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Examining Monetary Policy in the Absence of a Central Bank and Sovereign Currency in Palestine

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**Examining Monetary Policy in the Absence of a Central Bank and Sovereign
Currency in Palestine**



Senior Project Submitted to
The Division of Social Studies
of Bard College

by
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Lastly, this research goes to where it all begins and ends, Palestine.

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Introduction

In 1994, the Palestinian Liberation Organization signed on the Paris Protocol, an annex concerning economic relations between Israel and Palestine. The main objective was to “establish a sound economic base for Israel and Palestine by the principles of mutual respect of each other’s economic interests, reciprocity, equity and fairness.”¹ To fulfill this purpose, the Palestinian Monetary Authority (PMA) was established along with the current standing government, the Palestinian Authority (PA). Although the annex provided the PMA with most of the traditional functions of a central bank, its mandate was truncated by the Occupation to compromise its capacity to act as a full-fledged bank. Twenty years later, Palestine still lacks a central bank and its own sovereign currency. Palestine, a developing country with exceptional war circumstances, is missing the most essential components of a functioning economy.

There is extensive literature on the Israeli-Palestinian conflict that studies the historic, political, and social aspects. However, few scholars have examined the economic model that was born out of the conflict and the various implications behind it. According to Charles Goodhart: “A Central Bank has two main functions. Its first (macro-economic) function is the operation of discretionary monetary policy” and a “second (micro-economic) function, of providing support (e.g., via Lender of Last Resort assistance), and regulatory and supervisory services to maintain the health of the banking system”². However, with the Israeli Occupation’s imposed restrictions

¹ Palestine. Government of the State of Israel and the P.L.O., Representing the Palestinian People. *The Palestinian-Israeli Interim Agreement on the West Bank & the Gaza Strip ANNEX V: Protocol on Economic Relations*. April 9, 1994. Accessed February 9, 2016. <http://www.nad-plo.org/userfiles/file/Document/ParisPro.pdf>.

² Charles Goodhart. *Money, Information and Uncertainty*. (Massachusetts: MIT Press, 1989), 176

on the PMA, the latter falls short in carrying out either. Palestine's regulatory body does not have the monetary tools to tackle macroeconomic targets such as price stability, or achieve microeconomic objectives such as serving commercial banks. Thus, Palestine, does not have institutional and policy support to weather times of crisis and growth. This paper will examine two related monetary issues: First is the role central banks and sovereign currencies have in regulating and stimulating their respective economies. The second is the relationship between monetary sovereignty and state independence. The relationship between the two, including that between their monetary and fiscal authorities, will be illustrated throughout this project.

The first chapter will offer a brief history of money in Palestine and draw a timeline of all the currencies and monetary systems that took place after the dismantling of the British mandate and the establishment of Israel in 1948 up until the creation of the PMA in 1994. This chapter will provide the necessary context to understand the current situation by reviewing the Paris Protocol which laid the foundation for Palestine's economy today. The second chapter will study the ways in which the PMA tries to fulfill its role as Palestine's central bank. It will do so by showing the most recent accomplishments and initiatives to motivate, facilitate and regulate the growth of the Palestinian banking sector under most adverse conditions. Unfortunately, little work has been done to critically study the PMA's function and impact in the Palestinian economy. However, this chapter outlines the basic stylized facts about the tools available for the PMA to influence and regulate the economy.

The third chapter tackles the question: why are central banks necessary? The debate in the literature presents different views about the need for central banks and monopolized currencies. A set of alternative monetary arrangements throughout history will be discussed in the chapter. The purpose is to examine how monetary systems with and without central banks have contributed to

shaping the economy and, eventually, the realization of political sovereignty. By analyzing cases of economies without a central bank or a sovereign currency, we were able to better understand the implications behind the current economic model in Palestine.

What emerges out of this project is an understanding of how the Paris Protocol produced an economic relationship between Palestine and Israel that only serves the interests of the latter. I will illustrate the similarities between today's Palestine and former colonized countries in respect to their monetary and fiscal systems. So far, the economic gap between the two countries has only grown wider, and we will examine the reasons behind this disparity.

Chapter One: History of Money in Palestine

The British Mandate (1917-1948)

In 1917, Britain took over Palestine as a result of the Sykes-Picot agreement between the Allies after World War. The British Mandate allowed circulation of the Ottoman currency until it announced the Egyptian Lira and British Pound as legal tender in January 12, 1918. Interestingly enough, it was the British Mandate which made the word *masari* one of the most famous slang words in Arabic. People said *masari* in reference to *Masr*, the Arabic word for Egypt. However, similarly to India, Syria, and the rest of the British colonies at that time, Palestine received a currency board system (CBS) in 1926 from the British Secretary of State for the Colonies. The Board's activities, fully independent from the local government, were confined to issuing currency banknotes which were backed by an equivalent amount of Sterling in London. Excess sterling reserves were placed in the London Money Market for investment which in return accumulated sterling based investments to back the Palestine Pound. On February 7, 1927, the Currency Board started printing Palestine Pounds which were divided into 1000 mils. The currency was issued in denomination of 500mils, thus available currency values were £1, £5, £10, £50, and £100.³

On May 15, 1948, the British Mandate declared its withdrawal from Palestine, and Israel was declared a Jewish state. Millions of Palestinians either fled or were expelled from their homes. In accordance with the ethnic cleansing of Palestinians, the Palestine Pound was taken out of circulation upon the emergence of the Israeli State. Under direction from the British Mandate, over

³ Ottensooser, Robert David. *The Palestine Pound and the Israel Pound; Transition from a Colonial to an Independent Currency*. (Genève: E. Droz, 1955), 109

59 million Palestine Pounds were taken out of circulation. For the remainder of Palestinians, the British Mandate offered to purchase Palestine Pounds in exchange for English Sterling. Israel, on the other hand, confiscated Palestinian bank accounts and property under the pretense of holding “absentee” property. The Custodian of Absentee Property (CAP), a member of the Israeli government, deals exclusively with the property left behind by Palestinian refugees. The CAP passed a law to seize all Palestinian bank accounts and transfer the money to the Israeli Custodian, including all content in safe deposit boxes. All regional banks followed the order with the exception of the Arab Bank. Palestinians were denied access to their checking and savings accounts except Arab Bank’s clients. Not only did Israel seize bank accounts, but it also froze all Palestinian investments and checks issued to Palestinian businessmen and corporation to transfer them into the CAP. Those investments mainly consisted of share certificates and British government-issue bearer bonds.⁴

