idea of ​​an Optimal Currency Area (OCA): a group of countries that have either a single currency or at least fixed exchange rates with full convertibility between their currencies. Mundell identifies mobility as the key factor in an OCA since, when such mobility exists, fewer exchange rate variations are needed to correct external imbalances. McKinnon (1963) further develops the OCA idea, discussing the influence of the openness of the economy, i.e., the ratio of tradable to non-tradable goods and the problem of reconciling external and internal balances, emphasizing the need for internal price stability. Kenen (1969) refines the concept even more, maintaining that fiscal integration should be a criterion for determining optimality for participation in a single-currency area. He also introduces the idea that product diversification can be used to assess the desirability of permanently fixed exchange rates.

Highly diversified economies are better candidates for currency areas since diversification provides some insulation from the effects of sector-specific or industry-specific shocks, forestalling the need for frequent changes in the terms of trade via the exchange rate. Calvo and Végh (1992) define “currency substitution” as the use of multiple currencies for exchange in any given country. This phenomenon developed in the 1980s, with currencies subject to high inflation being replaced by those, such as the U.S. dollar, that had earned a reputation for being relatively successful in maintaining their purchasing power over time. Assessing the advantages and disadvantages of such currency substitution has focused on the viability and efficiency of adopting a foreign currency as a substitute for the local currency. For example, using the local currency gives a government another tool for collecting taxes and a potential mechanism for responding to respond to exogenous shocks. However, such additional freedom invites a excessive reliance on the “inflation tax” resulting from printing more local currency. Therefore, extreme measures against the use of domestic currency, such as “dollarization” control, may provide at least temporary relief against inflation. However, Calvo and Végh argue that a full dollarization policy without the “lender of last resort” function can make the local banking system vulnerable if such a policy remains in place in the face of a full-dollar run on banks which is likely to lead to a deep financial crisis.

According to Mundell (1997), a Currency Board Arrangement (CBA) represents an ideal monetary arrangement for a small country economically situated in close proximity to a larger one that has a stable inflation rate compatible with domestic inflation preferences. In a CBA, central bank money is completely backed by foreign exchange reserves (a pure CBA). A CBA is the tightest form of fixed exchange rate short of a complete monetary union, preserving the national currency and leaving open the option to alter the CBA if required. A CBA can produce all or most of the conditions of economic convergence that would be obtained through a monetary union without the political integration implied by it.

This study will examine the economic ties between Israel and the West Bank and Gaza Strip (WBG). Over the years, the degree of economic integration between the economies has varied, mainly as a result of geopolitical conflicts and economic agreements, as reflected in trade, labor, monetary, and financial processes, as well as in population movements. Due to the importance of the Palestinian Authority’s economic ties with Israel, the new Israeli shekel (NIS) is one of the main currencies used by businesses and consumers in the Palestinian economy in day-to-day trading. This work assesses, both qualitatively and quantitatively, the level of economic integration between Israel and the WBG over the last 100 years.

While economics is our prime focus, we cannot ignore the geopolitical situation and the associated ambitions and repercussions. According to Gross (2000), the argument between those supporting economic integration in the Middle East and the proponents of economic separation between Israelis and Palestinians reflects, to a large extent, the dichotomy of national sovereignty and independence versus the advantages derived from trade liberalization.

Arnon and Weinblatt (2001) discuss the trade-offs between sovereignty and prosperity with regard to the Israeli-Palestinian situation, arguing for the establishment of economic borders and a regime with less than complete integration, and proposing that such an arrangement might prove a better macroeconomic environment than one with complete economic integration.

Arnon (2007) examines Israeli policy-making toward the WBG with all of its complicated twists, turns and reversals. He contends that since 1967 and both before and after the Oslo process, Israeli policy was directed at preventing the “two”: the division of the land into two states and two economic and political sovereign entities while also negating the “one”: the establishment of a single such entity. Although Israeli policy has repudiated both the “two” and the “one,” it has undergone periodic changes in its character and formulations.

Chapter 2 describes 100 years of geopolitical and economic history with an emphasis on the level of economic integration between Israel and the WBG. The review is chronological, examining the period of the British Mandate for Palestine (1922–1947), the period between the wars of Independence and the Six-Day War (1948–1967), the period when the WBG came under Israeli control (1967–1993), the period following the Oslo Accords (1994–2005) and, finally, the period following Israeli disengagement from the Gaza Strip to the present (2005–today). Chapter 3 discusses monetary integration between Israel and the WBG and presents an assessment of the amount of NIS cash in circulation in the WBG by using the European Central Bank (ECB)’s calculation method for euros in circulation outside the euro area. Chapter 4 develops the Israel-WBG Integration Index (ISR-WBG-II) and presents the dataset, data treatment, and the methodology. This chapter also presents the results as well as sub-indices of the index’s individual components. Chapter 5 breaks down the ISR-WBG-II between the West Bank and the Gaza Strip, and Chapter 6 examines the relations between economic integration, terrorism, and unemployment rates. In this context, Granger causality between the various above-mentioned elements is assessed. Chapter 7 presents the main overall findings. According to the ISR-WBG-II and from a long-term perspective, the years before the First Intifada that broke out in 1987 were ones where the level of economic integration was at its peak; since then it has declined in the face of periodic embargos or restrictions on the movement of people and terrorist activity; some recovery was observed after the Second Intifada (2000–2005).

Given the political and economic situation in the Gaza Strip since Hamas’s rise to power in 2006, there are now three political and economic entities in the region: Israel, the West Bank, and the Gaza Strip. Consequently, it is necessary to examine separately Israel’s activities with each of the two Palestinian legal entities. A Granger causality test also established that more economic integration causes more terrorism. This supports the argument that terrorism is a response to political conditions and frustrations that have little to do with economics and poor market opportunities. Another Granger causality test furthermore established that higher unemployment rates in the WBG result in a higher level of economic integration. This finding could be linked to the course of Israeli policy toward the territories in that, when there is a fear of a significant lowering of the standard of living in the areas of the Palestinian Authority, Israel allows for more economic activity between it and the WBG.