Economic Cooperation and Conflict Resolution: Europe and the Middle East

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Résumé. *L'Union Européenne est probablement l'un des meilleurs exemples dans l'histoire des résultats positifs de la coopération économique qui dans le temps amène à une harmonisation croissante parmi les états-nations. La question est de voir si la dynamique qui s'est produite en Europe est un phénomène qu'on pourrait exporter en d'autres pays ou en d'autres régions. Cette article se propose de présenter une structure globale qui permet une analyse de la relation entre coopération économique et coopération politique, dans le but de déterminer les circonstances dans lesquelles la coopération économique est bénéfique. La structure se base sur deux éléments qui ont été jusqu'ici exclus des débats sur la coopération économique, bien qu'ils soient d'une importance capitale dans la relation entre coopération économique et résolution des conflits, à savoir l'écart de production et la confiance. A l'aide de cette structure, l'Auteur démontre que l'implémentation du Processus de Barcelone n'est pas optimale et conclut son analyse en examinant le type optimal d'intervention de l'Union Européenne dans le processus de paix au Moyen Orient.*

1. *Introduction*

The European Union is probably the best example in history of the positive effects of economic cooperation that have led over time to increased harmony between nation-States. The EU demonstrates that countries that were previously at war can – following a long process of economic cooperation – decide on common policies. In fact, the EU went even further, leading today to close cooperation in all fields, even the military.

The question that arises is whether the dynamics occurring in Europe are a phenomenon that can be "exported" to other countries and regions. There is no doubt that Europe has witnessed economic cooperation that led to political rapprochement. However, can a fragile peace be bolstered by economic relations? In other words, does economic cooperation between countries in conflict always lead to increased understanding and a resolution of the conflict, or the opposite – increased enmity?

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Not only should this question be raised regarding the EU, but certainly regarding the Middle East, since 1995 the EU launched the Barcelona Process for cooperation of the Mediterranean countries, asserting as its basis that economic cooperation will enable better relationships:

> The participants [of the Barcelona declaration] undertake in the following declaration of principle ... *to promote conditions likely to develop good-neighbourly relations among themselves* and support processes aimed at stability, security, prosperity, and regional and subregional cooperation...The participants emphasize the importance they attach to sustainable and balanced economic and social development.
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> Therefore, the participants *set themselves the following long-term objectives: ...encouragement of regional cooperation and integration.* With a view to achieving these objectives, *the participants agree to establish an economic and financial partnership* which, taking into account the different degrees of development, *will be based on the progressive establishment of FTAs* [free trade agreements]; the implementation of appropriate economic cooperation and concerted action in the relevant areas, and a substantial increase in the EU's financial assistance to its partners[1].

The belief that economic cooperation promotes neighborly relations and less conflict lies at the basis of the centerpiece of the Barcelona Process: a free trade agreement (FTA) for the Med-12 countries[2].

The purpose of this paper is to present an overall structure that will permit analysis of the relationship between economic and political cooperation, and to understand under what circumstances economic cooperation is beneficial. Economic cooperation can take many forms, but the one that is probably the most examined in relation to the EU is trade and the emergence of FTAs. We will therefore focus mainly on trade, but will also discuss other types of economic cooperation.

The analysis of the various aspects of economic cooperation will in turn permit an analysis of the relationship between economic cooperation and conflict resolution, which we will carry out while connecting the theory of trade with the apparatus used by the theories of international relations.

[1] Barcelona Declaration, 27-28 November 1995, pp. 3-4.

[2] The Med-12 countries are Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, the Palestinian Authority, Syria, Tunisia, and Turkey, although from 2004, it will become Med-10, since Malta and Cyprus will join the EU. We will therefore sometimes use the term Med-10.

This interdisciplinary research will permit an understanding of the main elements affecting the success of economic cooperation.

This paper will show that economic cooperation does not always have positive results, and will list the conditions under which economic cooperation may be useful. Our structure will be based on two elements which have been completely avoided in the discussion on economic cooperation, and which are crucial to the relationship between economic cooperation and resolution of conflicts. The first element is the effect of economic cooperation on relative welfare. Economic policy has up until now emphasized the effects of economic cooperation on economic welfare, but for resolution of conflicts, it is also necessary that the *gap between countries* be reduced by economic cooperation. Therefore, it is not enough to analyze welfare, but we must analyze *relative welfare.*

The second element that influences conflict resolution is the effect of economic cooperation on the increase in *trust* between countries. More specifically, when two countries practice economic cooperation, they each become open to the values and social norms of the other. We will show that an increase in economic cooperation does not necessarily have a positive effect on trust; in fact, under certain circumstances, it can have exactly the opposite effect.

These two elements – relative welfare and trust – affect conflict resolution because the utility of countries is not only influenced by pure economic variables. Indeed, there are opposing views on the relationship between economics and international relations. The first view is that economic decisions are affected only by economic interests. In this case, welfare is the main value that countries are interested in attaining.

The second view is that nation-States have specific values that are no less preponderant than pure economic interests. Countries do not fight only over resources and territory, but to defend the values and social norms that form their *national sovereignty*. Extending this second position, we claim in this paper that even if from a narrow economic point of view economic cooperation improves welfare, if cooperation leads to a negative effect on national sovereignty, then it will not permit conflict resolution.

This paper will relate to the Middle East and Europe, yet the ideas herein can also be applied to other areas and conflicts. In the next section, we present the various types of economic cooperation and their effects not only on welfare, but also on the two elements that we emphasize in this paper: *relative welfare* and *trust.* After having shown how relative welfare and trust are affected by economic cooperation, we move on to explain why relative welfare and trust are important for conflict resolution. We conclude our analysis by examining, in light of this paper, the optimal type of intervention on the part of the EU in the Middle East peace process.

