**Abstract**

Israel and the West Bank and Gaza strip (WBG) maintain close economic ties. These are the result of geographic proximity, history, culture, geopolitical conflicts, and economic agreements. Over the years, the degree of economic integration between the economies has varied, a process reflected in trade, labor, monetary and banking, infrastructures and resources, movement of population and wealth and standard of living. Our study starts with a review of the geopolitical events and aspects of economic integration in the region over the past century that shaped the economic ties between Israel and the WBG as they exist today. In each period we describe the economic activity that took place in the region and the impact of the geopolitical events on it.

Due to the importance of 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. For this reason, we closely analyze the scope and method of monetary and banking relations between Israel and the WBG, and estimate the scope and share of usage of cash in the WBG out of total NIS in circulation, based on the methodology of the European Central Bank (ECB). We found that this share is estimated at about 21% as of 2019.

Then, we construct what we term the Israel-WBG integration index (ISR-WBG-II), a methodological tool for monitoring the level of economic integration based on well-known regional integration indices. According to our findings, we suggest that in a long term perspective (1968-2019), in the twenty years after the 1967 war, thanks to Israel's open policy toward the West bank and the Gaza Strip, there has been a dramatic increase in the level of integration to a level that has not been achieved again (1987 is the peak year(. After the “First Intifada” in the late 1980s, the level of integration began to decline in the face of periodic closures and restrictions on the movement of people and the beginning of the terrorist events that accompanied this period and finally ended in the Second Intifada in the early 2000s. After the end of the Second Intifada, a certain recovery was observed, that reflects a steady increase in the level of integration. In recent years, a certain decrease in the level of integration has been observed as a result of lack of progress in the political process, and steps and policies taken by the Palestinian Authority to reduce the significant dependence on Israel. In order to address the situation in the Gaza Strip resulting from Hamas' rise to power in 2006 which created de facto two separate economies in the territories, we breakdown the ISR-WBG-II by geographical areas, so as to monitor each area separately as the view that WBG is a contiguous area economically may be misleading.

Finally, we use the Granger causality test for determining whether terrorism Granger causes the level of economic integration, or vice versa, the level of integration Granger causes terrorism. Similarly, we implement the same test on unemployment rate in the WBG and the level of economic integration and unemployment rate and terrorism.

We found that the level of economic integration Granger causes terrorism. This finding supports early work by scholars that argue that terrorism is a response to political conditions and long-standing feelings of indignity and frustration that have little to do with economics and low market opportunities or ignorance. For example, the years preceding the 1987 uprising had been marked by growing frustration on the part of the Palestinians. The ISR-WBG-II confirms that before the “First Intifada” the level of economic integration was the highest which was reflected in the fact that the unemployment rate was at an all-time low and the relative standard of living was at its peak. Also before the “Second Intifada” we found a rise in the integration level and reduction in unemployment rates in the WBG.

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 in the WBG caused by, among other things, a high unemployment rate, Israel allows for more economic activity with the WBG, for example the movement of workers without permits to work in Israel and also increases the quota of working permits in Israel.

Our findings are relevant in the context of the discussion of the idea of a one state scenario or the idea of a two-state scenario. According to our findings, the degree of dependence of the Palestinian economy on the Israeli economy, which is reflected in the level of economic integration between the Israeli and Palestinian economies, is very high and unilateral. We can argue that the more the Palestinian economy will be an independent and strong, the greater the chance of a scenario of two states side by side, while the more the Palestinian economy depends unilaterally on the Israeli economy, the greater the chance of a one state scenario. In that context and to the extent that no significant geopolitical change occurs, there should be also a discussion of a scenario of three economic and political entities between the Mediterranean and the Jordan River.

To conclude, this study contributes to an understanding of economic processes impacting the region and provides an economic backdrop for possible economic and political processes that may occur in the future.

The case of Israel and the WBG illustrates the process of *involuntary economic integration*, where the protagonists are bound in a Gordian knot.