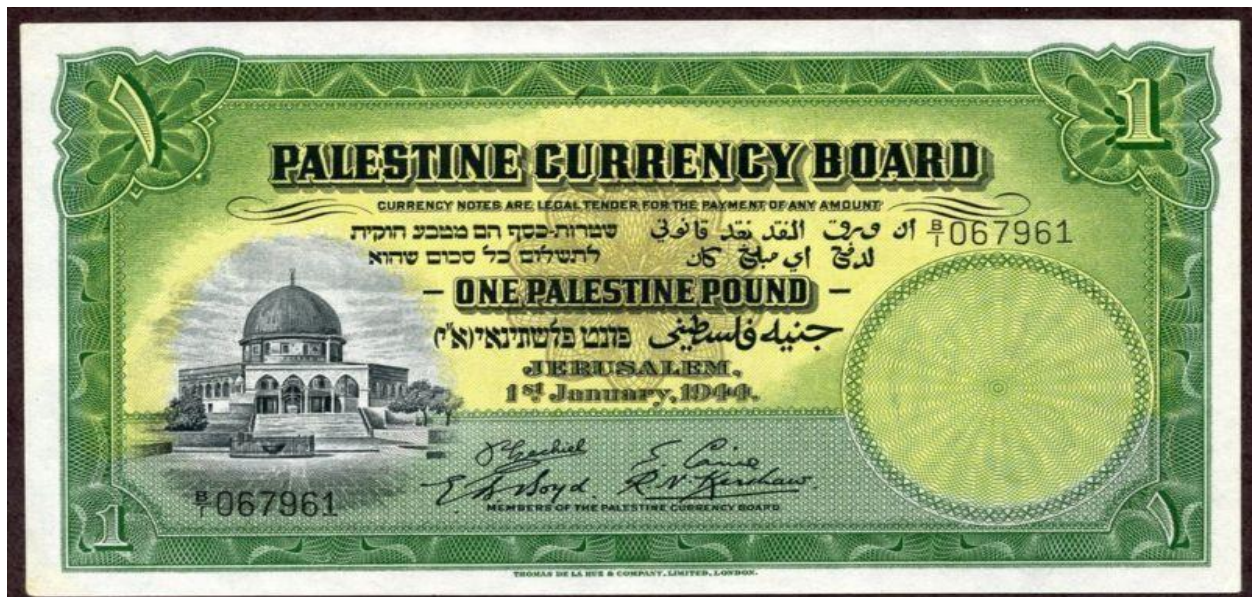


Figure 1: This picture shows an issued note of £1 Palestine Pound in 1944. It is interesting to note that British Mandate included Hebrew writings along Arabic and English. This shows that the British Mandate was already planning on accommodating a Jewish State in Palestine long before its establishment in 1948.

Source: <http://arabnyheter.info/sv/2014/02/03/palestine-banknotes-one-palestine-pound-note-of-1944-palestine-currency-board/>

⁴ *ibid.*, 111

Jordanian Rule (1948-1967)

With the establishment of Israel as a state on approximately a third of Palestinian land, the areas where Palestine Pound dominated as legal tender were now divided into several differently governed entities: the State of Israel, the Jordanian-occupied West Bank, the Hashemite Kingdom of Jordan, and the Egyptian-occupied Gaza Strip. The West Bank, which lies east of the Jordan valley and west of the newly founded Israel was annexed to Jordan and the Gaza Strip was annexed to Egypt.

With the new political geography emerged a new currency system that accommodated each of the new political entities. In Israel, there was a transitional period of four years between the end of the British Mandate and the adoption of a fully independent currency system. Between 1948 and 1952, the Palestine pound continued to be legal tender. In August 1948, the Jewish Agency-owned company called Anglo Palestine Company issued new banknotes. The Jordanian dinar replaced the Palestine Pound in the West Bank in 1949. The West Bank was officially annexed to Jordan by 1950 and that is when the Palestine pound stopped circulating. In the Gaza Strip, the Palestine pound continued to circulate until it was replaced by the Egyptian pound in April 1951. That is three years after the Egyptian army took control of the territory.⁵

Israeli Occupation (1967-1994)

In 1967, after what is known as the Six Day War, Israel occupied the entirety of the West Bank and the Gaza Strip. The Jordanian Dinar continued to be legal tender in addition to the Israeli Shekel, which had been introduced by the Israeli military rule. Salaries of the civil service employees in the West Bank and Gaza Strip were paid in shekel, while salaries of employees who

⁵ *ibid.*, 113

were hired by Jordan prior to the occupation continued to be paid in Jordanian Dinars. A large number of these employees continued to receive two salaries for more than three decades: one in Dinars from Jordan and one in Shekel from the Occupying authority. The payment of Jordanian salaries was carried out by networks of certified agents or middlemen, money changers, who used to cash the salaries in Jordan on behalf of the employees and deliver the money in cash to their respective localities against a certain commission.⁶

The same situation prevailed in the Gaza Strip. The Israeli Army allowed mobility of goods and between Gaza and the West Bank under certain “security” arrangements and permits. In Gaza, the Jordanian Dinar, the Israeli shekel and the Egyptian Pound were all legal tender.

It is only in 1984 that the first regional bank was allowed to operate in the West Bank, by allowing the Arab Bank to reopen one of 1st branches in the city of Ramallah. In subsequent years, branches like the Bank of Jordan and Cairo Amman were allowed to operate through local branches in the West Bank and the Gaza Strip.⁷

Oslo Accords & Economic Relations of Paris Protocol (1994)

In 1994 the Palestinian Liberation Organization (PLO) met with Israeli representatives in Paris to construct a treaty dedicated to ameliorating the economic situation in both the West Bank and Israel after the Israeli occupation period. Its aim was also to ensure future prospect for both economies based on common understanding and consent. As mentioned in the preamble, the “protocol establishes the contractual agreement that will govern the economic relations between the two sides and will cover the West Bank and the Gaza Strip during the interim period.” It is

⁶ *Ibid.*, 114

⁷ *Ibid.*, 117

important to note that the Paris Protocol was established to cover a five-year interim period. The interim period was supposed to be the time until the PLO gained full sovereignty and established a state of Palestine by 2000. The annex was made of eleven articles. The articles read as follows:

- Article I- Framework and the Scope of this Protocol
- Article II- The Joint Economic Committee
- Article III- Import Taxes and Import Policy
- Article IV- Monetary and Financial Issues
- Article V- Direct Taxation
- Article VI- Indirect Taxes on Local Production
- Article VII- Labor
- Article VIII- Agriculture
- Article IX- Industry
- Article X- Tourism
- Article XI- Insurance Issues

As seen from the articles above, the protocol more or less covers and dictates all aspects of the Palestinian economy. Given the focus of this paper, I will mostly examine Article IV regarding monetary and financial issues. The opening statement in Article IV declared that: “the Palestinian Authority will establish a Monetary Authority (PMA) in the Areas. The PMA will have the powers and responsibilities for the regulation and implementation of the monetary policies within the

functions described in this Article.”⁸ The protocol was also responsible for setting up the legal and operational framework in which the Palestinian Monetary Authority could use to regulate and develop its own economy. Under the impression that they were drawing a plan for a transitory period to full sovereignty, the PLO agreed on numerous monetary and fiscal limitations in order to establish the “Palestinian Authority” in the future. It also gave up on its financial sovereignty by consenting to a half-fledged central bank, which is the PMA.

Article IV set the legal and operational mandate for the PMA as a central bank like entity in Palestine. However, the official designated authority of the PMA does not originate, legally speaking, from the Paris Protocol but from the presidential order of Yasser Arafat to issue Law Number Two in 1997. The second article of the Law 1997 states: “An authority called the Palestinian Monetary Authority shall hereby be established with the status of an independent legal entity and full legal capacity to engage in all the activities and actions necessary to achieve the objectives for which it was established, including acquisition of the real estate and movable property necessary to carry out its work, in accordance with the provisions of the law.”⁹

In Article 5 of Law 1997 called *Objectives, Duties, and Powers of the Monetary Authority* the following has been stated:

1. Issue the national currency and coins in due course, in accordance with the terms and conditions to be determined by the law on issuing currency and securing the required cash reserves.
2. Regulate banking activities, issue and cancel bank licenses, control and supervise banks, and impose penalties on them.

⁸ Palestine. Government of the State of Israel and the P.L.O., Representing the Palestinian People. *The Palestinian-Israeli Interim Agreement on the West Bank & the Gaza Strip ANNEX V: Protocol on Economic Relations*. April 9, 1994. Accessed February 9, 2016.

