

## *The Economic Consequences of Peace in the Middle East*

*The costs of continued conflict in the Middle East have severely burdened the economies of the belligerents. A peace agreement between Egypt and Israel, bolstered by external economic support, can lay the basis for stable development.*

In his *The Economic Consequences of the Peace*, John Maynard Keynes wrote: "The great events of history are often due to secular changes in the growth of population and other fundamental economic causes, which, escaping by their gradual character the notice of contemporary observers, are attributed to the follies of statesmen or the fanaticism of atheists."

Keynes' brilliant polemic attacking the Versailles Treaty at the conclusion of the First World War has a haunting relevance to the unfolding contemporary drama of the search for a peace settlement in the Middle East. Whereas the statesmen at Versailles presided over the restructuring of a destroyed Europe, the statesmen at Camp David have sought

to devise a compact designed to avoid yet another round of destruction which could make even the devastation of the First World War seem pale. It was Keynes' conviction that the task of the Peace conference was "to honor engagements and to satisfy justice; but not less to re-establish life and to heal wounds." His focus therefore was the establishment of economic rewards that could facilitate and reinforce the dynamics of the peace process. The subsequent hyperinflation in Germany, the eventual collapse of the world economic system during the Great Depression, and the final catastrophe of the Second World War, attest to the failure of these efforts. It was not until the creation of the enlightened Marshall Plan that the nations of

Western Europe were able to forge an economic and political alliance system which assured the continuance of the newly established peace.

It is my contention that the ingredients for a successful long-term peace arrangement in the Middle East are at hand. The short-run problems of the fragile transition to peace are so great, however, that this transition will require the establishment of a massive international support system which provides economic and political rewards directly to each nation that enters into the peace process. I conjecture that the direct short-run economic benefits from peace between Egypt and Israel will be meager, particularly in light of the desperate economic state of affairs which thirty years of war have reinforced. Nevertheless, the long-run benefits from a settlement are likely to rise exponentially with the scope and duration of the peace, and these benefits will accrue not only to the nations of the area but also, and particularly,

to the economies of the United States, Western Europe, and Japan. From an economist's perspective, the benefits of peace can best be measured by considering the relevant opportunity costs engendered by a failure of the peace process. The military concentrations in the Middle East now rival those of the NATO forces in Europe, and given the inherent instability of the area, I am led to the belief that a failure of the peace effort could lead to a massive destruction of life and property in the Middle East, a major financial and economic disruption of Western economies, and a significantly increased probability of a major military confrontation between East and West. If the probability of such a catastrophe can be reduced by maintaining the momentum of the present peace initiatives, then the benefits of peace to Middle East states and to Western economies will be enormous. In order to substantiate the claim that the short-run payoffs from a minimal peace settlement between Egypt

Table 1

Year	Military expenditures as a percentage of gross domestic product	Economic Status of Egypt and Israel			Percent change in real GNP per capita (inflation rate deflator)	Percent change in real GNP per capita (money supply deflator)	Trade deficit millions of U.S. \$
		Percentage change in GNP per capita	Inflation rate	Rate of growth of money supply			
Egypt							
1969	11.5	3.8	3.2	5.4	.6	-1.6	—
1970	15.8	7.5	3.8	5.3	3.7	2.2	—
1971	20.1	3.6	3.0	3.2	.6	.4	—
1972	19.2	6.3	2.1	14.3	4.2	-8.1	—
1973	35.3	4.9	4.2	19.6	.7	-14.7	655
1974	40.2	12.1	10.3	25.6	1.8	-13.5	1,629
1975	36.9	13.3	9.3	18.6	4.0	-5.3	2,475
1976	27.4	26.2	9.1	23.0	17.1	3.2	1,597
1977	27.6	14.0	12.7	28.1	1.3	-14.1	1,700
Israel							
1969	26.7	12.6	2.5	2.5	10.1	10.1	—
1970	27.5	13.3	6.1	13.9	7.2	-.6	—
1971	24.2	20.7	12.0	28.0	8.7	-7.6	—
1972	40.8	23.0	12.9	28.7	10.9	-4.9	—
1973	38.0	23.6	20.0	32.3	3.6	-8.7	1,526
1974	34.0	40.0	39.7	18.0	.3	22.0	2,367
1975	29.8	35.7	39.3	21.7	-3.6	13.0	2,195
1976	35.0	23.8	31.3	27.7	-7.5	-3.9	1,703
1977	29.4	42.6	34.6	42.8	8.0	-.2	1,709