2. *Typology of Economic Cooperation*

In order to analyze the effects of economic cooperation on conflict resolution, one has to examine the various types of cooperation and analyze their effects on the variables that in turn affect conflict resolution. The first variable is increase in output, since economic welfare affects the utility of agents in all countries. The two other variables are *relative welfare* and *trust*, which as we have already briefly explained, also affect the utility function through extra-economic values. Our main focus will be on the effects of trade, but we present all possible types of economic cooperation using the typology presented by Bela Balassa[3]. We begin by analyzing the effects of all of these types of economic cooperation on welfare and relative welfare, and then on trust.

2.1 *Welfare and Relative Welfare*

2.1.1 *The Effects of a Reduction in Tariffs on Welfare and Relative Welfare*

In this part of the paper, we present an overview of the theories that analyze the effects of trade on welfare. The beneficial effects of trade are the main objects of the study of international trade theory that began with the work of David Ricardo in 1817, which emphasize the comparative advantage that is in fact an application to international trade of Adam Smith's division of labor.

A. *The Comparative Advantage Effect*

The theory developed by Ricardo focuses on the differences in productivity between countries. Each country (and we will focus on only two) is relatively efficient in the production of one good, *i.e.* it has relatively higher productivity in one sector. Output and consumption of

[3] B. BALASSA, *The Theory of Economic Integration*, Homewood, Illinois, 1961.

both countries will increase if each country specializes in producing the good in which it has a comparative advantage.

It is sometimes suggested that the benefits of free trade lie essentially in the opening of new markets to exports, yet this is not the main factor in improvement in the economy. The gains from free trade are not due to the opening of markets for export, but rather to *the possibility of importing goods at a lower price than the price at which you produce.* The mechanism of gains from trade is triggered by refraining from producing goods with low productivity and instead buying them from a foreign country. But, of course, to pay for these imports one must export.

This Ricardian theory, which focuses on the differences in technology between countries, was followed by the Heckscher-Ohlin models, which examine the effects of the differences in relative endowments in factors of production on trade. A country exports goods intensive in the factors of production that are abundant in this country. So, in countries where labor is relatively abundant, goods that are labor-intensive will be relatively cheaper, and will be exported against goods that are capital intensive. In this case also, the gains are from buying goods at a lower price than the price at which you produce.

However, these gains are not the only gains to be had from trade. In small countries, misallocation of resources due to interest groups and lack of competition is common. In such situations, trade can lead to increased welfare by opening up some sectors to competition.

B. *The Competition Effect*

Trade enables an increase in productivity by imposing competition from the import sector onto the domestic one, leading to gains in welfare. Misallocation of resources is particularly prevalent in developing countries, and import penetration necessitates increasing the rationalization in the production function. Moreover, powerful interest groups and monopolies further reduce output in the economy. By being forced to compete with other countries, these interest groups and monopolies lose their bargaining and monopoly power. Free trade and exposure to import is the best way to reduce the power of local monopolies.

C. *Increasing Returns to Scale*

The new trade theory emphasizes that intra-trade (trade between countries that are similar in their technology levels and in their relative abundance of factors of production) cannot be explained by the classical theory of comparative advantage. Rather, intra-trade stems from increasing returns to scale, which in turn leads to big gains from trade.

The basic idea underlying these non-classical theories is that when the production function displays increasing returns to scale and domestic markets are narrow, trade allows the concentration of production in one country instead of having two plants manufacturing the same good in two different countries. Therefore, trade enables a reduction of costs and an increase in output. The concentration of specific sectors in different countries is optimal, and explains the high level of intra-trade between developed countries: gains from the concentration of output production are due to the reduction in average cost.

D. *Externalities and Strategic Trade Theory*

In the section above, increasing returns could be appropriated by the firm. However, a country's production function can display increasing returns at the country level due to externalities, while displaying constant returns to scale at the firm level. Indeed, increasing returns could exist at the country level due to *spillover effect*s or to the accumulation of know-how and "learning by doing" specific to a particular country. In such cases, if some externalities occur through learning by doing, a country might be better off protecting those sectors until it has attained higher productivity, and in this case, free trade would no longer be optimal since markets display some market failure. In a context of general equilibrium, we show[4] that free trade may cause a country to lose its lead in some manufactured sectors, and its level of output is consequently lower than optimal.

Therefore, the new trade theory shows that in some cases free trade allows gains, while in others, it would be better to protect some sectors of the economy. However, a sector should be protected only if *the social benefits are not appropriable.*

Unfortunately, in the name of externalities, most developing countries protect sectors that should not be protected, and often these industries remain dependent on protection and are co-opted by special interests. There is a case for protection only if over time, protection will make the industry more competitive. If there are fundamental reasons why a country lacks a comparative advantage in manufactured goods due

[4] E.S. BREZIS, P. KRUGMAN and D. TSIDDON, "Leapfrogging in International Competition", in *American Economic Review*, December, 1993, pp. 1211-19.

to lack of skilled labor, entrepreneurs, managerial competence, and social organization, then protection will not render the entire economy more efficient, since protectionism and interventionism are not the correct policies and will only lead to corruption and inefficiency. A country in this situation should then export traditional goods and modernize the infrastructure of its economy.

E. *Welfare and Relative Welfare*

In summary, we have shown that there are many reasons why free trade and reduction of tariffs lead to greater welfare. The classic theories of trade have shown that free trade leads to specialization in sectors with comparative advantages, and therefore each country in such a situation produces more optimally and welfare increases. The new trade theory has shown that concentration of production leads to lower costs and greater profits, and therefore trade is beneficial. However, the trade theory is less obvious regarding the relative welfare effect of trade.

As early as the simple Ricardian model of comparative advantage, the increase in welfare is unequal in both countries. Both countries gain from trade, yet it may be that the more developed country gains more from trade. Moreover, in the new models of trade which incorporate spillover effects, the developed countries produce and export goods that incorporate either human capital or externalities, while developing countries specialize in manufacturing and agriculture, *i.e.* traditional sectors with no increase in productivity. Furthermore, on the demand side, the composition of trade over time can actually harm developing countries as opposed to developed ones, since the demand for high-tech goods relative to traditional goods increases, and the terms of trade of the developing country consequently might worsen.