⁹ Palestinian Monetary Authority. *Law No.2 of 1997*. West Bank, Ramallah, 1997. http://www.pma.ps/Portals/1/Users/002/02/2/Legislation/Laws/Law_No_2_of_1997_on_Palestinian_Monetary_Authority.pdf (accessed November 6, 2015).

3. Prepare, regulate and publish the balance of payments.
4. Provide liquidity to banks within the legally established limits.
5. Develop and implement regulations, decrees, and instructions to ensure maintenance of an effective, secure and sound banking system.
6. Regulate activities of money-changers
7. Serve as the bank for licensed banks
8. Serve as financial agent to the National Authority and Palestinian public institutions inside and outside Palestine
9. Maintain and manage the National Authority's reserve of gold and foreign currencies
10. Provide financial and economic advice to the National Authority, carry out economic and monetary analyses on a regular basis, and publish the results.
11. Serve as financial agent to the National Authority and Palestinian public institutions inside and outside Palestine.
12. Develop and implement regulations, decrees and instructions to ensure maintenance of an effective, secure and sound banking system.
13. Regulate the quantity, quality, and cost of credit in order to meet the requirements of economic growth and monetary stability, in accordance with the provisions of the Currency and Credit Law.
14. Serve as the bank of licensed banks, specialized lending institutions, and finance companies and supervise them to ensure the soundness of their financial position and the protection of depositors' rights.
15. Regulate activities of money-changers, finance companies and development and investment funds; issue them the relevant licenses, and control and supervise them.
16. Carry out any other tasks assigned to it by any relevant legislation, law, or agreement, provided that they do not conflict with the provisions of this law.¹⁰

The listed mandate by the presidential law is very similar to that of the Paris Protocol. It can be noticed that this law provided the PMA with enough discretion to operate as a full-fledged central bank. It supposedly has the jurisdiction to be the “banks’ bank” and to finance the state.

¹⁰ These were directly extracted from Article 5 of Law 1997, issued by a Presidential Decree from Yassir Arrafat.

However, in the following chapter we will examine the extent to which the PMA can practice its designated responsibilities from the Paris Protocol and the PA issued Law.

Chapter Two: Palestinian Monetary Authority

This chapter will offer a brief review of all the duties the PMA took part in as the regulatory body in Palestine's economy. Although some of these tasks fall under a modest scope of discretion compared to other full-fledged central banks, they show the degree of involvement the PMA has in the economy and the extent of its policy capabilities. The scarcity of literature on the performance and accomplishments of the PMA made this chapter heavily reliant on PMA published reports including their Annual Report and Financial Stability Report. Although they do not provide in-depth information on the PMA's role in either the public or financial sector, they provide insight into how the PMA contributed in sustaining and regulating the Palestinian economy.

The Palestinian Monetary Authority in the Financial Sector

As Karnovitz mentioned, "today's banking system necessitates a central bank."¹¹ In this section we will examine how the PMA fulfils such responsibility with the limited jurisdiction it has. As seen earlier, the Palestinian Authority's Law of 1997 has granted the PMA with the needed discretion to properly support and protect the Palestinian banking system. However, as the Occupation continues to forcefully halt such efforts, the PMA's role remains passive as it attempts to regulate the banking system with minimal powers. Nevertheless, as the PMA put it:

The financial sector's infrastructure, primarily composed of regulatory and supervisory framework and operating system, is considered a fundamental prerequisite to financial

¹¹ Karnovitz, Alan. "An Assessment of Alternative Monetary Regimes for a Future Palestinian State: Dollarization versus a National Currency." *Modernizing Financial Institutions (MFI: 2010)*, 4

stability. The PMA continues to make efforts that directly contribute to complete the foundation of this infrastructure and upgrade its capabilities, thereby supporting and promoting financial stability.¹²

The following are some of the initiatives the PMA has taken to improve and guarantee the soundness of the banking system.

❖ Regulatory and Supervisory Framework

It could be noticed that the PMA compensates its lack of monetary powers by an exceptional administrative role in the banking system. During the past five years, the PMA issued at least ten instructions to help supervise the banking system and facilitate its activities. They all vary in their scope of focus, but they can be briefly summarized as such:

- Instruction No. (1/2014): concerning the logistics of transporting money, precious metals and valuables. The PMA purchased specialized vehicles to secure on-land transactions between banks.
- Instruction No. (2/2014): concerning the regulation of housing and mortgage loans based on the dynamic loan-to-value ratio. The PMA implemented an LtV ratio for banks to adopt in the process of giving out mortgages to reduce default risks. Commercial banks are prohibited from giving out mortgage loans to customers who score below the LtV ratio threshold.
- Instruction No. (3) and (4) concern facilitating the launch of the the new real-time gross settlement system, BURAQ. This system will be later discussed in detail.

¹² Annual Report 2014: September." *Palestine Monetary Authority (PMA)*, September 2014. Accessed November 17, 2015, 86
<http://pma.ps/Portals/1/Users/002/02/2/Publications/English/Annual Reports/PMA Annual Reports/Annual Report 2014 Final En.pdf.pdf>.

- The rest of the instructions revolve around micro-regulatory rules the PMA set for Palestinian banks.
- Instruction No. (5/2014): to set official bank working days and hours.
- Instruction No. (6/2014): concerning credit granted to related parties. In efforts to avoid conflict of interest and corruption, the PMA set rules for credit granted by banks to their working members.
- Instruction No. (7/2014): is for categorizing fees and commissions and setting permissible ceilings for service fees charged by banks to their clients
- Instruction No. (8/2014): lowered the risk reserve rate from 2 percent to 1.5 granting the 0.5 percent for indirect credit facilities.
- Instruction No. (9/2014): concerning the management of the deceased's account to prevent any financial schemes by outside parties.
- Instruction No. (10/2014): involves bank stress testing which is a mandatory procedure imposed by the PMA to ensure the performance of banks in the times of crisis (i.e. war occurrence, economic shock, etc...) ¹³

It is evident that the PMA, as a financial regulator, seeks to micromanage the banking system through very specific instructions regarding everyday operations. The extent in which the PMA involves itself in banking policies shows its exceptional protectiveness over the financial system. Two reasons surface as to why the PMA is so rigorously strict with its financial institutions. First are the war circumstances in which the Palestinian economy functions under.

¹³ Financial Stability Report 2014: September." *Palestine Monetary Authority (PMA)*, September 2014. Accessed November 9, 2015, 20
http://pma.ps/Portals/1/Users/002/02/2/Publications/English/Annual Reports/PMA Annual Reports/Annual_Report_2014_Final_En.pdf.pdf.

Both the public and private sector are constantly exposed to potential political crises and economic shocks, such as the fiscal crisis in 2006 or the Gaza War in 2008 and 2012. Having limited powers to accommodate such economic setbacks, the PMA tends to take exceptionally strict measures to primitively protect the financial system against unexpected hits. Another reason behind PMA's noticeably disciplined approach is to prove its competence amongst other international institutions as parts of its efforts to become a full-fledged Central Bank. It can be observed from the narrative presented in the PMA's published reports that it is constantly attempting to implement programs and strategies that are complementary to international standards. Despite the effectiveness of such efforts, as both the International Monetary Fund and the World commend the PMA's performance on annual basis, it brought no change to its policy mandate.