Sources: Derived from various issues of: *International Financial Statistics*; *Middle East Economic Digest*; *Statistical Abstract of Israel*; *Annual Report of the Bank of Israel*; *Stockholm International Peace Research Institute (SIPRI) World Military Expenditure Yearbook 1978*.

and Israel are likely to be small, while the long-term benefits of a wider peace would be significant, it is necessary to examine the current status of the Egyptian and Israeli economies.

### *The economies of Egypt and Israel*

The economic indicators displayed in Table 1 reflect the great malaise afflicting Egypt and Israel. Both countries' strength has been sapped by the extraordinary allocation of their incomes to military purposes, amounting at times to 40 percent of their Gross National Product. This figure must be compared to 6 percent for the United States and less than 2 percent for other developing nations in order to gauge the staggering magnitude of the drain. Despite the apparent similarity of symptoms, the severity of Egypt's ailment dwarfs that of its neighbor, its economic corpus (as measured by per capita income) being less than one-tenth that of Israel's.

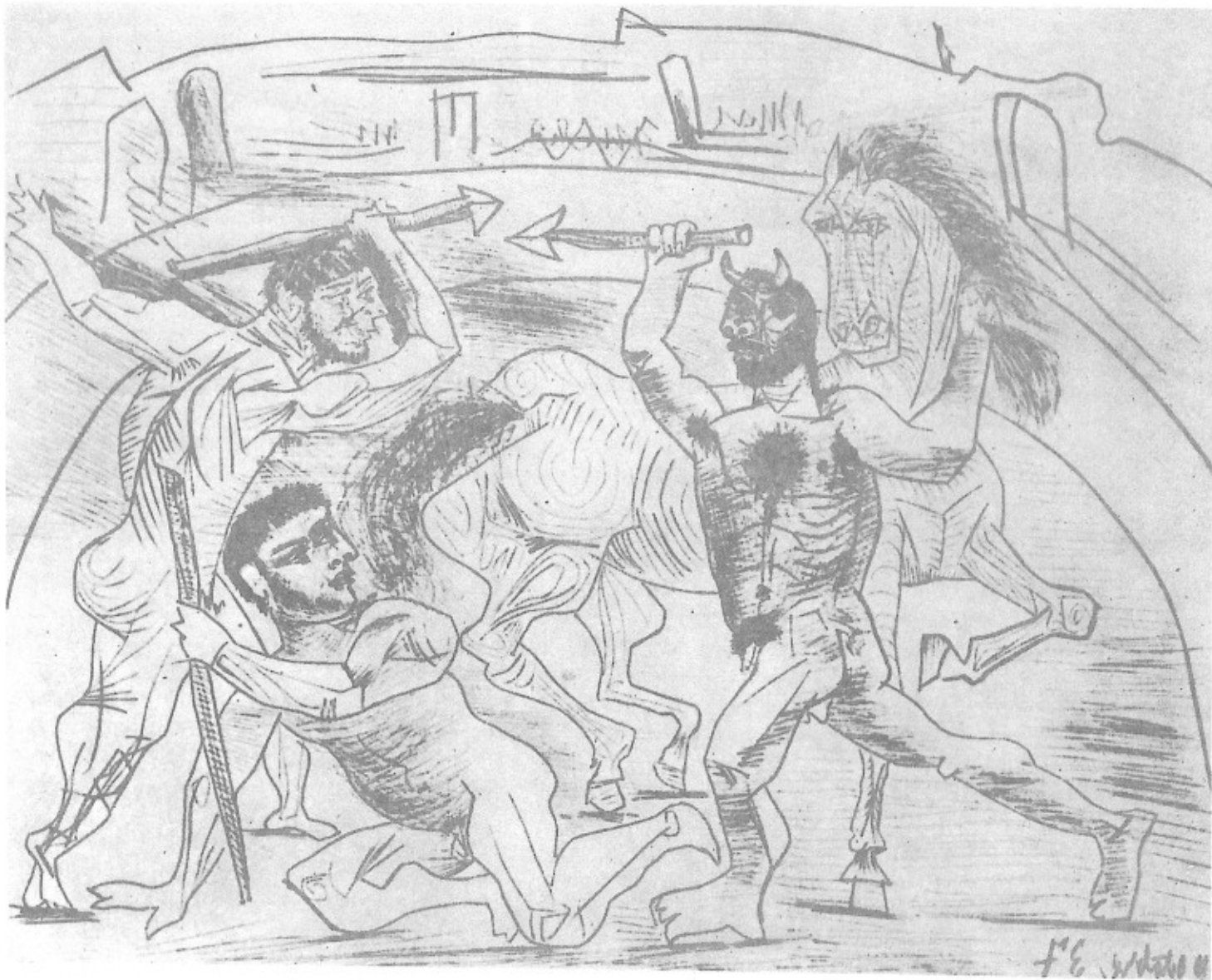
The percentage changes in the per capita GNP of the two countries give the misleading impression that the prognosis is more hopeful. The illusion is created by the rapid inflations brought on by the financing of vast military outlays. To make matters worse, the official inflation rates cited for Egypt are likely to be grossly underestimated due to the complex system of price controls and subsidies that permeate its economy. A crude but more accurate barometer of actual inflationary pressure is provided by the growth rate of the money supply. When this standard is applied to determine rates of growth in *real* per capita output, a dismal picture of deterioration becomes apparent. Both countries are experiencing rapid inflation, a declining standard of well-being and an over-burdening problem in their balance of trade. When military imports are added to the trade imbalances, both their deficits are inflated by more than 50 percent.

