

See discussions, stats, and author profiles for this publication at: <https://www.researchgate.net/publication/292139224>

# A Monetary Alternative for the Palestinian Economy: A Palestinian Currency

Article · March 1996

---

READS

4

1 author:



Adel Al-Zagha

Birzeit University

9 PUBLICATIONS 7 CITATIONS

SEE PROFILE

## **A MONETARY ALTERNATIVE FOR THE PALESTINIAN ECONOMY: A PALESTINIAN CURRENCY**

**Adel Zaghah**  
*Department of Economics*  
*Birzeit University*  
*Birzeit, Palestinian Territories*

**Abstract.** On historical and economic grounds this paper argues for a Palestinian currency. Israel refusal of this issue is mainly economic, namely, seigniorage revenue it extracts from the circulation of the Israeli shekel in the West Bank and Gaza Strip. This refusal endangers the whole peace process in the Middle East. A currency board system for the Palestinian National Authority (PNA) with a 100% reserve requirement by backing it up by the Jordanian dinar could yield seigniorage revenue for the PNA to implement a major part of its development projects and create jobs for an impoverished population half of which is unemployed. However, regional institutions must be created to take care of the distributional issues of the benefits of the peace process in the region.

## I. Introduction

Twenty-seven years of Israeli military occupation left the Gaza Strip and the West Bank (WBGS) an economically backward area, plagued by unemployment and the lack of investment, for which the infrastructure should be rebuilt. In Gaza it is even worse than in the West Bank since Gazans must work in Israel and when denied this possibility, which frequently happens, most of them languish in unemployment. Contrary to common economic sense, even contrary to the Israeli experience itself, the Israeli-PLO economic agreement, worked out during five months of negotiations in Paris (hereafter referred to as the Paris Economic Protocol or PEP), does not give the new Palestinian Interim Self-Governing Authority (PISGA) the means of actually governing its own economy.

One of the main features of the PEP is that it does not give the Palestinians the right to issue their own currency. The Israeli position as expressed by the Israeli negotiators can be explained, but not justified, on political and economic grounds.

On the other hand, it seems that the Palestinian negotiators had no say in the matter. This paper is an attempt to discuss the Israeli position. Furthermore, it presents an argument for a Palestinian currency.

## II. The Israeli Position

### II. 1. *What is the Israeli Position ?*

Israeli negotiators turned down all Palestinian demands for a currency. This refusal has been based upon political and economic considerations. Politically the Israeli position stems from the desire to deny the Palestinians anything which could be considered "a symbol of national independence". A national currency is a symbol of an independent national state. But history tells us that this is not necessarily the case. Furthermore, it is really paradoxical to accept one symbol of national independence (namely, the Palestinian flag) and to refuse some other ones (such as a legislative authority and a national currency).

## *II. 2. The Currency Board System*

So what is in history that tells us that a national currency is not necessarily a symbol of national independence?

In British-mandated Palestine, like in India and many other British colonies, a Currency Board System (CBS) was created and institutionalized by the British and had practically one function, i.e. to issue the local currency under certain rigid rules. The colonial power did this not as a "symbol" for an independent Palestine but for sound economic reasons. Without the Palestinian pound, British-mandated Palestine could never have played the key role which it did in the British war effort during World War II.

The Palestinian Currency Board (PCB) had no discretionary powers over the issue of currency since it was required to keep at the Bank of England a 100% sterling cover against its currency liabilities which consequently were convertible into sterling at all times. These sterling reserves were invested on the London Money Market and accumulated Sterling investment served also as a backing for the Palestinian currency outstanding.

The major argument (Sayers, 1952, and Greaves, 1957) in favor of the CBS took, in addition to the advantage of a sound local currency and *full and free convertibility* into sterling at a *stable exchange rate*, the 100% reserve requirement as its point of departure. It is often argued that such a provision has been extremely effective in preventing governments from resorting to domestic borrowing in order to finance their expenditures and, hence, has contributed to the economic stability of countries under the CBS. Currency Boards had neither the discretionary power to increase currency issues nor were they allowed to furnish their own governments with loans. Government borrowing from the commercial banks were almost impossible, not only because any such borrowing would have to be at the expense of loans to the private sector, but also because of the underdeveloped nature of the entire banking system. Furthermore, such borrowing, when it took place, had only limited inflationary consequences because the increase in the money stock resulting from larger government expenditures was eventually checked by the balance of payments.