Therefore, for countries like the European countries where most trade is intra-trade, welfare is not only beneficial, but the gap might be reduced due to the effect of both concentration of manufacturing and externalities between countries: all countries specialize in sectors with some spillover effects. However, this is not the case in the Middle East, where the differences in capital, human capital, economic structure, and even in levels of corruption (see Tables 1 and 2) lead to trade increasing welfare but not reducing the gap between countries. Indeed, if one examines the data of the gap in output, it has been reduced in the EU, while it has widened in the Middle East (see Table 3).

Table 1 - *Corruption, Efficiency and Bureaucracy in the Middle East and Europe*

	Red-Tape	Corruption	Efficiency
Israel	7.5	9.25	10
Egypt	3	3.25	6.5
Jordan	6.33	8.33	8.66
Netherlands	10	10	10
Sweden	8.5	9.25	10
Norway	9	10	10
UK	7.75	9.25	10
France	6.75	10	8
Germany	7.5	9.5	9
Italy	4.75	7.5	7.92
Switzerland	10	10	10
US	9.25	10	10

Note: The scale is from 1 to 10, when a higher score means better governance.

Source: P. MAURO, "Corruption and Growth," in *Quarterly Journal of Economics*, Vol. 110, no. 3, 1995, pp. 681-712.

Table 2 - *Education in the Middle East, Percentage of Scolarisation Relative to Population in 1995*

	Primary		Secondary		Universities	% adult illiterate	
	Female	Male	Female	Male		Female	Male
Egypt	89	105	69	81	17	61	36
Jordan	95	94	54	52	19	21	7
Israel	96	95	91	84	35	-	-

Source: *World Development Report.*

Table 3 - *Relative Welfare of Countries in the Middle East and Europe*

	GDP per capita (PPP) in $		Gap with the most developed country		
	1994	2001	1983	1994	2001
Egypt	3,720	3,560	.13	0.24	0.18
Jordan	4,100	3,880	.30	0.27	0.19
Syria	3,500	3,160	.09	0.23	0.16
Israel	15,300	19,630	1	1	1
Greece	10,930	17,520	.34	0.56	0.69
Portugal	11,970	17,710	.19	0.61	0.70
Spain	13,740	19,860	.42	0.70	0.78
Ireland	13,550	27,170	.44	0.69	1.07
UK	17,970	24,340	.8	0.92	0.96
Italy	18,460	24,530	.55	0.94	0.97
Holland	18,750	27,290	.86	0.96	1.08
Belgium	20,270	26,150	.8	1.04	1.03
France	19,670	24,080	.91	1.01	0.95
Germany	19,480	25,240	1	1	1
Denmark	19,880	28,490	1.01	1.02	1.13

Note: The most developed countries in 1983 are Israel for the Middle East, and Germany for Europe. The gap is the *ratio* of the country output to the output of the most developed country. When the *ratio* increases, the gap is reduced.

Source: *World Development Indicators Database*, 2003.

Therefore, in most cases, trade has very positive effects on output and welfare, but not always on reducing the gap between countries. Before turning to examine the effect of trade on trust, let us first examine the other types of economic cooperation and their effects on welfare.

2.1.2 *Effects of FTA on Welfare and Relative Welfare*

A. *Trade Diversion and Creation*

In recent decades, free trade agreements (FTAs) have become common. An FTA is a treaty in which countries agree to remove trade barriers between them, yet do not have a common policy of trade toward countries outside the FTA. An FTA might lead to a reduction in welfare due to the *trade diversion effect*[5].

There are differences between (i) an FTA within the EU; (ii) an FTA among Middle Eastern countries, and (iii) FTA treaties between the EU and the various Med-12 countries. Indeed, the diversion effect, while interesting theoretically, is irrelevant for big countries and especially for the EU, since there is more trade creation in the EU than there is diversion. Recall that trade between the EU countries is mostly intra-trade, and therefore FTA leads to a creation of trade leading to specialization, concentration, and positive welfare effects.

However, for a developing country specializing in traditional goods that joins an FTA, there could be some trade diversion depending on the content of its trade. However, this is not the case for most Mediterranean countries. Indeed, the complex development of agreements between the EU with periphery countries departs from the typical analysis of the FTA: the relationship between the periphery and the EU is best described by the hub and spokes (HS) model[6].

The concept of hub and spokes describes the case where the bulk of exports from the peripheral countries (the spokes) go mainly to one country or bloc (the hub), and there is little trade between peripheral countries. It should be noted that most spokes are developing countries with limited intra-trade; therefore, an FTA between them will not bring significant change in the pattern of trade.

Empirically, the Mediterranean countries are best described as a natural formation of hub-and-spoke, that is, most of their imports and exports are with the EU, and not with each other. Indeed, the intra-MED-12 trade accounts for less than 4%, while the exports of the Med-12 to the EU account for more than 50% of their trade. Therefore, these countries can only benefit from an FTA with the EU.

Yet the FTA as described by the Barcelona Process is different; it will not result in a large welfare increase, since the type of goods that one

[5] P. KRUGMAN, *Is Bilateralism Bad?*, in E. HELPMAN and A. RAZIN (eds.), *International Trade and Policy*, Cambridge, 1991.

[6] R. WONNACOTT, "Trade and Investment in a Hub and Spoke System versus a Free Trade Area", in *The World Economy*, Vol. 19, 1996, pp. 237-251 and A. ENDERA and R. WONNACOTT, "The Liberalization of East-West Europe and Trade: Hubs, Spokes, and Further Complications", in *The World Economy*, 1996, pp. 253-272.

country exports is not correlated to the other country's exports[7]. Indeed, countries that exhibit little export diversification have little incentive to trade with each other, so that they mostly trade with the EU. As explained above, an FTA between them would not affect their pattern of trade, and would in consequence have almost no effect on welfare.

B. Other Effects of FTA

There are gains to be had for a country from joining an FTA other than the reduction of tariffs analyzed in the above section, namely the creation of a preferential relationship. Some theories on trade and growth emphasize that via trade, social norms become global. In other words, by joining an FTA, the infrastructure of a developing country might adapt to the norms of developed countries. While this is true for democracies, when examining the Med-10 countries, which are mostly non-democratic, one cannot see an improvement in recent years in their social and economic structures.