Egypt, unlike Israel, suffers from an exploding population, which adds an extra million people per year requiring the basic necessities of life which the Egyptian economy can ill afford to provide. At present, Egypt is faced with an estimated housing shortage of 1.1 million units, and the burgeoning population adds a demand of 110,000 new units per year. In the past year, the Egyptian economy was able to add only a meager 57,000 units to the housing stock.

The problem of providing adequate nutrition for 40 million Egyptians is even more severe than the problem of housing. Some 20 million Egyptians are classified as rural residents. An International Labor Office study revealed that, whereas in 1964-65, 27 percent of the population were classified as living below the poverty line (calculated in terms of minimum dietary needs), by 1975 the number had risen to 44 percent. The accumulation of between 100 and 130 tons of silt trapped behind the high dam at Aswan has not only brought about a decline in the production of bricks for construction from a yearly rate of one billion in 1964 to only 50 million in 1973, it has also robbed the soil of its natural replenishment of nutrients. Urban development and poor water management systems have also resulted in a fall in the number of *feddans* (acres) available for cultivation, in spite of massive efforts at land reclamation. The absence of a pricing mechanism for the use of water, and inadequate drainage facilities, have pushed the Egyptian agricultural sector to the brink of an avoidable ecological disaster. Waterlogging, a rising water table, and increased soil salinity now affect almost 80 percent of the cultivated land mass, resulting in a reduction of crop yields approaching 30 to 50 percent in some areas. Unless this process of degradation is quickly reversed, Egypt could face a problem of widespread starvation.