Larger government expenditures entailed a larger volume of imports which means greater outflow, or at least a smaller inflow of foreign exchange and thus a decrease in currency issued. Faced with such limitations, most governments in British-mandated countries, even in those who got independence but retained the CBS (e.g., Jordan until 1964), were forced to adopt *balanced budget policies* or to rely on foreign aid to cover any excess expenditure over domestic revenues. Consequently, most of the territories under the CBS were saved from a chronic problem of inflation resulting from budgetary deficits. The inflation or deflation were precluded from originating domestically. Safety and soundness were the hall marks of the CBS.

Kattan (1976, 151) had assessed the period of the Jordanian Currency Board (JCB), i.e., 1954 -1964, and found that the money supply grew at an average annual rate of 7.3%. Almost all of this was attributed to the increase in the monetary base; the value of the money multiplier did not change to any significant extent. The price level during this period was remarkably stable. Prices were estimated to have increased at an average annual rate of 1.5%. Similarly, the ratio of real cash balances was fairly stable. Real per capita income increased at average annual rate of 6%.

There are of course from the viewpoint of the currency issuing country some disadvantages of adopting a CBS. The monetary authority would be deprived of any

authority to issue currency on discretion, and to control the activities of the commercial banks since most of these would favor to keep most of their deposits in foreign assets abroad. The 100% reserve requirement would also deprive the country from using its reserves abroad in executing development projects.

To sum up, a CBS had been used in colonies for sound economic reasons and helped to maintain a stable monetary system in them. A local or national currency was issued in colonies and were not symbols of national independence. However, the CBS could be carried over and was instituted for some time in independent countries.

So politically speaking Israeli could have resorted to the CBS while still militarily occupying the WBGS without endangering its existence there. More important Israel should not deal any more with symbols in the case of the Palestinian problem. It is rather the real economy which now matters. *The Other Israel* (Aug. - Sept. 1994, 20) quoted the Israeli Foreign Minister Shimon Peres saying that "We do not deal with symbols but with the real economy, and a Palestinian currency is economically superfluous".

This summary and the quotation from Peres raise two questions that should be dealt with:

1. *Does Israel deal with the real economy of the Palestinians?*
2. *Is a Palestinian currency superfluous?*

The answers to these two questions will be used to resolve the Israeli paradoxical attitude of accepting some national symbols and refusing others.

### *II. 3. Does Israel deal with the real economy of the Palestinians?*

Israel, as we have mentioned above, did not resort to a CBS for the Occupied Territories (OTs) since the beginning of the Israeli occupation in June 1967. Instead the Israeli lira, and then the shekel, was made a legal tender beside the Jordanian dinar in the West Bank. While only the shekel is legal tender in Gaza, the dinar is also widely used.

Most economists agree that this Israeli policy was, as it really did, to facilitate the process of integration of the Palestinian economy in the Israeli economy, not to mention the substantial seigniorage revenue Israel derives from circulation of the shekel in the OTs. In terms of monetary integration, Arnon and Spivak (Sept. 1994, 20) suggest that the order of the magnitude of this integration is high as revealed by high correlation between Israel and the WBGS.

One, hence, can safely argue that Israel by refusing the option of a Palestinian currency would like to perpetuate the economic dependency of the Palestinians on the Israeli economy. The consequences of this matter have been proved to be disastrous for the possibilities of employment

and economic development in the past and current experience of the OTs.

In the Gaza Strip there is a large unused reservoir of manpower, including a considerable number of skilled workers, either unemployed or driven to socially less respectable simple manual jobs for lack of anything better. The severity of unemployment has been exacerbated by the frequent security-justified denial to give a work permission for Gazans and West Bankers willing to and seeking work in Israel. It is also well established that the infrastructure is in a state of collapse, and there is an obvious necessity of starting a great number of public projects for some of which detailed plans already exist but not implemented because the promised international aid, so far, proved tardy in arrival. Nevertheless, Israeli leaders refer the Palestinians to this aid while denying them the right to issue their own currency on the ground that a Palestinian currency is "economically superfluous", an argument which has not been proved. On the contrary, the discussion presented here suggests that the Israeli policy seeks to make the existence of a Palestinian economy economically superfluous and to perpetuate the past trends of dependency.