Another beneficial effect for a democratic developing country, or a spoke, of joining an FTA is the *hand-tying effect.* FTA agreements must be implemented gradually, and when the time comes to dismantle barriers, some powerful lobbies would like to impede free trade. However, since the country has signed an international agreement on gradual dismantling of barriers, it will resist the national monopolies and not succumb to them, claiming that their hands are tied by international agreements. Therefore, the legal status of an FTA leads to credibility where the internal lobbies are concerned that free trade will be implemented[8].

These two positive effects (the preferential relationship and the hand-tying effect) are certainly in evidence in the FTA between the EU and Israel. Israel signed an FTA with the European Community in 1975, which was upgraded in 1995. These agreements have enabled changes in the social norms of doing business, as well as their enabling higher productivity.

[7] Arnon et al. suggested that this is also the case for Israel: Israel's exports and its neighbors' imports are not correlated. See A. ARNON, A. SPIVAK, and J. WEINBLATT, "The Potential for Trade between Israel, the Palestinians and Jordan," in *The World Economy*, Vol. 19, 1996, pp. 113-34.

[8] This is similar to the *hand-tying* effect analyzed in monetary policy in the field of fixed exchange rates (see C. WYPLOSZ, "EMU: Why and How It Might Happen", in *Journal of Economic Perspective*, 1997, pp. 3-22).

Israel today specializes in high-tech, a field in which it is difficult to gain leadership, since the creation of a critical mass is essential in high-tech. In consequence, as emphasized in models of core vs. periphery[9] the possibility of *multiple equilibria* exists. Because history plays a vital role in the determination of which equilibrium is chosen, it is better to try to join the hub via an FTA as soon as possible, before the high-tech sectors relocate, and concentrate in the hub[10]. The formation of an FTA is therefore a quite positive development for a small developed country such as Israel.

In conclusion, for European countries, the FTA has enabled an increase in welfare in each country, not only due to the resulting increased competition and concentration, but also due to the spillover effects of social norms (in Table 1, we show that indeed the differences among EU countries in corruption and red tape are very small.) Moreover, since most European trade is intra-trade, the gap between countries has been even further reduced.

Benefits from an FTA with Europe exist for the Mediterranean countries, but they are modest. Again with the exception of Israel, the Med-10 countries have non-diversified manufacturing production, and also specialize in agriculture. It is therefore not clear what the positive effects of an FTA with Europe would be, since the CAP (Common Agricultural Policy) does not allow benefiting from a comparative advantage in agriculture. Moreover, the Med-10 do not benefit from trade in sophisticated goods, but only from comparative advantage. Israel, being a developed country specializing in high-tech, would stand to gain more from free trade.

Moreover, it could be argued that when the education level is low (see Table 2), and the political system is not a pure democracy, corruption and bureaucracy are hardly thwarted by free trade, since there seems to be no influence through trade on social norms, specifically either on causing more competition or less corruption. Therefore, gains from trade are not evident, and the system is trapped in its underdevelopment. In consequence, an FTA as expressed in the Barcelona Process increases welfare for all participating countries, yet at the same time, the gap between the developed and developing countries might increase.

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9 See P. KRUGMAN and A. VENABLES, *Integration and the Competitiveness of Peripheral Industry*, in BLISS and BRAGA DE MACEDO (eds.), *Unity with Diversity in the European Community*, Cambridge, 1990.

10 See E.S. BREZIS, *Europe and Israel: The Effects of EMU on Development and Growth*, in E. AHIRAM and A. TOVIAS (eds.), *Israel and Europe: Common and Divergent Interests*, Peter Lang, 1995, pp. 165-175.

2.1.3 *Customs Unions, Free Movement, and FDIs*

The effects on welfare of non-trade cooperation have been analyzed less than has been trade, but they are still worth examination. A *customs union* is an arrangement whereby countries decide on a common trade policy toward other countries. A stronger cooperation than an FTA, a customs union is chosen when countries want to eliminate borders, as is the case with the EU. Moreover, when there are no borders between two nations, a customs union is the only possible type of tariff cooperation, which is the case between Israel and the Palestinian Authority (PA): since there are no borders between Israel and the PA, and goods can move freely between them, they must agree on common tariffs imposed on other countries. Indeed, in the Paris Protocol signed between Palestinians and Israelis in 1994, the cooperation chosen was of a customs union type.

Another even stronger cooperation is free movement of factors of production: capital and labor. Regarding labor, developed countries do not usually agree to open borders for free movement of labor from countries in which wages are much lower. From the point of view of the developing country, the effects of emigration are not clear-cut. The emigration of unskilled labor is welfare-improving since it reduces unemployment and leads to higher wages. However, the emigration of skilled labor leads to a brain drain. Human capital is already scarce in developing countries and emigration to developed countries leads to even more scarcity. However, the possibility of working abroad can act as an incentive for young people for investing more in human capital, so that the total investment in human capital might increase.

The movement of capital can take two forms. The first is financial movement of capital, *i.e.* investing in stocks and bonds of other countries. The second form is investing in real assets in other countries, which is termed Foreign Direct Investment, or FDI. FDI takes the form of investing in foreign firms or opening subsidiaries. This type of cooperation is very important to the welfare of developing countries. It may have, however, some negative trust effect, as we will see in the next section. We now turn to analyzing the effects of all of these types of economic cooperation on trust.

2.2 *Economic Cooperation and Trust*

Economic theories analyze trade and other types of cooperation in a narrow way - an economic orientation. Indeed, the purpose of economic theory is to examine the effects of economic cooperation on economic variables. Yet "in any modern society, the economy constitutes one of the most fundamental and dynamic arenas of human sociability"[11]. Economic cooperation also affects the society in non-economic ways: it leads to interaction between people, and therefore also affects social parameters. For instance, economic cooperation leads the business elite to work together, to bargain, and to dialog. Economic cooperation also leads individual citizens in both countries to meet and to learn the other's mentality, culture, and social norms. The question is whether this encounter necessarily leads to better understanding and more trust between the two countries in question.