Keynes observed that a postwar depression in the standard of living "will mean actual starvation of some. . . . Men will not always die quietly. For starvation, which brings to some lethargy and a helpless despair, drives other temperaments to the nervous instability of hysteria and to a mad despair. And these in their distress may overturn the remnants of organization, and submerge civilization itself in their attempts to satisfy desperately the overwhelming needs of the individual." The dramatic Egyptian bread riots of 1977, in protest over proposed reductions in food subsidies, which now cost the government 1.6 billion dollars per year, attest to the relevance of Keynes' observation.

The urban centers of Egypt fare little better. Cairo is now estimated to have a population of some 9 million with almost 1 million residents living in the tombs of old cemeteries. The parasitic disease, bilharzia, is widespread, medical services woefully inadequate, and water quality seriously deteriorating. *Al-Ahram*, the semi-official daily



paper of Cairo, asserted that some 60 percent of the buildings in Cairo were unsafe and that 35 percent were in danger of imminent collapse. Cairo's utility system is now between sixty and seventy years old, and minimal maintenance in the face of a tripled population regularly results in bursting water mains, a situation which recently resulted in a severing of all external communications with the outside world for three days. A new communications system for Cairo alone is estimated to cost between 3 and 4 billion dollars. The chronic housing shortage has been exacerbated by more than a decade of rent control, and an 8 percent maximum return on investment in housing, which

is about equal to the interest earnable on bank deposits. The shortage of building materials and skilled manpower suggests that these problems are unlikely to diminish, in spite of the massive investment projects the government has encouraged with five- to fifteen-year tax holidays as part of the Sadat "open door" policy to encourage foreign capital.

The resulting inflow of foreign capital has, nevertheless, been one of the brightest accomplishments of the dramatic Sadat "opening," and a generous restructuring of Egypt's debt commitments has for the moment avoided a financial crisis. This development has also increased the

important interconnections between Egypt and the Gulf states, particularly Saudi Arabia. Egypt rightfully regards itself as the cosmopolitan leader of the Arabs, a self-image rooted in its massive population, which accounts for nearly two-thirds of the pool of skilled labor in the Arab world.

But despite these hopeful signs, a global assessment of the Egyptian economic situation can only result in the conclusion that the remaining problems are vast, and that it would be folly to expect that peace will provide an adequate panacea. Peace with Israel is, at best, a necessary but not a sufficient condition for amelioration of Egypt's situation.

Israel's economy, in contrast, is more likely to exhibit improved health within five years of the conclusion of a successful peace arrangement. This prognosis is not based on the belief that Israel has relatively more to gain from a peace settlement, but rather that the problems Israel must overcome are not nearly as overwhelming as those of Egypt. The first twenty-five years of Israel's history attest to its inherent economic soundness. In spite of its need to construct huge amounts of social infrastructure, maintain an abnormally high level of defense expenditure, absorb an unusually heterogeneous population, and work with a poor and limited agricultural base (with the scarcity of water also a serious limiting factor), Israel has managed to attain one of the most spectacular records of economic growth—surpassed only by Japan, Korea, and Taiwan. By 1967, Israel had increased its ratio of exports to imports to 68 percent from a rate of only 11 percent in 1947, but this consistent upward trend was reversed as a result of the two ensuing wars. By 1974, the export-to-import ratio had fallen to 42 percent, but again recovered to 57 percent by 1976. The gains in the all-important agricultural sector revealed a two-and-a-half-fold increase in land brought under cultivation, a six-fold increase in irrigated lands, and a twelve-and-a-half-fold increase in the quantity of agricultural production, all in just over a quarter of a century. These gains reflect, in part, a sophisticated indigenously developed agricultural technology which has brought about an actual reduction of 20 percent in water input per acre during a period in which the value of agricultural output at constant prices increased by 100 percent.

Though these achievements have been spectacular, it must be noted that the strains of the war economy have resulted in rampant inflation, reduced productivity and growth rate, increased labor unrest, a huge overall balance of payments deficit, and a diversion of resources from social expenditures required to close the income gap between Israel's European and Asian-African populations.