❖ **Establishment of the Palestine Deposit Insurance Corporation:**

As Asli Kunt noted "deposit insurance has become an increasingly used tool by governments in an effort to assure the stability of banking system and protect bank depositors from incurring large losses due to bank failures."¹⁴ Following the international efforts to develop deposit insurance corporations, the PMA launched the Palestine Deposit Insurance Corporation (PDIC). In their Financial Stability Report of 2013, the PMA briefly listed its initiatives and accomplishment in regulating and developing the financial sector. However, in this section the PMA noted that "these achievements served to meet the requirements for transforming the PMA

¹⁴ Demirgüç-Kunt, Asli, Edward Kane, Baybars Karacaovali, and Luc Laeven. "Deposit Insurance around the World: A Comprehensive Database." *Deposit Insurance around the World Issues of Design and Implementation*, 2008, 4

into a modern and full-fledged central bank. Perhaps the most prominent accomplishments was the establishment of the Palestine Deposit Insurance Corporation (PDIC)”¹⁵

The main aim behind creating the PDIC, according to the PMA, was to “protect depositors in accordance with a deposit insurance ceiling set forth by law, thereby reinforcing confidence in the Palestinian banking system”¹⁶ The PDIC was backed by a Presidential Decree to grant it the legal discretion to operate fully independent of both the banking system and the government. However, in their first year the PDIC was able to set an insurance ceiling of \$10,000 to every bank account in Palestine. This left approximately 93% of bank depositors in the West Bank covered by the PDIC’s insurance policies. Thus, the creation of the PDIC falls under the PMA’s efforts to “mobilize savings, promote economic growth, enhance financial stability, and bolster confidence in the Palestinian financial and banking systems.”¹⁷

❖ **The Electronic National Switch (ENS)**

The PMA successfully managed to unify its ATM Machines as well as Point of Sales (PoSs) into a single database. This made access to cash much more efficient for citizens as it provided the service regardless of time and location. According to the PMA this “system will encourage the banks to issue more debit and prepaid card and will also encourage the distribution of the point of sale machines.”¹⁸ This is part of PMA’s recent efforts to gradually replace the use of cash in Palestine with advanced payment methods, including digital checks, electronic wallets,

¹⁵ Ibid.

¹⁶ Ibid., 21

¹⁷ Ibid., 22

¹⁸ Ibid., 24

and mobile payments. Introducing the ENS establishes an infrastructure for such transition as it aims to reduce the risk of fraud and abuse from using technological payment systems.

❖ **The Public Key Infrastructure (PKI)**

With the switch to more digital means of payment, comes the need for a secure transaction medium. In order to ensure the safety of the electronic exchanges, the PMA introduced an encryption system as a way “to manage the creation, administration, distribution and revocation of keys and digital certificates.”¹⁹ (Website) Public Key Infrastructure (PKI) is an encryption system that “supports the distribution and identification of public encryption keys, enabling users and computers to both securely exchange data over networks such as the Internet and verify the identity of the other party.”²⁰ It also helped secure global transactions going in and out of Palestine.²¹

❖ **The Automated Clearance System**

To further secure payment mechanisms the PMA launched a new automated clearance system called Perago Clear in 2014. According to the PMA this automated clearance system’s “main function is to provide safe and effective check-clearing processes while also securing retail payment transactions in the Palestinian service sector.”²² Perago does so by supervising and keeping track of check-clearing operations and retail payment instruments.²³

¹⁹ "What Is PKI (public Key Infrastructure)? - Definition from WhatIs.com." SearchSecurity. Accessed May 04, 2016. <http://searchsecurity.techtarget.com/definition/PKI>.

²⁰ "PMA Implements First Step toward Foundation of Public Key Infrastructure." PMA Press Releases. Accessed May 04, 2016. <http://www.pma.ps/Default.aspx?tabid=205>.

²¹ Ibid.

²² PMA Press Releases. Accessed March 12, 2016. <http://www.pma.ps/Default.aspx?tabid=205>. Web

²³ Ibid., 25

❖ Development of the Credit Bureau System

In an economy that is constantly going under recessions and setbacks, Palestinian merchants, commercial banks, and individuals need to take extra precautionary measures before placing their investments. To help secure future investments from default risks and fraud the PMA took the initiative to establish a credit bureau system. Credit bureau are agencies that look and research into individual and corporation credit information and sells it for a fee to potential creditors. The main purpose of credit bureaus is to provide viable information to credit agencies in order for them to make sound lending decisions. Parties that use credit bureau agencies are usually banks, mortgage lenders, financing companies and credit card companies. Of course, credit bureau agencies have no part in making lending decisions, but their main purpose is to provide credit score and logs of potential clients.²⁴

Banks in Palestine now have the option to enroll in a Unified Query System where they have access to “check customer’s scores on the Bounced Checks System, request details of the customer’s rating, know whether the customer is a loan grantee of banks or lending institution, establish whether the customer has unpaid due installments and finally check the customer’s overall credit history.”²⁵ According to the PMA this will boost confidence by local and outside investors in the financial sector as the credit bureau system will gradually become more efficient and accurate in providing detailed credit ratings.

²⁴ "Credit Reporting Agency Definition | Investopedia." Investopedia. 2008. Accessed March 03, 2016. Web <http://www.investopedia.com/terms/c/credit-reporting-agency.asp>.

²⁵ "Financial Stability Report 2013: September." *Palestine Monetary Authority (PMA)*, September 2013. Accessed November 9, 2015, 87
<http://www.pma.ps/Portals/1/Users/002/02/2/Publications/English/Annual%20Reports/Financial%20Stability%20Reports/Financial%20Stability%20Report%20English%20Final%20web%202013.pdf>

Financial Inclusion and Small to Medium Enterprises (SMEs)

Not only is Palestine considered to be an underdeveloped country but it faces a set of exceptional challenges as it lives in the shadows of occupation. War circumstances, along with poor living standards, has minimized the public's awareness of the world of finance. The political complexity has generated a lot of physical and economic obstacles for non-privileged Palestinians to access financial services and institutions. As part of its responsibility to stimulate and sustain economic growth, the PMA has launched a financial inclusion program aimed to raise public awareness and facilitate access to financial services in rural areas. To further evaluate this initiative one has to fully understand the meaning of financial inclusion. There is no definitive meaning behind it, but taking the definition generated by the Consultative Group to Assist the Poor (CGAP) organization; financial inclusion "means that households and businesses have access and can effectively use appropriate financial services. Such services must be provided responsibly and sustainably, in a well-regulated economy."²⁶ The PMA has used this rhetoric to establish their own idea of financial inclusion to be defined as "enhancing the access to the financial services for all the groups in the society, with fair, transparent, and affordable costs."²⁷

The PMA has made several efforts to carry out the financial inclusion mission across the country. It launched programs that target both potential investors and regular citizens. The PMA recognizes the importance of supporting small enterprises and startups. Small to Medium

²⁶ Wang, Xiu Hua, and Fadi Hassan Shihadeh. "Financial Inclusion: Policies, Status, and Challenges in Palestine." *International Journal of Economics and Finance IJEF* 7, no. 8 (2015), 199

²⁷ PMA Press Releases. Accessed March 08, 2016. <http://www.pma.ps/Default.aspx?tabid=205>. Web.

Enterprises (SMEs) contribute around 55% of the GDP and make 91% of businesses in Palestine.²⁸ To support startup businesses, the PMA has hosted an international banking conference titled “*Empowering Small and Medium Enterprises in Palestine through Enhancing Access to Finance*” which aimed at assessing the financial needs for small businesses and granting them access as such. The PMA has also encouraged the reduction of interest rates and easing the attached conditions to structured loans granted to small enterprises. Given its compromised mandate the PMA uses its only tool to do encourage lending by exempting commercial banks from the 2% risk reserve requirement to any loanable funds or financial services provided for small enterprises. The PMA has also established a database for all SMEs in order to boost bank efficiency in lending startups. Banks have access to database that helps them map the financial needs of small businesses and thus offer the suitable instruments and services.

