**Chapter 1**

**Introduction**

Economic integration is a well-defined subject in the literature. As predicted in international trade theory, first and foremost, you trade with your neighbors, and according to empirical findings, 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/territories in the same geographical area that allows 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 developed economies, economic integration can cause a steady increase in global growth. Starting from the position of isolation, closer integration can be achieved by increasing trade in goods or by increasing the flow of ideas. However, if the economies have different endowments or technologies, it will induce allocation effects that shift resources between the two sectors in each country. At the international level Rodrik (2000) discuss the process of internationalization. In a long-term perspective, international economic integration has still a long way to go. The process will continue as technological progress will both foster economic integration and remove some of the traditional obstacles. Second, it is hard to envisage that a substantial part of the world’s population will want to give up the material benefits that an increasingly integrated world market can deliver. Third, 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 the idea of monetary integration, Mundell (1961) presented the idea of ​​an *Optimal Currency Area* (OCA) as a group of countries that maintain a single currency, or if they maintain separate currencies these are at fixed exchange rates with full convertibility of corresponding currencies. Mundell identified the mobility factor as the key feature of an Optimum Currency, since when such mobility exists, less variation of the exchange rate is needed to correct external imbalances.

McKinnon (1963) further developed the idea of OCA by discussing the influence of the openness of the economy, i.e., the ratio of tradable to nontradable goods, on the problem of reconciling external and internal balance, emphasizing the need for internal price stability. Kenen (1969) further refined the idea, maintaining that fiscal integration should be a criterion to judge optimality for participation in a single-currency-area. He also introduced 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 than less-diversified economies since diversification provides some insulation to 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) defined "currency substitution" as the use in a given country of multiple currencies as medium of exchange. This phenomenon developed in the 1980s, with currencies that displayed high inflation being replaced as medium of exchange by currencies such as the US dollar that had earned a reputation for being relatively successful in maintaining their purchasing power over time. The pros and cons focused on the viability/inefficiency of adopting foreign currency as a substitute for local currency. Promoting the use of local currency gives the government another way to collect taxes and the possibility to respond to exogenous shocks. However, such additional freedom invites a surplus reliance on inflation tax. Thus, extreme measures against the use of domestic currency, such as "dollarization" control, may provide at least temporary relief against inflation. However, they argued that full dollarization without the "lender of last resort" function could make the local banking system vulnerable, if such a system was not abandoned when the actual limit of a full-dollar run on banks was 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 close to a large one, with a stable inflation rate that is compatible with domestic inflation preferences. In a CBA, central bank money is completely backed by foreign exchange reserves (pure CBA). A CBA is the tightest form of fixed exchange rates, short of entering a complete monetary union; it falls short with regard to preserving the national currency, and it leaves open the option that the CBA may be altered if needed in the future. CBA can produce all or most of the conditions of economic convergence that would be obtained by a monetary union without the political integration implied by a monetary union.

The case of Israel and the West Bank and Gaza strip (WBG) economic ties will be examined in our work. Over the years, the degree of economic integration between the economies has varied -- mainly as a result of geopolitical conflicts, and economic agreements -- a process reflected in trade, labor, monetary and financial processes, and movement of population. Due to the importance of economic ties with Israel, the Israeli shekel (NIS) is one of the main currencies used by businesses and consumers in the Palestinian economy in day-to-day trading. Our aim is to measure – both qualitatively and quantitatively -- the level of economic integration between Israel and the WBG over a period of the last 100 years.

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

Arnon and Weinblatt (2001) discuss the trade-offs between sovereignty and prosperity, with regard to the Israeli-Palestinian mechanism, and argue for the establishment of economic borders and a regime characterized by less-than-full integration and propose that such an arrangement might constitute a better macroeconomic environment than one with complete economic integration.

Arnon (2007) examines the Israeli policies towards the WBG with all their twists, turns and reversals. He argues that since 1967, both before and after the Oslo process, Israeli policy was directed at preventing the ‘Two’, i.e. the division of the land into two states and two economic (and political) sovereign entities while also negating the ‘One’, i.e., the establishment of a single political and economic entity. Although Israeli policy repudiated both the ‘Two’ and the ‘One’, it changed character and formulations from time to time.

Following this introductory section, Chapter 2 presents a description of the geopolitical and economic history over 100 years with an emphasis on the level of economic integration between the region of Israel and the WBG. Our review begins with the British Mandate of Palestine (1922-1947), continues over the period between the Wars (1948-1967), then precedes to the period when the WBG came under Israeli control (1967-1993), then precedes to the period after the "Oslo Accords" (1994-2005), and finally deals with the Israeli disengagement from the Gaza strip and its consequences (2005 onwards). Chapter 3 discusses the aspects of monetary integration between the region of Israel and the WBG and presents assessment of the amount of NIS cash in circulation in the WBG by using the European Central Bank (ECB) method of estimation of euro currency in circulation outside the euro area. In chapter 4 we develop the Israel-WBG integration index (ISR-WBG-II), present our dataset, data treatment and the methodology. Finally, the results, as well as Sub-indexes of the individual components of the index, are presented. In Chapter 5 we breakdown the ISR-WBG-II by specific geographical areas – the West bank and the Gaza strip . In Chapter 6 we examine the relations between economic integration, terrorism, and unemployment rates. In this context we assess Granger causality between the various above-mentioned elements. Chapter 7 concludes our main findings: According to the ISR-WBG-II, in a long-term perspective, the years before the “First Intifada” were the years where the level of economic integration was at the peak, since then it began to decline in the face of periodic closures and restrictions on the movement of people and the beginning of the terrorist events. Some recovery was observed after the "Second Intifada". The political and economic situation in the Gaza strip since Hamas' rise to power in 2006, requires an examination of Israel's activities separately in relation to each area and discussion of three political and economic entities in the region. We also found that the level of economic integration Granger causes terrorism. This finding supports the argument that terrorism is a response to political conditions and frustration that have little to do with economics and low market opportunities. We also found that unemployment rate in the WBG Granger causes the level of economic integration. This finding could be linked to the Israeli policy toward the territories, that when there is a fear of a significant decrease in the standard of living, Israel allows for more economic activity with the WBG.