Once again, Keynes' astute observations concerning the causes of economic decline are as apt in 1979 as they were half a century ago. He cited "Internal disorder; the creation of new governments and their inexperience in the readjustment of economic relations . . . the loss of efficient labor through the casualties of war or the continuance of mobilization . . . continued underfeeding; the exhaustion of the soil; and, the unsettlement of the minds of the laboring masses" as the major causes of the slump in economic activity.

### *Economic prospects after a peace settlement*

The benefits from a peace settlement between Egypt and Israel will ultimately depend upon the degree to which defense expenditures can be reduced and the extent to which gains from trade can be realized. In the first few years of a settlement it is highly unlikely that we will witness significant reductions in military outlays; it is more likely, indeed, that the initial period of transition will necessitate a higher level of military expenditures, particularly for Israel.

The Camp David accord calls for the withdrawal of Israeli armed forces from the Sinai and the turnover of the airfields near El Arish, Rafah, Ras en Naqb and Sharm el Sheikh to Egypt for civilian purposes. In order to compensate Israel for this significant loss of strategic defense, the United States has agreed to help in the construction of two new airfields in the Negev which are estimated to cost over one billion dollars. The potential instability of the Sadat regime, the strong memories of the 1973 surprise attack, the threatening rhetoric of the other Arab states, and the requirements of major strategic redeployment to maintain current security levels, militate against the chances of a reduction of Israeli military

expenditures in the near term. Political and psychological factors make an increase more likely.

Under the Camp David accord, Israel has agreed to return the Alma oil field to Egypt. This means that the Israelis will have to make arrangements for alternative oil supplies.

One area for immediate cooperation between the two countries will, thus, almost certainly be the planning of future oil sales by Egypt to Israel. Up to the present, Israel has relied on Iran for more than 50 percent of its petroleum needs, but the recent strikes in Iran have made that source precarious for a long time to come. Israel will therefore have to rearrange its sources of supply and this, in turn, is likely to entail transitional costs.

It is ironic that the immediate impact of a peace treaty will be to impose an even greater military burden on the Israeli economy. The outlook for Egypt is somewhat more hopeful. While it is likely that Egypt will still seek to upgrade some of its military capital, the return of the Sinai clearly increases Egypt's strategic depth; and this, in turn, may allow the redeployment of almost one-third of

the Egyptian army, which numbers 750,000 men, to work on civilian projects. Among the highest priority items are the installation of clay drainage systems and civilian construction projects. Since some 50 percent of the Egyptian army personnel are classified as skilled workers, this release of resources to the civilian sector can be important in at least reversing the deteriorating situation in housing and agriculture. But because of the continued state of belligerency between Israel and her other Arab neighbors, no similar redeployment of Israeli military manpower is likely in the near future.

To give perspective on the magnitude of possible benefits from longer-term peace arrangements, Table 2 presents some "best case" scenarios, which might have been realized had the last decade been characterized by a reduction in the actual levels of defense expenditures for both countries to 6 percent of GNP. Scenario A simply assumes that defense expenditures could have been allocated to private consumption; columns 1 and 3 indicate that, on average, private consumption could have been increased by 38.6 percent for Israel and 26.1 percent for Egypt. Scenario B assumes that the released military resources had been allocated directly to investment and that such investment yielded a marginal product of 20 percent, which was in turn allocated to private consumption. Columns 2 and 4 reveal that, over the period considered, private consumption expenditures could have been increased by 73.9 percent for Israel and by 83.4 percent for Egypt. While these estimates are admittedly crude, they suggest that a reduction of military budgets to "normal" levels could induce significant improvements for both economies, limited only by their absorption capacity. It is unlikely that such gains will be quickly realizable, but they will be more readily assured if the scope of the peace is broadened with an overall reduction in military might throughout the area.

