ARTICLES

The Palestinian Bretton Woods

By Nur Arafeh

Palestinian decision-makers have been talking about the introduction of a national Palestinian currency. Keeping in mind the national, economic, and financial repercussions of such a move, this article reviews the current monetary and financial system established by the 1994 Paris Protocol, and delves into the future prospects of issuing a national currency.

A look in the rear-view mirror

The Palestinian pound was introduced in 1927 following the establishment of a Palestinian currency board by the British Civil Administration in Palestine. The Palestinian pound replaced the Egyptian currency, which had been considered the country's legal currency since 1917, and was equal in value to the pound sterling. It remained in circulation until the disastrous partitioning of Palestine and the creation of Israel in 1948. Between 1948 and 1967, the Jordanian dinar (JD) was the legal tender in the West Bank, while the Egyptian pound was used in the Gaza Strip. Then, following the illegal Occupation of the rest of the Palestinian territories in 1967, Israel imposed its own currency, the Israeli lira, which later became the Israeli new shekel (NIS).

The rest stop

The current Palestinian monetary and financial system was set forth by the 1994 Paris Protocol, which established a "contractual agreement" to formalize economic relations in the West Bank and the Gaza Strip (WBGS) for an interim period of five years. However, despite the expiration of the interim period sixteen years ago, the Paris Protocol still constitutes the basis of economic relations between the Palestinians and the Israelis, and the main framework for the Palestinian Authority's (PA) economic, monetary, and fiscal policies.

Among the main outcomes of the Paris Protocol was the establishment of the Palestinian Monetary Authority (PMA). According to the Paris Protocol, the PMA has several functions: to act as the sole economic and financial agent of the PA; to supervise the performance, stability, solvency, and liquidity of financial institutions; to manage the PA's foreign currency reserves; to authorize foreign exchange transactions; to determine liquidity requirements on all deposits in banks working in the WBGS; to create or license a clearinghouse to clear money orders between banks; and to convert excess NIS obtained from banks in the WBGS into foreign currency at the Bank of Israel.

The PMA thus acts as a central bank but without the ability to issue a currency. The shekel was in fact designated as "one of the circulating currencies" that

The current Palestinian monetary and financial system was created by the 1994 Paris Protocol, which led to the establishment of the Palestinian Monetary Authority (PMA). While the latter acts in many ways as a central bank, it cannot issue a national currency, leading to a problematic multi-currency financial system in Palestine.

Money changer. Photo from Palestine Image Bank.

"will legally serve as means of payment for all purposes including official transactions" in Article IV (10). Hence, the current financial system operating in Palestine is a multi-currency system, as three main currencies are used: USD (which amounted to around 39.7 percent of banks' deposits in the fourth quarter of 2014), NIS (30.8 percent), and JD (25.7 percent).

The current system

The current financial and monetary system is problematic for several reasons. The absence of a national currency has had three major repercussions. First, the PMA has been prevented from using macroeconomic or exchange-rate policies. It cannot undertake the necessary measures to influence money supply or interest rates, and is instead dependent on the Bank of Israel's monetary policy. Second, while the Paris Protocol stipulates that, "the PMA will act as the lender of last resort," the PMA was not given the means to execute that role, as it does not issue its own currency. Third, the PA is deprived of seigniorage revenue, since the Paris Protocol does not address the issue of seigniorage, that is, the revenue earned by the money issuing authority, which is the difference between the face value of banknotes and coins and the cost of "printing" them. A 2004 study estimated that seigniorage revenue would represent between 0.3 percent and 4.2 percent of the Palestinian Gross National Income.

In addition, the use of three currencies exposes Palestinian consumers, bankers, and investors to exchange rate risks, as they have to contend with changes in the exchange rates of the three currencies, and monetary shocks from Jordan, the US, and Israel. Hence, with nearly free capital movement and little trade between the Palestinian and Jordanian economies, Jordanian monetary shocks are channeled to the Palestinian economy through the capital account. However, since the majority of Palestinian trade is done with Israel, fluctuations in the Israeli shekel are transmitted to the Palestinian economy through the current account as well. These fluctuations in exchange rates adversely affect the Palestinian banking sector's assets, and discourage long-term investment, thus constraining development prospects.

Furthermore, not only has the Paris Protocol allowed Israel to tighten its grip on Palestinian trade, financial, monetary, and fiscal policies, on a number of occasions Israel has also violated many of the Palestinians' rights that should have been protected by the protocol. For instance, after Hamas' rise to power in 2007, Israeli banks stopped providing banks in Gaza with NIS banknotes in violation of Article IV (14), and stopped representing them in the Israeli clearinghouse, causing major burdens on Palestinian liquidity.