In the past, the Israeli government had derived substantial seigniorage revenue from circulation of the shekel in the OTs. In years of hyperinflation, which Israel experienced in the seventies and early eighties, this revenue was even greater due to

another source of seigniorage, i.e. the inflation tax. Depending on the economic growth and inflation rate in the Palestinian economy, Israel continues to derive this revenue. There is nothing in the PEP which refers to this issue. In WBGS circulate US \$809 million worth of Jordanian dinar (about 31.3% of total dinar circulation in Jordan and Palestine), and US \$977 million worth of Israeli shekel (about 25.4% of total shekel circulation in Israel and Palestine). According to the World Bank (1994, 11) estimates, Jordan would extract seigniorage revenue of about US \$ 50 million per annum from circulation of the dinar in the WBGS depending on a scenario of a 10% nominal growth rate in the WBGS. This amount would be roughly 1% of Jordanian gross domestic product (GDP). Estimations of this source of revenue to Israel are not available. However, and due to a higher degree of integration between the economies of the WBGS and Israel, there is every reason to believe that seigniorage revenue which Israel derives from the WBGS would be not less than 1% of Israel GDP.

A country A would generate seigniorage revenue from the circulation of its money in some other country B in proportion to :

- (a) the size of the economy of country B in relation to the size of the economies of both A and B, and
- (b) the size of its currency in circulation in country B in relation to the size of

currency in circulation in both A and B.

The higher these factors are, the higher seigniorage revenue would be in relation to GDP. Weights could be calculated to reach an estimate of the percentage of seigniorage revenue to the GDP that Israel derives from Palestine. These weights are equal to:

$$(a) W_1 = S_P / S_{I+P} + D_P / D_{J+P}$$

where  $S_P$  and  $S_{I+P}$  are dollar worth of shekel in circulation in Palestine, and in both Israel and Palestine, respectively.  $D_P$  and  $D_{J+P}$  are dollar worth of dinar in circulation in Palestine, and in both Jordan and Palestine, respectively, and

$$(b) W_2 = Y_P / Y_{I+P} + Y_J / Y_{J+P}$$

where  $Y_P$  is the GDP of Palestine,  $Y_{I+P}$  is the sum of GDPs in Israel and Palestine, and  $Y_{J+P}$  is the sum of GDPs in Jordan and Palestine. Accordingly and based on the World Bank figures (1994, 10-11),

$$W_1 = 977 / 3,849 + 809 / 2,588 = 0.81$$

and

$$W_2 = 2,161 / 61,265 + 2,161 / 6,247 = 0.10$$

One can add these two weights and multiply the result by the seigniorage revenue to GDP percentage (S) which Jordan derives from the circulation of its dinar in Palestine to obtain an estimate for S that Israel derives from the circulation of its shekel in the same area. So for Israel, S would be =  $(0.81 + 0.1) * 0.01 = 0.0091$ , which means that in 1991, for example, Israel derived =  $0.0091 * 59,104 = \$537.8$  million as seigniorage revenue from the WBGS.

Had the Palestinian National Authority (PNA) the right to issue its own currency, it could be able to generate about 45.2% of the GDP of the WBGS (according to statistics from 1991) by withdrawing the Israeli shekel from circulation in these areas in return for dollars by which it can finance the purchase of goods and services necessary to rebuild the infrastructure in the area. This process alone could allow the PNA to start implementing the public projects of its own and employ thousands of people suffering from the evils of unemployment without waiting for the international aid. The PNA would then be able to levy taxes to generate revenues to partially cover the government budget. It is really terrible to advise that the PNA start collecting taxes from an impoverished population, of which about half are unemployed. Income taxes would be nuisance not only in relation to total revenues but also in relation to government expenditure. A national currency issued and controlled by the Palestinian Monetary Authority (PMA) is the only way out of our misery.

#### *II. 4. Is a Palestinian currency superfluous?*

The discussion above makes it easy to answer this question by now. The answer is negative. In a patronizing way, Israeli finance ministry officials talk about "saving the Palestinians from themselves" and argue that "a Palestinian currency would lead

to spiraling inflation". Interestingly enough, in the first years of Israel the decision makers lead a rather different view of national currency and its role.

Upon its creation in 1948, the state of Israel disposed of no more resources than the Palestinians do today. Yet immediately upon the withdrawal of the last British troops, the Anglo-Palestine Bank in Tel-Aviv was renamed "Israel National Bank" and authorized by Ben-Gurion to issue banknotes. In the first four years of Israel, the population doubled itself by immigration waves; the economy was kept moving mainly through this new currency, which financed more than half of the government budget; yet the inflation rate was lower than in today's Israel. In the first two years of its existence, revenue from taxes amounted to only a third of the total expenditures. Arnon and Spivak (1994, 8) estimated that the ratio of taxes to total expenditures improved to 61% only two years later.