In addition to the internal possibilities of economic advantage from demobilization, there are some minor trade gains to be realized by increased commerce and exchange of technical skills between the two nations. Areas of likely cooperation include tourism, water management, transportation, communications, oil, banking, and solar energy,

Table 2

Hypothetical Percentage Increases in Private Consumption Expenditures from a Reduction of Actual Military Expenditures to "Normal" Levels

	Israel		Egypt	
	Scenario A	Scenario B	Scenario A	Scenario B
1967	13.0	—	7.0	—
1968	23.9	—	6.0	—
1969	32.1	1.0	8.0	—
1970	35.8	17.1	15.2	1.0
1971	32.0	23.8	21.3	25.9
1972	62.4	35.0	19.7	30.3
1973	56.1	44.6	44.2	41.3
1974	45.7	50.0	50.0	49.7
1975	39.8	58.2	45.9	60.7
1976	46.1	65.2	34.7	74.4
1977	38.0	73.9	35.1	83.4
Average increase over period	38.6		26.1	

Source: See Table 1 sources. Scenario B derived from Fred Gottheil, "An Economic Assessment of the Military Burden in the Mid-East, 1960-1980," in *Journal of Conflict Resolution*, September 1974.

but it is doubtful that such joint ventures could add more than a few percentage points to GNP growth. These ventures could serve more significantly as an economic early warning system, reflecting the degree of tension between the nations in the fragile transitional stage of the peace process.

The establishment of economic relations between the former belligerents is likely to produce a demonstration effect that will bring foreign capital into the area, since there would be less fear of the disruption of property rights due to either military engagement or internal instabilities.

### *Toward a broader peace*

An optimist might well assess these gains as significant. A realist will recognize that the gains will not be large enough in the short run to reinforce the peace process adequately. That process is in constant jeopardy, due to the historic tendency to convert internal disillusionment into rage vented on an external enemy. To avoid this threat to the peace, the Western nations and Japan will have to undertake a massive financial and technical program designed to provide former belligerents with direct evidence of the rewards to be reaped from peaceful relations. This is necessary because even the successful establishment of normalized relationships is unlikely to yield sufficiently great gains to alleviate in a recognizable way the hardships created by thirty years of war. Moreover, explicit rewards to the participants in the peace process would serve to attract other former belligerents, thus solidifying the prospects that longer-term benefits could be captured by all parties to the process. A hopeful scenario for the Middle East, as I envision it, is the participation of nations that share common political and economic perspectives in an informal economic and political alliance system from which all participants can gain mutual benefit. To work, such a system should be based on realistic economic and military complementarities that serve the mutual interests of all the parties. The candidates for such an implicit alliance system include Egypt, Israel, Jordan, Sudan, Saudi Arabia, Kuwait, Qatar, and the United Arab Emirates. All of these nations have a strong Western political orientation, and share important financial

and economic links with the Western economies. In terms of requisite complementarities, these nations combine an unusual resource potential well-suited to capture major gains from joint development.

The Egyptian contribution includes a labor force of both unskilled manpower and highly skilled technicians—one-third of whom are already located in other Arab lands. The Sudan offers a massive land base and plentiful water resources. In concert with Egyptian labor, foreign capital investment, and joint Israeli-Egyptian agricultural technology, the Sudan has the potential of becoming the "bread basket" of the Middle East. It boasts of a land-to-population ratio of 2.3 *feddans* or acres per person—compared to only 0.1 *feddan* per person in Egypt. Since both countries share the Nile resource, the possibilities for mutual gain are obvious.

Israel is endowed with a highly skilled labor force, an indigenous small-scale agricultural technology well suited to its neighbors' ecological needs, and important know-how in areas of tourism, electronics, desalinization, and solar and nuclear energy. Since a significant proportion of Israel's Jewish population speaks Arabic, the communication of technological information should be easily facilitated. Implicit cooperation between the military establishments of Israel and Egypt can also serve to increase the military stability of the entire region. The oil-rich nations of the gulf—which rely so heavily on imported labor skills—can provide an important portion of the investment needs of the other nations in the alliance. Given the pooling of land, labor, capital, and technological resources in the area, such investments would be justified on economic grounds alone.

