

معهد أبحاث السياسات الاقتصادية الفلسطيني (ماس)



Palestine Economic Policy Research Institute (MAS)

خيارات العملة والسياسة النقدية المستقبلية في فلسطين: مراجعة تقييمية

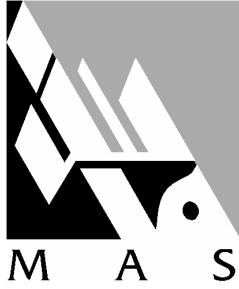
Future Currency and Monetary Policy Alternatives for Palestine: A Review

نعمان كنفاني

Nu'man Kanafani

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The Palestine Economic Policy Research Institute (MAS)

Founded in Jerusalem in 1994 as an independent, non-profit institution to contribute to the policy-making process by conducting economic and social policy research. MAS is governed by a Board of Trustees consisting of prominent academics, businessmen and distinguished personalities from Palestine and the Arab Countries.

Mission

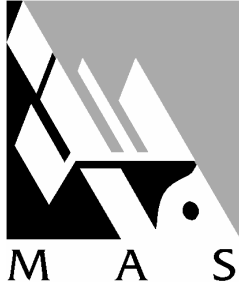
MAS is dedicated to producing sound and innovative policy research, relevant to economic and social development in Palestine, with the aim of assisting policy-makers and fostering public participation in the formulation of economic and social policies.

Strategic Objectives

- ◆ Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- ◆ Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- ◆ Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- ◆ Disseminating up-to-date socio-economic information and research results.
- ◆ Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
- ◆ Strengthening economic and social policy research capabilities and resources in Palestine.

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Foreword

As part of its Research Program for 2014-2015, the Palestine Economic Policy Research Institute (MAS), launched a new activity aiming at producing review articles that take stock of work done on important economic and social policy issues that touch on the Palestinian development and that have been often revisited over the past two decades but where no closure has been reached. The articles in this series are intended to provide a reference for practitioners and students of that subject, and also to provide the proper background analysis, evidence, and policy options for actions by decision makers. A comprehensive bibliography will be included in each article.

In this issue, MAS is pleased to present the first article in the series, which addresses the monetary regime options for the State of Palestine. This article has been carefully prepared by Numan Kanafani, one of MAS' senior researchers for almost two decades, and I trust that it will also serve as a model for future works in the series in terms of its coverage and its approach. Other articles will follow and two are already in preparation and are planned to be published later this year.

On behalf of MAS, I would like to thank the Arab Fund for Economic and Social Development for its support, which made this publication possible.

Nabeel Kassis, PhD
Director General

Executive Summary

This paper provides a review of methodologies, analyses and results of around 35 studies on currency and monetary policy options in the future independent Palestinian State. To complete the picture, the study gives a synopsis of the theoretical framework and empirical background of the advantages and disadvantages of the different exchange rate regimes.

The first chapter gives a systematic review of the different currency regimes initially available for the future Palestinian State, starting from retaining the current system (absence of a national currency and use three currencies: USD, NIS and JD), to a monetary union with another country, to choosing a currency of another country as the sole legal tender. Other alternatives include the creation of own national currency under different exchange rate regimes, starting with the free-floating system and ending with a strictly fixed exchange rate (currency board). Possible alternatives relate also to the choice of the anchor currency, being either the currency of another country or a basket of a number of foreign currencies. After reviewing the possible alternatives, the chapter gives a glance at the exchange rate regimes that are adopted by various countries in the world so as to identify the most appropriate for Palestine. The chapter then summarizes the monetary policy instruments, paying particular attention to the advantages and disadvantages of the floating exchange rate regime versus the fixed exchange rate system.

The second chapter builds on previous studies to draw a comparison between the fixed exchange rate regime and the floating one for the case of Palestine. It concludes that the former system is actually the option recommended by the majority of studies. A fixed exchange rate regime can ensure credibility of the national currency and the new monetary system. The chapter devotes a section to discuss the credibility issue stressing its vital role in achieving stability of the currency and sustainability of the monetary system.

Chapter three examines the demand for money and seigniorage (revenue obtained from currency issuance). The chapter surveys the methodologies adopted by the various studies to estimate the demand for money in the Palestinian Territory and the resulting seigniorage, examined as lost seigniorage due to the current use of Israeli Shekel or estimated as future seigniorage, in case a national currency is created.

Chapters four, five, six and seven discuss the four possible monetary regimes: maintaining the current system (the system set forth by the Paris

Protocol), monetary union with another country (particularly Jordan), dollarization (using another country's currency, whether the US dollar or another currency as sole legal tender) and the adoption of currency board system. Each of these four chapters presents the analyses, methodologies and results of the studies that argue in favor or against the option under discussion. The four chapters represent a thorough review of advantages and disadvantages of each of the aforesaid systems for Palestine. Chapter seven examines the currency board regime which has been the system more comprehensively addressed and recommended for adoption by the future Palestinian State. The chapter also discusses the issue of choosing the pegging currency, its specifications and significant pertinent features in the Palestinian context. The chapter summarizes the latest theoretical and empirical developments which give contemporary currency boards greater flexibility, allowing them a broader role and a greater importance compared to old currency boards.

Chapter eight presents a number of concluding remarks and recommendations. It concludes that the process of choosing a currency regime should take two considerations into account. Firstly, there is no monetary system that is permanently perfect because optimality develops along with the development of the economy and accumulation of expertise. Secondly, all known monetary regimes have both pros and cons, and the choice between the different regimes depends on balancing the pros and the cons in accordance with each country's requirements and conditions at the specific time period. Exchange rate regime alternatives for Palestine should be evaluated in light of five variables: Which regime achieves the highest degree of credibility and stability of currency value? Which regime secures the highest macroeconomic stability? Which regime stimulates growth and investment? Which regime ensures highest fiscal discipline and which regime guarantees seigniorage income? While these five objectives are important, their prioritization varies from one period to another. Since the circumstances surrounding the Palestinian political and economic landscape in the upcoming period require first and foremost guarantee of credibility and stability, the majority of the reviewed studies recommend the adoption of a strictly fixed exchange rate, i.e. a currency board system.

Chapter eight also makes a range of recommendations related to future research needed to expand the theoretical and practical knowledge of currency board regimes, particularly conducting in-depth studies of monetary policy tools utilized in the absence of a national currency and within the particular Palestinian economic environment, especially with regard to foreign trade and labor market.