According to all international experience economic development is subject to the self-supporting economics of agglomeration. In this process core regions with the highest economic and technological potential tend to grow at the expense of the weaker regions which risk to be marginalized. Weiss (1994, 6) concluded that this tendency is well-known both theoretically and empirically.

The absence of a Palestinian national currency will make the income distribution



between the countries of the triangle even worse than it is now, i.e., affluent economies will become richer at the expenses of the weaker partners. This issue has been neglected in the theoretical discussion of optimal currency areas (OCA). Such distributional problems do exist within the European Union (EU) and have been taken into consideration. Particular political decision-making routines have been established to maintain such distribution policies within the EU channeled through the European Regional Fund, The European Social Fund, and the European Investment Bank. These issues have not been considered in the PEP.

The fact that the same currency circulates implies that the WBGS cannot be isolated from price changes in Israel and Jordan. But since prices are more similar to those in the country who trades heavily with, the prices in the WBGS are highly correlated with the prices in Israel. Arnon and Spivak (1994, 13) concluded that these price links between Israel and the WBGS is "a point *against* the current agreement".

To summarize, a Palestinian currency is not economically superfluous, and it is not optimal for Palestine not to have the right to issue its currency for sound economic reasons. Upon the withdrawal of the Israeli shekel from circulation in the WBGS, the PMA could earn seigniorage revenue which would be sizeable enough to start the implementation of development projects with positive effects on job creation.

This would enable the PISGA to ameliorate the harsh economic conditions for a labor force which more than half of it is left to the evils of unemployment while waiting for the "promised" donations.

The Israeli refusal to accept the right of the PISGA to issue a Palestinian currency is not justified. It endangers the whole peace process and, hence, is politically and economically undesirable.

### III. A Monetary Arrangement for PISGA

The discussion above suggests that a Palestinian currency is optimal for Palestine. However, monetary management is crucial to a stable currency without which a sound economy could not function. Therefore, two monetary arrangements should be discussed: one for the short-run (up to 5 years), and the other for the long-run (beyond 5 years).

#### III. 1. Short-run Monetary Arrangement: A Palestinian Currency Board

A Palestinian currency board (PCB) system should be established. The PEP enables the Palestinians to establish the PMA which is according to the PEP, less than a PCB. Renegotiating the PEP to add the function of issuing a Palestinian currency to those functions of the PMA is a political and economic necessity.

The proposed Palestinian currency

should be explicitly linked to and backed up by the Jordanian dinar.

The withdrawal of the Israeli shekel will not lead to a fiscal crisis in Israel. Relatively the impact of a withdrawal of the current legal tenders in the WBSG would yield a less harmful effect on Israel than on Jordan. To offset the fiscal effects on the Israeli economy upon the withdrawal of about \$977 million equivalent from circulation and the immediate request for foreign assets upon return of the withdrawn notes could be absorbed by creating a "currency redemption facility" to help Israel overcome the harmful effects of such a withdrawal. The IMF and the World Bank should be able to help the creation of such a facility in case the Palestinians refused to buy Israeli goods and services by the gained foreign exchange.

The historical experience of the CBS described above suggests that a stable currency would require a 100% reserve by the back up currency. The PMA could maintain such a reserve at the Central Bank of Jordan (CBJ) and could be able to issue Palestinian notes equal to those kept by the CBJ. This could be annually enlarged by an amount equal to the income earned on these reserves at the CBJ. In such a fashion, monetary expansion would not be inflationary.

This arrangement is called a pure CBS, and it cannot provide the necessary conditions for the implementation of a discretionary monetary policy. However, it has

some important advantages. First, if the dinar is stable, the Palestinian currency of the PCB will be as stable. Secondly, a PCB can extract at least part of the seigniorage otherwise gone to the CBJ. Thirdly, this arrangement would permit the confidence of the Palestinians in the PCB's notes and would reduce the possibility of capital flight.

When this system is established and proves efficient it could be made more flexible by allowing the reserve requirement to be less than 100%. In such a case the PCB, de facto the PMA, could be able to extend credit to banks, and to issue notes with some discretion, i.e. gradually the PCB could turn into a monetary authority in the tradition of central banks.

Such a flexibility of the PCB to create money would be however limited, and it could be in a position to control inflation which prevents the need of devaluation and speculative attacks on the PCB's notes.