The concept of trust has been analyzed in recent years in the context of economic cooperation[12]. On the social context, Fukuyama emphasized that trust is related to the various sets of cultural norms that each country has[13]. Nation-States have fundamental values that are the basis of their specificity, based on either religion or ethnicity, and which over time lead to specific social norms. These social norms are part of the *national sovereignty* of countries; these values and social norms are the essence of the specificity of their nation. Countries tend to want to maintain their specific cultures, social values, and social norms that are part of their national sovereignty.

Trust between countries occurs when the countries in question do not feel threatened by the social norms of the other country: when the social norms in each country may be perfectly compatible. But the opposite can also be true. In other words, when the citizens of one country feel that the citizens of the other country respect their values and do not threaten their social norms, trust is increased. When in contrast, disrespect for the intrinsic values of a country is exhibited, trust is reduced.

Trust could be considered an exogenous variable[14]. In this paper, I argue that trust is endogenous. More specifically, trust is influenced by the

[11] F. FUKUYAMA, *Trust*, Free Press, New York, 1995, p. 6.
[12] See E. GLAESER, D. LAIBSON, J. SCHEINKMAN and C. SOUTTER, "The Determinants of Trust", in *Quarterly Journal of Economics*, 2000, pp. 811-46.
[13] F. FUKUYAMA, op. cit.
[14] F. FUKUYAMA, op. cit.

interaction between countries. Interaction that is a consequence of economic cooperation leads to people becoming more conscious of the cultural differences or similarities that either separate them or unite them.

Let us take tourism as an example: meeting can lead to better understanding and increased harmony, but can also lead to dislike, which was not the case before meeting. In the case of trade, promoting exchanges between countries leads to businesspeople meeting and finding out that they either have common values or that their ways of doing business and lifestyles are quite dissimilar.

When countries have the same cultural basis, it seems probable that despite the differences between them, they will ultimately see their common values and economic cooperation will lead to greater understanding and less opposition. It is interesting to note that quite often, trade between countries in past centuries was conducted between social groups from the same minority, in which trust was high, thereby mitigating the negative effects of cooperation.

The experience of the EU during the 20th century is one in which economic cooperation has built trust, yet the EU countries *a priori* had similar backgrounds, and through cooperation, nations learned that they have much in common. Another good example of this symbiosis is the relationship between Eastern Europe and the EU. Despite having differences, their common culture and religion affects the success of the enlargement process.

The same could be true between the Med-10 countries that have similar social norms. However, the differences between Israel and the Arab world are not easily bridged. If we compare Israel to its neighbors, there are few common values. Values of honor on one side and democracy on the other often lead to a cooperation that does not build trust, but does the opposite. The countries in question feel threatened by the others, and it could very well be that cooperation, instead of leading to greater trust, leads to a sense that the other country "threatens" their values. So, one cannot necessarily take the example of Europe and apply it to other regions.

Let us take a simple example: if tourism was promoted between Jordan and Israel, Jordanians could be exposed to freedom and democracy, and the differences in lifestyles between the two countries, especially regarding women. Yet this exposure could actually threaten Jordanians' social values, and they could interpret this as threatening their national sovereignty.

This trust problem is inherent in all types of economic cooperation, from trade to tourism. It is therefore not obvious that economic cooperation, and especially trade, leads to a rapprochement between peoples.

In this section we have related economic cooperation to three variables: welfare, relative welfare, and trust. We have shown that trade has a clear positive effect on welfare. However, regarding relative welfare and trust, the effect is less obvious. We now turn to the relationship between economic cooperation and conflict resolution. To illustrate the relationship between these three variables and conflict resolution, we will incorporate economic cooperation into theories of international relations. We first present the various views on international relations, and we then present a structure that relates all of these various elements.

3. *Theories of International Relations Regarding Economic Cooperation and Conflict Resolution*

While the field of international trade has focused only on the effects of trade on welfare and inequality, the field of international relations has dealt with the effects of economic cooperation on international conflict and conflict resolution. On the empirical side, the research has been related to the question of whether economic cooperation leads to more conflict or less. On one hand, studies by Barbieri[15] show that trade is positively associated with conflict. Barbieri analyzed pairs of States for an extended period of time covering the years 1870-1992, including alternative indicators of the importance of bilateral trade. She concluded that greater interdependence significantly increases the risk of a militarized dispute.

On the other hand, very similar research on a different period (1950-1992) and a slightly different subset of countries found that interdependence significantly *reduces* the likelihood of conflict[16]. Mansfield shows similar results[17]. In conclusion, like in many other fields, the results of the empirical research are not clear-cut.

[15] K. BARBIERI, "Economic Interdependence: A Path to Peace or a Source of Interstate Conflict?", in *Journal of Peace Research*, 33(1), 1996, pp. 29-49, and K. BARBIERI, *International Trade and Conflict: The Debatable Relationship*, Mimeo, 1998.
[16] J.R. ONEAL and B. RUSSETT, "Assessing the Liberal Peace with Alternative Specifications: Trade still Reduces Conflict", in *Journal of Peace Research*, 36(4), 1999, pp. 423-42.
[17] E.D. MANSFIELD, *Power, Trade and War*, Princeton University Press, 1995.

On the theoretical side, there are theories that directly connect trade and conflicts. However there are also structural theories for which distribution of power is the only relevant variable for explaining conflict[18]. For them, war depends only on the structure of the international system. However, if to the latter theories we add a relationship between economic cooperation and power, we get an indirect relationship between trade and conflict.

We start by presenting the non-structuralist views, which can be divided into liberalist and mercantilist. Briefly, the liberalist view maintains that trade relations foster dependence among participants, it is termed the *interdependence theory*. In this line of reasoning, Nye[19] (1988), Keohane and Nye[20], and Mueller[21] all claim that more economic cooperation leads to less conflict.