The PMA has also launched an awareness campaign that involves international and local banks setting up educational programs to inform the public about their services. Banks from all over the West Bank have annually hosted thousands of students to lecture them about the nature of banking and finance. Banks also launched programs where staff members visit schools and hold information sessions to students and school staff. With the sponsorship of the PMA, banks from different branches visited more than 1,600 schools in the West Bank and the Gaza Strip to meet with more than 87,000 students. The campaign also aimed at empowering inexperienced small shareholders by informing them about their rights, voting mechanism and ordinary & extraordinary meetings of the General Authority.²⁹ The PMA also launched a campaign under the name of “*Primary Account for Each Citizen*” which aims to optimize the number of people using financial

²⁸ Wang, *Financial Inclusion: Policies, Status, and Challenges in Palestine*, 209

²⁹ *Ibid.*, 210

services by reducing access barriers. Low-income Palestinian citizens have very minimal to no knowledge about how banking works, which in return discourages them to make bank deposits. The PMA attempted to encourage lending and borrowing by instructing commercial banks to reduce paperwork as much as possible. People who are unaware of banking processes are intimidated by the bureaucracy. The ultimate purpose of this initiative was to facilitate and encourage the use of financial instruments in the Palestinian economy. By spreading awareness about the nature of banking and investments, while also providing access to those who lack the financial or physical means, the PMA was able to take the first step to improve Palestine's socio-economic status.

Handling War Crisis in Gaza (2014)

One of the many duties a central bank has as the regulatory body of the economy is crisis management. However, with the case of Palestine its monetary authority, two exceptions fall into place. The first is the nature in which the PMA is designed, and the mandate it is given. In comparison to the average central bank, the PMA's power and influence are very much compromised by the political and economic constraints imposed by the Israeli Occupation. Second, the unique political and economic situation in Palestine, the definition of "crisis" is very much war oriented. Despite functioning under occupation, the PMA has to sustain the economy with what it has of monetary, institutional and fiscal tools. Gracianna Del Castillo discussed the role of central banks and governments during the post-war economic recovery period. She argues that:

Policymakers adopting monetary in such situations may consider broader objectives – including growth employment and most importantly, the financing of peace-related project in cases where foreign financing is lagging. Without the possibility of financing critical

project, the whole peace process may collapse. Thus, deficit financing should increase policymakers' options in particular cases in the transition from war.³⁰

In 2014, Israel launched a military attack on Gaza leaving the city's infrastructure and its people in complete devastation. The economic repercussions of these attacks produced a city with the highest unemployment in the world. In 2014, the World Bank reported that Gaza holds an unemployment rate of 48% making it "have higher unemployment than any other economy in the world"³¹ However, neither the Palestinian Authority nor the PMA have the jurisdiction to finance "peace-related projects" or target unemployment like Castillo suggested. Instead, the Gaza economy's recovery was dependent on insufficient foreign grants that were highly contingent on specific political terms. The war on Gaza was a prime time to test the extent in which the PMA can carry out a central bank's most essential duties – to aid the economy in times of crisis.

Nevertheless, as soon as Israel started its military aggression against the Gaza Strip, the PMA set up a "crisis management cell" to aid the economy and try to soften the disaster. The PMA designated team worked hand in hand with commercial banks in Gaza and the West Bank to coordinate a plan to minimize the war impact on the Gaza banking system. The following list was taken directly from the PMA annual report which lists the initiatives and measures it took during war:

- Enactment of bank business continuity plans and convening consultancy meetings on a daily basis.

³⁰ Castillo, Graciana Del., and Edmund S. Phelps. *Rebuilding War-torn States: The Challenge of Post-conflict Economic Reconstruction*. Oxford: Oxford University Press, 2008, 20

³¹ World Bank, *Economic Monitoring Report to the Ad Hoc Liaison Committee*, May 27, 2015, 6

- Supplying branches with necessary means to ensure business continuity (electrical generators, fuel).
- Provision of sufficient liquidity in advance of the crisis. The PMA does so by setting up theoretical economic scenarios, crises included, based on the initial global economy's performance and accordingly tests the reserves of each bank to determine if they're successful in backing their liquidity in times of crisis.
- Distributing cash across branches in case of emergency and avoiding cash concentration at near-border branches.
- Feeding ATMs with cash as required and ensuring adequate liquidity.
- Ensuring the possibility of cash withdrawal from different points of sale.
- Reinforcing security and safety procedures.
- Timely decision-making (working hours and closure of branches in periods of ceasefire as agreed upon).
- Offering directions to customers seeking banking services, and identifying the bank branches and offices and ATMs to be visited during the war.

On the other hand, the PMA made important decisions to organize banking with regards to clearance, payment and settlement systems and credit rating. These were as follows:

- Suspending the collection of bounced checks fees from check issuers.
- Suspending credit rating using the bounced check system.
- Suspending credit rating for borrowers (individuals, companies and institutions).
- Waiving conditions on mortgage loans for loans obtained through credit rating based on the LTV ratio.

- Granting borrowers wider-ranging allowances by raising the ratio of monthly installments to total income from 50 percent to 65 percent.
- Postponing installments due for private, corporate and institution debtors until the end of 2014.
- Suspending the collection of delay fees on postponed installments.³²

Judging by this list it becomes obvious that the PMA's role is far from a traditional monetary authority as it has minimal discretion to carry out direct stimuli packages to either tackle unemployment in Gaza or run a deficit to rebuild the city. Rather, the PMA acts as a supervisory figure that functions in a passive manner. The PMA's discretion goes as far as filling ATMs with cash or prepare banks for crises by running stress tests, but it however lacks the very essence of a central bank. The financial easing the PMA tries to provide in the time of crisis comes in the form of late fee exemptions as mentioned above. Although this might be effective as it redeems people's financial commitments in the times of desperate need, it does not necessarily stimulate economic growth or development. Moreover, the PMA tries to encourage lending and borrowing by suspending credit rating to make financial instruments more accessible for people but again, this is far from enough to the offset a 48% unemployment economy.

The International Monetary Fund's Take on the PMA

Being marginalized by the Occupation, the PMA takes extra pride in international recognition as it boosts its confidence in potentially transforming into a full-fledged central bank in the future. The International Monetary Fund and the World Bank have been working closely with the PMA in the last decade to offer policy and financial guidance to better regulate the

³² Palestinian Monetary Authority, Financial Stability Report 2014, 51

Palestinian economy. The IMF sends a mission on annual basis to examine the Palestinian economy and evaluate the PMA's performance as such. In their most recent reports, the IMF has discussed several challenges that face the Palestinian economy, including the financial sector, the public sector and the government's balance of payments. Throughout their analysis, the IMF has stressed the importance of Israel's commitment to the Paris Protocol, especially in transferring clearance revenues back to the PMA. Moreover, the IMF has commended the PMA's performance given the fiscal and monetary restrictions imposed by the Israeli occupation. The IMF stated "despite the difficult economic and political situation in 2014, the fiscal authorities maintained their efforts to deliver lower deficits."³³ This was mainly reflected on the clearance revenue growth that outpaced budget projections, helped by a sharp rise in excise revenue collection.

The IMF's statement also touches on the importance of continuing to safeguard the financial stability in a volatile environment. An economy under war requires extra measures from the PMA to maintain stability and ensure safety. According to the IMF, the PMA "has made considerable progress in the area of risk-based supervision, upgrading its stress-test methodology, and enhancing crisis preparedness."