The further diversion of surplus oil funds to productive investments in the Middle East would serve the cause of both external and internal stability in the oil-rich nations. Even Saudi Arabia, with its vast surplus of capital, can ill afford to continue its extraordinary military buildup (which cost the nation almost 8.5 billion dollars in the past year). The illusion that rapid modernization and vast military outlays can increase internal stability was rudely shattered by the recent turmoil in Iran—a lesson which the astute Saudis will

surely not overlook.

Jordan's contribution to the proposed informal alliance will depend more heavily on its political assets than on its economic endowments. Jordan's majority population is Palestinian; in addition, its geographic and political contiguity with the West Bank place it in a unique position to negotiate an arrangement with Israel which satisfies both the aspirations of the Palestinians and the security needs of the Jewish nation. The political difficulties of such an arrangement are undoubtedly great, and remain the key obstacle to a long-run settlement.

Monarchies, parliamentary democracies, national socialist states, and sheikdoms make strange political bedfellows. Their common pro-Western orientation, their increasing reliance on market allocation systems strongly linked to Western economies, and the internal logic of their complementary economic and military resources, nevertheless suggest at least the possibility of cooperation between them, despite their admitted antagonisms.

### *The role of the developed economies*

If the foregoing conception of a broader regional alliance system is to become a reality, it will require the full-scale financial and technical support of the United States, Western Europe, and Japan. These nations should establish a massive regional development program, patterned on the Marshall Plan, which is specifically designed to reward each participant in the peace process with necessary and visible aid. Large-scale "showpiece" projects such as nuclear desalinization plants should be avoided, while direct aid in the important areas of agriculture, housing, medical services, education, communications, and other social overhead expenditures should be encouraged. Europe and Japan know well the gains to be realized from such a reconstruction effort, and all the developed economies (as I have mentioned) will be significant beneficiaries from a stabilized Middle East. By 1973, Europe was already relying on oil to generate 60 percent of its energy—of which 70 percent came from the Middle East supplies. Similarly, Japan imported 100 percent of its oil, which provided 76 percent of its energy requirements. These dependency rates have increased in recent years. (The

picture for the United States is somewhat different: less than 50 percent of total energy needs are met by oil; and 35 percent of that is imported, with only 10 percent being supplied by the Middle East.)

The greatest danger to the peace lies in the prospect that inflated expectations may be dashed by limited rewards. In order to create realistic expectations, the rhetoric of "swords into plowshares" and "blooming deserts" should be replaced with a detached economic analysis of the realistic economic benefits which can be achieved in both the short and the long run. Since in the short run these benefits are likely to be small, they must be augmented—particularly in the early stages of alliance building—with the kind of systematic reconstruction program referred to above, aimed at rewarding those nations that enter seriously into the peace process. The economic and financial dangers from further instability in the Middle East to the intertwined developed economies are so great that vast expenditures are justified if they can significantly reduce this threat.

The emerging realignment in the Middle East is unlikely to establish an idyllic or even pacific state of affairs. As the process of economic integration continues, however, each state's existence and stability must become a more important asset to the overall alliance system. Those who cast aspersions on this possibility must be continually reminded of Keynes' warning that the alternative might well "submerge civilization itself." Keynes' faith in the force of economic motivations in Europe led him to observe that "even if there is no moral solidarity between the nearly related races of Europe, there is an economic solidarity which we cannot disregard." The same can be said of the Middle East today.

As to the future, Keynes' conclusion serves admirably: "The events of the coming year will not be shaped by the deliberate acts of statesmen, but by the hidden currents flowing continually beneath the surface of political history, of which no one can predict the outcome. In one way only can we influence these currents—by setting in motion those forces of instruction and imagination which change *opinion*. The assertion of truth, the unveiling of illusion, the dissipation of hate, the enlargement and instruction of men's hearts and minds must be the means."