3.1 *Interdependence*

The interdependence theory of political science states that the more economic cooperation between countries – leading to welfare gain – the more countries have to lose if they start a conflict. The interdependence theory claims therefore, that the more interdependence, the less the likelihood of conflict. Thus, all types of cooperation that increase welfare will lead to some interdependence, and countries will choose not to start a conflict.

The interdependence theory is especially true regarding Foreign Direct Investment (FDI), since a country that has invested in another country's infrastructure can lose its investment in a conflict. However, this is also true for trade cooperation. Opposing these liberal views are nationalist views, which assert that dependency or *asymmetric trade* increases the likelihood of conflict.

[18] H. MORGENTHAU and K. THOMOPSON, *Politics among Nations: The Struggle for Power and Peace*, Knopf, New York, 1985.
[19] J.S. NYE, "Neorealism and Neoliberalism", in *World Politics*, 40, 1988, pp. 235-51.
[20] R.O. KEOHANE and J.S. NYE, *Power and Interdependence: World Politics in Transition*, Little Brown, Boston, 1977.
[21] J. MUELLER, *Retreat from Doomsday: the Obsolescence of Major War*, Basic Books, New York, 1989.

3.2 *Mercantilist and Nationalist Views*

The mercantilist views as expressed by the German Historical School did not perceive of the economy as separate from politics. Mercantilism is a doctrine that relates not only to the welfare of the individual, but also to the power of the nation-State relative to other nations. Moreover, Mercantilists stress that power is a concept relative to other nations: the increase of one country's power necessarily means the relative decrease of another's.

Therefore mercantilism is "...a system centered on the nation-State conducting economic policies for the purpose of achieving power and national unity"[22]. The essence of commercial policies is the political goal of national sovereignty. Since the mercantilists perceived trade as a zero-sum game, free trade was not perceived as an optimal policy.

The modern version of mercantilism in international relations theory is represented by Viner[23], Waltz[24], and Hirschman[25]. They claim that more economic cooperation leads to more conflicts, arguing that since gains from trade are usually asymmetrically distributed across States engaged in trade, trade can influence the distribution of power and increase the probability of conflicts.

To these two pure theories of international relations – interdependence and mercantilism – one can add an argument that is based on bargaining, sometimes presented as the *buffer theory.*

3.3 *The Buffer Theory*

In order to prevent conflict and to create a situation in which disagreements will not necessarily lead to all-out wars, countries use *buffers*, and one of which could be economic relations. Indeed, when some dispute arises, in an absence of preliminary concessions on which to

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[22] E.S. BREZIS, "Mercantilism", *Oxford Encyclopedia of Economic History*, forthcoming, 2003.

[23] J. VINER, "Power versus Plenty as Objective of Foreign Policy in the seventeenth and eightennth Centuries", in *World Politics*, 1, 1948, pp. 1-29.

[24] K.N. WALTZ, *The Myth of National Interdependence*, in C.P. KINDLEBERGEI (ed.), *The Multinational Corporation*, MIT Press, Cambridge, 1970 and K.N. WALTZ, *Theory of International Politics*, Addison-Wesley, 1979.

[25] A. HIRSCHMAN, *National Power and the Structure of Foreign Trade*, University of California Press, 1980.

bargain, countries might start a conflict. Yet if buffers exist, instead of starting a conflict, countries could first call back their diplomats or cancel sports competitions or academic conferences. Economic relations can also be analyzed as a buffer: when a conflict does occur, it is better to halt economic relations than to enter into a more costly conflict.

We now turn to the structural theories.

3.4 *Relative Power and Trade*

Some scholars in the field of international relations view the theories presented above with suspicion. For them, power is one of the main variables that affect the outbreak of conflict. For instance, Gilpin[26] writes: "The major point to be made in these matters is that trade and other economic relations are not in themselves critical to the establishment of either cooperative or conflictual international relations...In general, the character of international relations and the question of peace and war are determined primarily by the larger configuration of power".

3.4.1 *Power and Conflict*

The structural theories that relate power to conflict are mainly interested in the question: to what extent does *distribution of power* influence the outbreak of war? There is fierce debate on this question, and I will only present the theories that directly can be related to our subject, or those that connect the eruption of conflict to the *concentration* of power, *i.e.* the relative inequality of power between States. The theory known as the *balance of power* theory asserts that when power is balanced among major powers, conflicts are less likely to occur, due to the deterrent effect of power. If countries have parity in their levels of power, the probability of winning a war is low, and therefore the costs of a war can be important[27].

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[26] R. Gilpin, *War and Change in World Politics*, Cambridge University Press, New York, 1981, p. 58.

[27] There are theories that claim the opposite relationship. For instance, the *preponderance theory* stresses that a significant gap in the relative power of countries leads to *less* conflicts.

A derivative of the balance of power theory, and one that is more closely related to small countries, is the *power transition* theory. The power transition theory claims that States enter into conflict when one of them wants to change the existing equilibrium. In this case, the mechanism that accounts for conflict is the dynamics of *power transition*[28].

To conclude, the distribution of power and balance of power theories state that an increase in the relative power of the stronger State will increase the probability of conflict. In the opposite case, when levels of power are similar, the likelihood of conflict decreases.

These structural theories relate conflict to relative power. However, this does not mean that these theories negate the possibility that trade has an effect on conflict resolution. Indeed, if to these theories we add a relationship between power and economic cooperation, we get a relationship between economic cooperation, power, and conflict resolution, as incorporated by the mercantilist view. We now turn to analyzing the possible relationship between economic cooperation and power.

3.4.2 *Economic Cooperation and Power*

Power is defined as *a means of enforcing the sovereignty of a country*, and in most theories it encompasses economic as well as military factors. Regarding the economics, the most important factor regarding power is *output*. Since as explained above, it is not power that is an important element for conflict, but rather *relative power*, then by the same token *relative output* is an important element. More specifically, we saw that according to the balance of power theory, when relative power increases, the probability of conflict increase. In other words, when relative output of the stronger country compared to the weaker country increases, the probability of conflict likewise increases. Since in the first section of this paper, we showed that economic cooperation leads to a change in the relative output (welfare) of countries, we then have a relationship between economic cooperation and relative power.