Besides the progress in risk management and crisis handling, the IMF also commended the PMA for its efforts in installing the financial inclusion program. Given that Palestine is an underdeveloped country, the majority of people lack awareness and access to financial services. Thus the PMA has launched a financial inclusion strategy "that bodes well for efforts to enhance

³³ World Bank. 2015. *Economic monitoring report to the ad hoc liaison committee*. Washington, D.C.: World Bank Group. <http://documents.worldbank.org/curated/en/2015/05/24525116/economic-monitoring-report-ad-hoc-liaison-committee>

access to credit on more affordable terms to a wider share of population, including small- and medium-sized business” as the IMF described it.

Chapter Three: Central Banking

Central Banks have been hotly debated in the academic literature and policy circles. The issue at hand has been not only how they function but whether they should even exist in the first place. Some economists see benefits from having a central bank but disagree about its functions and mandates. Other finds that, regardless of how well central bank try to operate, they are not only unnecessary but indeed may be disrupting the free market self-regulatory mechanism. Economists such as Kevin Dowd, Ludwig Von Mises, Milton Friedman, and Lawrence H. White fall in the last tradition (even as they hail from different schools of thought). They generally support the notion that central banks are unnecessary, since the economy would automatically reach equilibrium if markets were given full autonomy in the absence of government intervention. At the other end of the spectrum, authors like C.A.E Goodhart and Gunar Heinsohn find central banks to be critical for a fully functioning economy, although the differ in their rationale behind this position.

Starting with those who oppose central banks both as an institution and macroeconomic mechanism, we begin with Kevin Dowd's *Automatic Stabilizing Mechanisms Under Free Banking*. In this paper Dowd draws a hypothetical scenario of a free banking system in which banks, collectively, are responsible for issuing currency and running monetary policy. The aim of his hypothesis is to prove how "a banking system would evolve in the absence of state intervention" and to show that "automatic stabilizing mechanisms are inherent"³⁴ in such system.

³⁴ Dowd, K. *Automatic Stabilizing Mechanisms Under Free Banking*. University of Sheffield School of Management and Economic Studies, 1987.

This doctrine follows the neoclassical model in which free markets are self-correcting and are regulated by an “invisible hand.” He then uses the free banking system scenario as a benchmark to assess the current economy, which is government-run via central banks.

He begins by establishing a system with the following distinctive features:

- (1) multiple note issuers who would guarantee to redeem their notes in a commodity that the community recognizes as valuable
- (2) regular note exchange between these note issuers
- (3) insertion of “option clauses” into the convertibility of contracts to protect the note issuers against sudden excessive demands for liquidity.³⁵

In his hypothetical scenario, Dowd shows that the natural emergence of all these banking practices occurs without institutional or state intervention. His model is built on the assumption that all market participants will pursue their self-interest and thus would want to maintain a credible reputation in the market. Dowd argues that if the industry of minting currency was left for the market, then equilibrium would be autonomously realized through free competition, thus drawing the conclusion that a free banking system would be regulated by the forces of the free market. He says:

The essential difference between free banking and central banking is that the latter involves the suppression of stabilizing mechanisms that would arise spontaneously without government interference. *This strongly suggests that central banking is a destabilizing form of state intervention.*³⁶

The idea behind this is that a free market system where suppliers compete with one another over demand will force market participants to take the necessary measures to assure their continuity.

³⁵ Ibid., 643

³⁶ Ibid., 644

Adopting the free banking system as an example: if one bank over issues currency it will eventually hurt its profits compared to other banks. This is due to the distinction Dowd draws between being able to *put* money into the market and being able to make it *stay*. Banks can print as much currency as they please, however, every bank is responsible for redeeming any unused currency they issue, which ultimately eliminates any incentive for them to over-or-under issue. Dowd says: “a bank would not deliberately choose to issue an excess of notes because they would not remain in circulation long enough to justify the expense of putting them into circulation and then taking them back again.”³⁷ Following the same logic, Dowd believes that a system of issuing convertible notes, a note-clearing mechanism, and the development of a liquidity market (substituting the central bank’s open-market-operation and lenders of last resort function), would all emerge out of mere necessity.

Dowd also touches on how the current central bank model hurts the economy’s performance and its monetary system due to its exposure to exogenous forces by the government. He says “history also confirms that the current monetary system is frequently unstable and very different from the system that would have evolved in the absence of state interference.”³⁸ There are several ways in which state intervention, according to Dowd, hurts the banking system and the innately stable free-markets. He starts by stating that the creation of central banks and monopolizing currency is a means for governments to optimize their revenue. He notes that such a monopoly would not have existed. He said a government would impose this model by “suppressing competition forcing its subject to accept a quality of service they would reject if they had a wider freedom of choice.”³⁹

³⁷ Ibid., 647

³⁸ Ibid., 652

³⁹ Ibid.

Dowd also believes that government intervention limits the capacity of the banking system to develop and compromises its stability. He believes our current model suppresses the emergence of a fully functioning clearing system. Unlike a free-banking system that would naturally lead private banks to establish a clearing system, the government's currency monopoly prevents such a phenomenon from taking place, which in return "makes banks more vulnerable to shocks, thus undermining the stability of the banking system."⁴⁰ With a multiple-bank issue economy, banks that over-issue currency will be checked relatively quickly by the joint clearance system. However, with a monopolized money issuer, there is no clearance system and instead the central bank would directly redeem all notes returned by the public which will take relatively longer.

Another misuse of the government for its monopoly over the monetary system is the way it uses its power to force banks into covering its spending in times of fiscal crises, such as times of war. This further compromises the stability of the banking system as it pressures their reserves and weakens their ability to absorb external shocks. Ultimately, this would by default lead governments to intervene with the attempts of repairing the damage produced by their own policy. This eventually creates a vicious cycle of bad decisions and monetary policies that only stemmed by government intervention in the first place.

Dowd uses this to expand on the monopolistic nature of the current model, which is "clearly unstable", by showing how current monetary disturbances are symptoms for the lack of competition a central bank has in issuing notes and restrictions. He says: "the lack of competitors thus gives a monopoly bank of issue greater discretion than any competitive bank would have."⁴¹ Although a typical orthodox approach would usually favor less regulation, Dowd is suggesting

⁴⁰ Ibid.

⁴¹ Ibid., 653

that in a competitive economy, market participants would have less leverage to misuse financial instruments and are therefore tied to making sound decisions. This notion is the core of the “invisible hand” concept where a free market under massive competition will regulate itself from within. The higher the competition the smaller is the margin for market participants to implement or adopt policies that might hurt the economy or the public interest as that will jeopardize their continuity. This, however, does not apply to central banks as the regulatory force of free markets is missing and is instead replaced with unlimited government discretion. Consequently, the responsibility which would have been divided by the number of banks in the market is now in the hands of a single currency issuer, the central bank.