Moreover, in contravention of Article IV (15), which affirms the PMA's "right to convert at the Bank of Israel excess NIS received from banks operating in the Areas (the WBGS) into foreign currency," Israel has set limits on the amount of NIS cash transfers from Palestinian banks. For example, in 2009, Bank Hapoalim decided to stop accepting cash shipments from Palestinian banks, and was followed by Bank Discount in February 2010. As a result of the imposed limits on monthly cash transfers, Palestinian banks had excessive cash accumulation, which reached NIS 800 million by September 2014, leading to an increase in lending rates, and adversely affecting financial intermediation.

The road ahead

It is partly against this background that Palestinian decision-makers have been considering changing the current financial and monetary system. Regarding the currency regime, there are two main options for the future: absence of a national currency, or introduction of a new national currency.

If Palestinians choose to have no national currency, there are three possibilities: retain the current system; establish a monetary union with another country, most likely Jordan; or dollarization, i.e., the choice of another currency (USD or any other currency) as the sole legal tender for public and private transactions, contracts, and bank accounts.

> At the heel of twenty tumultuous years of using the Paris Protocol, Palestinians are increasingly talking about the possibility of adopting a new currency regime. What are the options in front of them, and are they prepared to introduce a new currency?

However, Palestinian decision-makers have been more interested in the second option, issuing a new national currency. Such a move would have several benefits, as pointed out by the PMA (2014). First, issuing a national currency has symbolic value, since it is seen as a way for Palestinians to strengthen their sovereignty. Second, it would enable the PMA to emerge as a central bank with the ability to execute an independent monetary and exchange rate policy, and thus control money supply and interest rates and align them with the Palestinian economy's needs. In addition, the presence of a national currency protects the banking system and the overall economy from being exposed to many risks, especially exchange rate risks, which arise from the use of a multi-currency financial system. Moreover, the adoption of a national currency would widen the public revenue base of the PA through seigniorage revenue.

Nonetheless, the introduction of a new currency is also associated with costs, including the technical costs of producing the new bills and coins and

Photo by Mohammad Aqrouq.

issuing the currency; administrative costs related to the establishment of new institutions, the transformation of existing ones, and the training of staff, among others; and costs in the form of disruptions of trade flows, given that the currencies most often used in international trade transactions are the ones to be replaced by the new currency. There are also fears that the central bank would not be sufficiently independent and would thus be vulnerable to political pressures to expand the money supply in times of economic recession.

However, the important question is, Are we prepared to issue a national currency? Although the PMA has come a long way in terms of organizing the financial and monetary system in Palestine, Palestinians are still not ready to issue their own currency. Several considerations should be taken into account in order to ensure a successful introduction and management of a credible and stable currency: political sovereignty, especially sovereignty over borders; high credibility and confidence in the new currency; financial and macroeconomic stability; fiscal sustainability and discipline to protect against any errors and policy abuse, which can wreak havoc on the economy; an active and sound banking system that achieves credibility; and human and institutional competencies to carry out a coherent monetary policy.

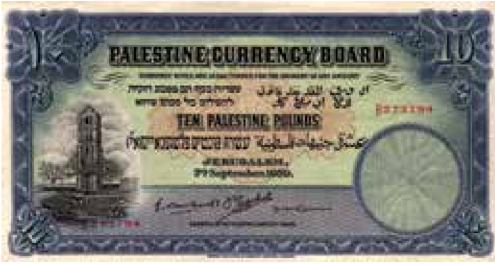
While the overriding consideration is

political sovereignty, a few studies have considered initial efforts to build up credibility and confidence in the currency.

The majority of these studies have recommended the adoption, in the short run, of a Currency Board System (CBS). In a CBS, a board issues a national currency that maintains an exchange rate fixed to an anchor currency. The monetary authority should also have foreign currency reserves worth at least 100 percent of the issued domestic currency, and cannot increase the amount of currency issued if the reserves' backup is not sufficient.

A CBS would be advantageous for the Palestinian economy in the sense that it provides the highest degree of credibility, guarantees macroeconomic discipline, and its administration is fairly easy. However, a CBS would also have some drawbacks relating to the inability of the monetary authority to use monetary policy or to act as a lender of last resort. Moreover, lower revenue is generated from a CBS than from seigniorage. Additionally, the national currency would be exposed to shocks from the anchored currency, and there would always be a need to change the fixed exchange rate over time in order to reflect the shifts in the economy.

Overall, the choice of a currency regime should take two points into consideration. First, a monetary system does not remain ideal forever since



optimality develops as the economy grows and as expertise is accrued. Second, since all monetary regimes have pros and cons, focus should be given to balancing the advantages and disadvantages in accordance with the country's specific conditions.

However, in the current context in which the Palestinian economy remains structurally distorted, fragmented, and dependent on Israel's economy and political goodwill, the introduction of a national currency seems more like a dream that Palestine should start pursuing in the future. First and foremost, the internal Palestinian divisions should end, Palestinians should have political sovereignty, and they should build a national economic vision centered on resisting Israel's colonization of the Palestinian economy/economies, thus breaking free of the Paris Protocol.

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