This monetary arrangement would allow an exchange rate of 1 Palestinian note to 1 Jordanian dinar, as long as the reserve requirement is 100%. This would ensure the trust in the new currency. Jordan's track record of macroeconomic management has been good. The ability of Jordan to keep this record would add to the trust in the new currency. However, the IMF and the World Bank should stand by offset any speculations against the dinar. One should, however, be aware of the possibility of precautionary movements out of the

dinar into the dollar. This is evident in the more rapid than anticipated depletion of reserves in the CBJ since January 1994, a few months before the creation of the PMA. To ameliorate this problem, the PMA should permit the Palestinian to keep their savings in dollars in the operating banks in the WBGs. Another precautionary measure against an expected increase in the supply of the PCB's notes because of the "dollarization" could be the sale of Palestinian bonds for the public to partially finance the development projects.

### III. 2. Long-run Monetary Arrangement

The PCB, suggested here, could move into a full sovereign monetary arrangement in the long-run. Though this movement may depend on political circumstances, economic conditions in the region and the world would entail an appropriate arrangement. It is the responsibility of the PMA to be flexible enough to timely identify and assess the situation. In any case, the PMA must try to be independent and not fall into the temptation of printing money to finance the PISGA budget for such a trap is simply inflationary. The motto of the PMA must always be "evolution rather than revolution".

### IV. Conclusion

On historical and economic grounds this paper argues for a Palestinian currency. Is-

rael refusal of a Palestinian currency is mainly economic, namely, seigniorage revenue it extracts from circulation of the shekel in the West Bank and Gaza Strip. This greed on part of Israel endangers the whole peace process.

A currency board for the PISGA, with a 100% reserve requirement by backing it up by the Jordanian dinar could yield seigniorage revenue for the Palestinian authority to start implementing the development projects and create jobs for the impoverished population of which about half are unemployed.

Pareto optimal distribution of the benefits of the peace process in the Middle East requires not only to let the Palestinians have their own currency but also to create regional institutions to take care of the distributional issues in the region.

The PMA, the de facto PCB, must opt to independence and seek monetary stability and should not attempt to fall in the temptation of the money press. The monetary arrangement of the PMA should be evolutionary rather than revolutionary.

### References

- Alexander, Esther (1994), "A Palestinian Currency". *The Other Israel*, 62-63, 19 - 20.
- Arnon, Arie and Spivak, Avia (Oct. 1994), "Monetary Arrangements between the Israeli, Jordanian and Palestinian Economies", paper presented in the conference "Sustaining Peace in the

- Middle East through Economic Cooperation", Amsterdam.
- \_\_\_\_\_ (Oct. 1993), "Alternative Monetary Regions, Israel and Jordan", paper presented in the conference organized by the project "Sustaining Peace in the Middle East through Regional Cooperation, Brussels.
- De Grauwe, P. (1992), *The Economics of Monetary Integration*, Oxford University Press, Oxford.
- Greaves, Ida (1957), "Colonial Trade and Payments", *Economic* 24, 47 - 58.
- International Monetary Fund (1994), *International Financial Statistics*.
- Kattan, Jack N. (1976), *Financial Institutions, Money and Prices in Jordan, 1950 - 1974*, unpublished Ph.D. thesis, University of Georgia.
- Krugman, P. (1992), "Policy Problems of a Monetary Union", in *Currencies and Crises*, MIT Press, Cambridge MA.
- McKinnon, R I. (1963), "Optimum Currency Areas", *American Economic Review* 53, 717 - 725.
- Mundell, R. (1961), "A theory of optimum currency areas", *American Economic Review* 51, 657 - 665.
- Protocol on Economic Relations between the Government of the State of Israel and the P.L.O. representing the Palestinian people.
- Sayers, R. S. (1952), (ed.), *Banking in the British Commonwealth*, Oxford University Press, Oxford.
- Weiss, Dieter (1994), "European - Arab Development Cooperation and the Middle East Peace Process", a paper presented in the Amman Meeting of Former Jordanian Scholarship Holders in Germany, Dec. 5-6, 1994.
- World Bank (1994), *Peace and the Jordanian Economy*, Washington, D.C.
- \_\_\_\_\_ (1993), *Developing the Occupied Territories, An Investment in Peace*, Vol. I, Washington, D.C.
- Zaghah, Adel (1994), *Fiscal and Monetary Measures to Stimulate Capital Formation in Developing Countries, A Case Study of Jordan*, Verlag Koester, Berlin.