We next turn to the father of monetarism: Milton Friedman, who is widely known for his critical views on government intervention and its adverse effects on the economy. The reason why economists like Milton Friedman oppose centralized monetary systems is because they believe that the one-man model central banks function under is inefficient. When governments monopolize issuing notes and monetary policies to one bank, it automatically places a huge burden on these institutions to constantly try and do the “right thing”. In one of his interviews, when asked about the current centralized banking system, Friedman said “a system that depends on the right man is a bad system”⁴². The “right man” in this context is the government which attempts to regulate the economy through a central bank. This, he says, is also dedicated to the Keynesian economists that defend centralized economies by pointing fingers at government policies rather at the interference itself. Friedman finds the very roots of this system to be flawed as the economy is hostage to the government’s actions and policies. He continues to say that “we need to have a system that does

⁴² Friedman, Milton. Interview with Robert McKenzie, *Anatomy of a Crisis- Free to Choose*, 1980

not rely on the right man pushing the right buttons at the right time. We need a system that relies on a framework that functions independently, an invisible hand mechanism.”⁴³ Dowd backs up claim by saying that the “problem of finding the right policy would soon become even more difficult because the private banking system would adapt to the monopoly note issuer and gradually force the monopoly bank into the role of ‘guardian’ of the monetary system.”⁴⁴ One can conclude that from an orthodox point of view, centralized monetary systems are inefficient because they mandate all monetary policy responsibility to one single institution. As a result, central banks will always be in constant struggle to “find the right policy” he continues, “but the right policy would be increasingly difficult to find.” In a free banking system under a decentralized monetary system such responsibility will transform into a collective effort that is part of a self-regulatory mechanism. jeopardise

Nevertheless, there is a reason why our current system works the way it does now. In his analysis to the establishment of the European Union along the European Central Bank, Gunnar Heinsohn presented a historical case for the rise of the Federal Reserve System from a multi-issue bank system to gradually become monetarily centralized. He uses that to examine the reasons behind such transformation and relates it to the current model in the European Union. It is safe to say that the United States had no centralized monetary authority between the Federal Reserve Act of 1913 and the Banking Act of 1935. The monetary authority then consisted of a Board of Governors from Washington along twelve other regional Reserve Banks from different states. These Reserve Banks were all somewhat semi-central banks since they had the power and

⁴³ Ibid.

⁴⁴ Dowd, *Automatic Stabilizing Mechanisms Under Free Banking*, 653

discretion to set discount rates which at that time “was the primary tool of monetary policy.”⁴⁵ Not only so but the Board of Governors was secondary in the decision process as it could only issue a policy under with full coordination with the twelve Reserve Banks. Moreover, Reserve Banks were given the mandate to issue dollar notes. Although the system was not fully decentralized given the presence of a governmental Board, but in reality the power to shape and form monetary policies and currency was in the hands of the Reserve Banks. However, later on, with the discovery of the open market operations in the 1920’s, Reserves Banks established an Open Market Investment Committee (OMIC) in 1923. This committee included representatives from Boston, New York, Philadelphia, Cleveland and Chicago Reserve Banks with the chairmanship of the New York Bank. The objective behind this was to create a platform in which banks were able to interact without the interference of the Board, and thus further decentralizing the banking system. The OMIC was dismantled to be reestablished as the Open Market Policy Conference with the participation of all twelve Reserve Banks. However, with the recession following the Great Depression the Reserve Banking Act of 1933 established a new open market system named the Federal Open Market Committee (FOMC) with only the twelve presidents of the Reserve Banks but with the inclusion of the Board of Governors even though “the governors did not get a vote in open market policy”⁴⁶

It was only until the Banking Act of 1935 that change has been brought to the former economic model by granting significant discretion to the Board. It did so by implementing major reforms to the FOMC as it reduced the number of bank memberships from twelve to only five presidents. It also buttressed the role of the Board by not only giving it the right to vote but a

⁴⁵ Heinsohn, Gunnar, and Otto Steiger. *The European Central Bank and the Eurosystem: An Analysis of the Missing Central Monetary Institution in European Monetary Union*. Bonn: Zentrum Für Europäische Wirtschaftsforschung, ZEI, 2003, 4

⁴⁶ *Ibid.*, 9

permanent majority in the committee itself. Moreover, the Act mandated the New York Bank with exclusive rights to practice open market operations and the responsibility of being lender of last resort to all other Reserve Banks with 40 percent of all assets. The other twelve banks, however, maintained their right to issue notes. Surprisingly, economists like Milton Friedman welcomed this change with appreciation as he and Anna Jacobson Schwartz wrote:

There was nothing that could be called a System policy. The System was demoralized. Each Bank was operating on its own. All participated in the general atmosphere of panic that was spreading in the financial community and the community at large. The leadership which an independent central banking system was supposed to give the market and the ability to withstand the pressures of politics and of profit alike and act counter to the market as a whole, these- the justification for establishing a quasi-governmental institution with broad powers- were conspicuous by their absence.⁴⁷

According to Heinsohn the new Federal Reserve System following the Banking Act of 1935 was working so well that it became a benchmark for other decentralized systems around the world including that of Europe's at the time. However, it is obvious that the distinguishing feature of the new American Federal system was the increased involvement of the government through the reduction of Bank representatives and granting majority for the Board. Barry Eichengreen said: "only after authority was definitely centralized in the hands of the Board of Governors and the Federal Open Market Committee did the new institution finally come to operate smoothly"⁴⁸

Heinsohn's paper studied the evolution of the Federal Reserve System from a free-banking system to a centralized economy to assess the establishment of the European Union and the

⁴⁷ Ibid., 12

⁴⁸ Ibid., 10

European Central Bank. The model in which the EU economy functions under is very similar to that of the United States in the 1920's. The discretion Reserve Banks had in tailoring monetary policies and controlling the money supply, by depositing and issuing hard currency, is enjoyed by the National Central Banks (NCBs) of the European Union. In its early years of establishment, the European Central Bank was very much like the Board of Governors in the first Federal Reserve System; secondary and marginalized. NCB's had the discretion to collectively, through the Governing Council, set monetary policies and independently issue Euro notes while the ECB had no say in either setting interest rates or even function as a lender of last resort. The European Union was in reality a decentralized economy in core but designed in a way to show otherwise with responsibilities granted to only make the ECB "a torso of a central bank". With increasing international suspicion by institutions like the International Monetary Fund about the obscurity of the ECB's central role in the EU, the Governing Council decided to add ECB representatives to the Committee but that was not enough. The Governing Council tirelessly tried to perfect the masquerading of the ECB as a central monetary authority by granting it more half-baked responsibilities, and that includes the printing of money and funding NCB's. However, none of the previous functions were actually carried out but rather put on paper and obscurely mentioned in the ECB's balance sheet. Heinsohn described it as: "a mere statistical allotment of the ECB's twelve mothers to their helpless daughter is turned into the rare case of dowry given by the daughters to their parent"⁴⁹

What Heinsohn stressed on the most was the missing lending-of-last-resort figure in the ECB's monetary framework. He said "the most bizarre violation of the principles of central banking in the design of the Eurosystem is the simple omission of the very rationale of a central

⁴⁹ Ibid., 25

bank, its responsibility as lender of last resort.”⁵⁰ Not only did that worry Heinsohn but the International Monetary Fund was the first institution to note and say “the lender-of-last-resort responsibility has not been assigned to any institution in EMU; consequently; there is *no central provider or coordinator of emergency liquidity in the event of crisis*”⁵¹ To keep in mind, Heinsohn wrote this paper more than a decade ago, thus his pool of reference about recessions in decentralized economies was exclusive to the Federal Reserve System pre-1935 and the Great Depression. He uses the collapse of the banking system in the United States during the Great Depression as a prime example to the potential threat the EU faces in the future. Moreover, in comparison with the Federal Reserve System pre-1935, the EU system is found highly unstable. Heinsohn noted that the lender-of-last-resort arrangement in the U.S. was relatively better than the EU since the Bank of New York had the discretion to carry out such duty. While the “decentralized organization of the Eurosystem leaves neither NCBs nor national governments clearly responsible for supervision of Pan-European banks for ensuring EMU-wide financial market stability.”⁵² That is, however, a problematic approach since leaving NCB to adequately assess the risk of contagion by printing their own Euros and tailoring their respective monetary policies would “create an uneven playing field and introduce different levels of moral hazard across EMU.”⁵³

Hence, for Heinsohn, decentralized economies have no real monetary backbone as they not only lack the presence of a regulatory body to facilitate and monitor bank activities but also a safety net for liquidity in the times of crisis and that is a lender-of-last-resort figure. Banks who were not fully centralized like the New York Bank before the Act of 1935 found itself incapable

⁵⁰ Ibid., 36

⁵¹ Ibid.