All these theories of international relations linking economic cooperation and conflict resolution can be incorporated into a simple economic structure that will allow us to analyze under which conditions economic cooperation indeed leads to reduction in conflicts.

[28] See A.F.K. ORGANSKI and J. KUGLER, *The War Ledger*, Chicago University Press, Chicago, 1980, and R. GILPIN, op. cit.

4. *A Structure for Economic Cooperation and Conflict Resolution*

The various theories presented above enable us to present an overall structure incorporating the effects of economic cooperation on output, relative output, and trust. The structure will be based on the premise that while deciding whether or not to initiate a conflict, a State compares the expected improvements in its relative position in the international order that might result from waging a war, against the expected associated costs. Such a structure could be presented as a theoretical model, but we will present the main ideas without many of the economic technicalities; only the most basic equations will be presented.

The objective of a country is to maximize its utility function, or more specifically its expected utility. However, in our model, utility is not only a function of the State's consumption; utility also incorporates *national sovereignty*, which expresses the desire on the part of countries to remain independent nation-States with their specific values and social norms. Values and social norms represent the common aspirations for the citizen of the State as culture, mentality, idiosyncratic legal system, and so forth. A country takes cares not to lose these, and these values can clash with the values of other nations. Loss of autonomy occurs when due to a conflict, a country has lost either some autonomy or some of its territory and its independence. While loss of autonomy can occur only as a result of conflict, a loss of values does not need a conflict, yet might happen as a result of cooperation, as explained above.

In Equation 1, we express the fact that the utility of a country is a positive function of its total consumption (which is almost equivalent to output) and national sovereignty.

$$U = U(C, NS) \text{ where } U_c > 0 \text{ and } U_{NS} > 0 \tag{1}$$

where C is consumption and NS is national sovereignty.

Consumption and national sovereignty are affected by economic cooperation (Ec). As we saw, welfare, *i.e.* consumption, increases when we have cooperation. National sovereignty is also a variable influenced by cooperation. We saw that the effects of interaction and cooperation on national sovereignty are not known in advance, and therefore cannot be taken into consideration *ex ante.* Countries do not have perfect knowledge regarding the values of the other State and whether they present no threat to or threaten its own values. Therefore, each period of interaction increases this knowledge. If after interaction, a country sees that the other country has values similar to its own, and cooperation is good, then national sovereignty increases. However, if the cooperation leads to hostility, utility is lessened by threatening the values of the country or its national sovereignty. Therefore, this effect is some sort of externality of cooperation and interaction that can be either positive or negative.

Thus, the utility function is affected in two ways by the degree of economic cooperation, Ec, as shown in equation 2: (i) regarding consumption, it is positive, but (ii) regarding national sovereignty, it depends on the values and social norms of the countries in question.

$$U = U[C, NS] = U[C(Ec), NS(Ec)] \text{ where } C_{Ec} > 0 \text{ and } NS_{Ec} \leq \text{or} \geq 0 \quad (2)$$

Economic cooperation is incorporated in the model also through relative power. Indeed, based on the balance of power theory, we assume that the probability of war increases when the differences in power between States increases, since differences in power lead to increased instability.

$$p = p(PW_i - PW_j)^2 \quad \text{where} \quad p' > 0 \quad (3)$$

where p is the probability of war, and PW_s is the power of country s, s = i, j.

Moreover, we saw that the relative power of the two countries in question is a function of relative welfare, which is in turn affected either positively or negatively by economic cooperation. Therefore:

$$p = p[PW_i - PW_j]^2 = p[Y_i - Y_j(Ec)]^2 \quad \text{where } (Y_i - Y_j)_{Ec} \geq \text{or} \leq 0 \quad (4)$$

where Y_s is the output of country s, s = i, j.

In consequence, economic cooperation in general, and trade in particular, have two direct effects and one indirect effect on the utility function. The first direct effect is that free trade and economic cooperation lead to higher output and consumption. However, free trade can also increase the output gap between countries, especially if one is more developed than the other. In this case, relative power increases, which in turn increases the probability of war. Moreover, we also have the indirect effect, wherein greater economic cooperation leads to a higher level of national sovereignty if the countries have similar values, but decreases it when after cooperation, countries have less trust in each other.

Given this structure, we can find the optimal policy of each country, *i.e.* the optimal degree of economic cooperation. We arrive at the following proposition:

Proposition

(i) When the effect of economic cooperation on relative welfare is positive, *i.e.* economic cooperation leads to a greater gap between the two economies, the optimal degree of economic cooperation is *not to* allow the maximum possible economic cooperation.

(ii) When the effect of economic cooperation on relative welfare is negative, *i.e.* economic cooperation leads to a reduction in the gap between the two economies, the optimal degree of economic cooperation is to allow the maximum possible economic cooperation.

(iii) When cooperation leads to harmony and trust, it is optimal to even increase it, while when cooperation leads to discord, the optimal degree of cooperation is lower than the chosen one.

Without bringing any formal proof, we can explain this proposition intuitively. Countries maximize their expected utility given that the probability of conflict is p and is a function of economic cooperation as shown in equation (4). The utility function as presented in equation (1) is also a function of economic cooperation. When all effects on the economy of economic cooperation are positive – an increase in welfare, decreasing the output-power gap, and an increase in trust – then the expected utility is an increasing function of economic cooperation, and therefore maximum cooperation is the optimal choice.

However, when economic cooperation leads on one hand to an increase in welfare, but on the other hand to an increase in the gap and a reduction in national sovereignty, since there are opposing effects, the optimal degree of cooperation will be less than the maximum possible.

This structure integrates the various elements via which economic cooperation influences conflict resolution, allowing us to find the optimal policy. Our main conclusion is that maximum cooperation is not always optimal, although this structure does not permit us to pinpoint exactly the optimal amount: it may be true that for some countries, some free trade is optimal, but not further cooperation. For others, free trade and even capital flow can be optimal, and for others, even less than free trade is optimal. However, the main lesson from this structure is that economic cooperation cannot be considered a *panacea.*

5. *Conclusion*

This paper analyzes the effects of cooperation on conflict resolution. We have formulated a structure that incorporates all of the various channels through which economic cooperation affects the peace process. We have shown that three elements are essential to understanding the effects of economic cooperation: welfare, the gap in output, and trust.

In light of this structure, it becomes obvious that the Barcelona Process is not only irrelevant to conflict resolution in the Middle East, but its implementation could even exacerbate the conflict. The desire on the part of the EU to take its successful experience of economic cooperation within Europe and apply it to other regions is downright hazardous. Two main differences between the Middle East and Europe prevent the implementation of the Barcelona policy.

The first is the differences in the respective countries' economic structures. Israel is a developed country with little corruption, high capital output ratio and human capital, and specializes in high-tech, which sector displays increasing returns to scale and spillover effects.

The other Med-10 countries are still developing countries with social structures and factors of production that do not permit their specialization in goods displaying increasing returns to scale or some externalities. Therefore, Israel gains more from trade, and the gap might even widen. This in turn means that the probability of conflict may increase over time, and it is therefore not optimal to have strong economic cooperation between Israel and its neighbors.

The second main difference between the EU and the Middle East is related to cultures and social norms. The countries of Europe share common values and culture, which is not the case in the Middle East. The differences in the Middle East stem from religion, political and social structures, and levels of respect for freedom and democracy.

In consequence, the premise that economic cooperation leads to political cooperation is not always borne out. Conflict resolutions do not necessarily follow the same paths; while there is no doubt that economic cooperation was fruitful for Europe, it will not necessarily be so for the Middle East. Since we have shown that economic cooperation within the Mediterranean countries is not optimal, in order to reduce conflict, it is actually not wise to force the countries into an FTA or other economic cooperation there.

The counter-productivity of the Barcelona Process does not mean, however, that Europe cannot play a central role in reducing conflict and enhancing prosperity and development. The role of the EU in the Middle East is not to promote its path to cooperation in the Middle East, but to find the specific one that can succeed there. We have shown that two main areas are problematic in collaboration in the Middle East: the gap in output and culture. The lesson from the structure proposed herein is that in order to reduce the incidence of conflict, a reduction in the output gap as well as in the social norms between countries is needed, and it is on these two fronts that Europe should expend its efforts.

Regarding the reduction in the output gap, the developing countries of the Mediterranean must disentangle themselves from their underdevelopment trap. The first step in doing so is for these countries to increase their human capital and reduce bureaucracy, corruption, and monopolies. All countries must consciously and unilaterally undergo a process of economic reform. Europe can help the developing countries on the road to development by forming their own elite class and ensuring that the necessary conditions for development exist: creation of infrastructure, increase of human capital, and eliminating corruption.

Developing countries need more Foreign Direct Investments in the private sector as well as investment in infrastructure. Private funds will be invested only when the bureaucracy in these countries is efficient and free of corruption. Therefore, Europe should focus on policy that aids in these areas.

The second front for change should be the cultural one. Without a reduction in the differences in social norms between the Arab countries and Israel, economic cooperation will simply exacerbate the conflict. Public opinion in each nation-State has to recognize and accept the other country's values in order to maintain a sustained peace. This type of cooperation was not needed during the formation of Europe, since the European countries already shared the same values - they came from the same cradle.

When differences between values and social norms are as wide as those in the Middle East, it is first necessary that there be greater understanding between the citizens of both countries in general, and particularly among the elite. It is perhaps difficult for Europeans to understand, but despite a peace treaty between Jordan and Israel, intellectual and cultural relations are non-existent. Israeli poets, dancers, and even university professors may not be invited by their Jordanian or Egyptian counterparts, under the threat of being thrown out of their professional associations. This non-acceptance of the other can be explained only by a fear that cooperation threatens a country's values.

There is a need for a long preparation that can lead to an understanding of the other's values, in turn leading to mutual respect. This is an area in which the EU can take a leadership role, leading the way to cultural cooperation. It should therefore be a priority to organize seminars in which Israelis and Arabs of the Mediterranean countries can meet. This encounter will reduce the cultural gap that exists between the Middle Eastern countries.

Another intellectual form of cooperation that also has economic implications, since it leads to increase in human capital, is to develop schools for the elite of the Middle East in Europe. Such schools will not only enable the formation of an elite class, but will allow the elite to get to know each other. Indeed, the elite of the next generation will be less suspicious of the other countries, since they have shared the common student experience.

It is crucial that the entry to this school be on a meritocratic basis and not based on being chosen by the elite in power. Europe wants to form the best elite class, not simply those with connections to the present elites. In other words, I propose creating some sort of ENA-like institution where the elite of the Middle East will be trained[29]. Moreover, it could be that the elites formed in this "Middle-East ENA" will turn out to be the regulators and the civil servants, and will work to reduce corruption in their respective countries. These structural changes in the human capital and in the bureaucracy will attract capital and Foreign Direct Investment, thereby enabling the Middle Eastern countries to grow and develop.

In conclusion, there is room for a new "Mediterranean process of peace and progress," but it should be based on enhancing cultural and intellectual cooperation as well as the formation of a new elite class less suspicious of the other countries. The challenge for Europe that we propose herein is based on a long-term commitment; it takes time to create cultural cooperation, elite formation, and FDI. But in contrast to an FTA, it can indeed change the face of the Middle East, support sustainable development, and enhance conflict resolution.

[29] I am aware that there are also negative effects of a school like ENA, and that over time the recruitment becomes very narrow. This is not the case for the first generations (see E.S. Brezis and F. Crouzet, *Elites Schools, Circulation of Elites and Economic Development: the ENA Case*, in E.S. Brezis and P. Temin (eds.), *Elites, Minorities and Economic Growth*, Elsevier, North-Holland, 1999, pp. 235-49).

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