⁵² Ibid.

⁵³ Ibid.

of bailing out Wall Street when it was “bleeding money on an unprecedented scale.” Although sister banks like the Chicago Bank had plenty of excess reserves to lend out, it was skeptical that without a central monetary authority to reimburse it, it would face massive losses. The Board from Washington at that time did not enjoy enough discretion to force banks into lending one another and ending the Prisoner's Dilemma the banking system faced when it hit recession. Therefore, in Heinsohn's words: “as long as there is no lender of last resort in Euroland it will face the problems rampant in the pre-1935 Fed.”⁵⁴ Interestingly enough, five years after Heinsohn wrote his piece, the EU faced its first financial shock with the global crisis in 2008. At that point Heinsohn's suspicions were met as the EU's lack of any central backbone manifested in the absence of a lender of last resort. Countries like Greece had to receive bailout packs from international institutions and neighboring countries contingent on specific recovery plans which to a lot of economists was considered as counterproductive. This instance showed the fragility of the EU monetary model as the financial crisis that took off in Greece was barely stopped from spreading to all other periphery countries. The quasi-decentralized system that Heinsohn had several issues with its structural built was put in questions by numerous economists and politicians all over the world.

Heinsohn was not the only economist to tackle the nature of decentralized economies, Charles Albert Eric Goodhart, one of the most involved economists in the topic of central banking, also explained why the economy, and the banking system in particular, needs a central bank. It is useful to start by quoting Goodhart when he said that “from a neoclassical, Walrasian, position wherein all markets clear perfectly and there is a unique stable equilibrium, it becomes extremely difficult to see any necessary role for a Central Bank”⁵⁵ However, in his chapter “Why Do Bank

⁵⁴ Ibid., 38

⁵⁵ Goodhart, Money, Information and Uncertainty, 178

Need a Central Bank” from his book *Money, Information and Uncertainty*, Goodhart discusses two issues in depth simultaneously. The first revolving the orthodox claim that markets enjoy a self-stabilizing mechanism if left with no government intervention or any other exterior force to disturb it. The latter issue is complementary to the proof that free markets are not perfect and from that stems Goodhart’s argument for the need of central banks.

He begins his argument by pointing out that “inadequacy and insufficiency of information” is inherent in markets which in return makes them imperfect. That eventually leads to the argument that an outside force is needed to reduce the effects of asymmetric information and make sure to prevent unfair competition between market participants.⁵⁶ Goodhart views information as just another commodity on the market that is obtained by who can afford it. It is then clear that special knowledge is provided to the people who are willing spend money on it making it “only available for few participants in the market and thus establish an unfair race between different races.” The information Goodhart refers to is what it requires both the customer and seller to acquire in order to make the best purchase or investment. Those who enjoy the capital to gather and process market and consumer information will most likely make more sound decisions than those who do not. It is then possible for some corporations to be more knowledgeable of market indicators in terms of quality and prices than others which in return gives them an edge in the competition. Not only is it a threat to fair competition but asymmetric information given that “clients seeking their services are naturally at an informational disadvantage”⁵⁷ might compromise the general wellbeing of the public with the presence of marketing schemes since it is “easy to appeal the gullible by promising to offer a higher yield.”⁵⁸

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ Ibid.

Economists like Hayek and those who come from a similar school of thought defend free markets by claiming that eventually reputation will filter those who either scheme or provide inferior service by the process of trial and error customers undergo. This stems from the assumption that as time goes by customers will identify those who offer suboptimal prices or provide poor services and those businesses will automatically cease for their incompetence. Following that trail of logic market participants would have no incentive to misinform their clients because it might reflect on their sales since it might hurt their reputation. This is a classic argument from free market supporters as it all eventually boils down to pursuing self-interest. It then goes against the self-interest of corporations to ignore their customers' needs since the intensity of the competition will leave little margin for businesses to disappoint. However, Goodhart responds by saying that this only holds true if the relationship between both the seller and potential buyer was to be "repeated and repeated continuously, then reputation might, indeed, suffice to maintain the stability of the system. In practice, however, these conditions do not occur."⁵⁹ There are several reasons why the "reputation theory" fails to be met in practice.

To begin with, Goodhart raises a valid point about the inconsistency of the relationship between businesses and consumers. Some industries that include specialized professions that usually have "infrequent dealings" with clients like doctors, lawyers or real estate agents charge a lot of money for a one-time advice or deal. Not only do these professions have a lot of impact on the client's well-being, especially those cases regarding physical health or involving law issues, but they rarely counter the same customers twice as people do not often seek medical or real estate advice. To continue with the example, it is then possible for a doctor to claim the discovery of a "miracle cure" and be on his way after numerous consumers have already paid considerable

⁵⁹ Ibid.

amounts of money. Secondly, the increase in marketing schemes correlates perfectly with the rising intensity of free-market competition. Businesses will find new marketing means to gain an edge over their competition. This includes the branding and re-branding of products, which makes it more difficult for the average consumer to not fall in the same scheme twice. This goes hand in hand with what Goodhart described as “free riding.” Well-established businesses with a decent reputation might invite other corporations to tag along in the same market and thus grant themselves the opportunity to sell for those who are oblivious about the differences in quality and brand. This proves that market participants, especially from the consumer’s end, need some outside entity to ensure their financial and physical safety. That responsibility belongs to an institution like a central bank that implements regulations to prevent unfair competition and protect consumers from market predators.⁶⁰

Another reason why an economy might require the presence of a central bank is for the sake of sustaining the continuity and soundness of the commercial banking system. This falls into the “microeconomic function” of a central bank which Goodhart later expands on. In a free-banking market, the neoclassical model that is, where competition is fierce, businesses, or banks in this example, might form a “club” in which they run collectively to increase their market power by pooling their resource to offer better services. This might include better interest rates, easier accessibility and deposit insurance for their customers. However, a club of banks might also lead them to “indulge in anti-competitive, cartel agreements, exaggerating restrictions on entry beyond what is desirable, and fix prices, commissions, interest rates in an oligopolistic fashion.”⁶¹ This is one of the three reasons Goodhart believes why the banking system needs a centralized monetary

⁶⁰ Ibid., 180

⁶¹ Ibid.

authority. The other two have to do with insurance issues as he thinks any insurance plan will need state level of discretion to both implement and maintain. This is because any sort of client behavior management and monitoring will require jurisdiction that is only enjoyed by the state. This includes keeping a record on client's activities to prevent any intentional misuse by insured parties since compensation fees might give incentive for moral hazardous actions.

When discussing central banking several discussions surface and that usually revolves around the lender-of-last-resort function and the issuance of currency. For the sake of this research, I will be discussing the debate revolving the latter and that is the sovereignty of currency and the act printing it. There has been a long standing debate on the origins, nature and function of money. One on end, those who support centralized economies often agree that issuing currencies should be left monopolized under the central bank. However, those who support a free banking economy argue that currency, like any other commodity in the market, should be left for the private sector to produce and distribute.

Lawrence H. White is one of the most cited economists in writings involving free-banking and privatized currency issuance. His piece *Competitive Money Inside and Out* discusses in depth why monopolizing money is unbeneficial and if anything costly. Being a strong advocate for free-markets, White offers a strong case for de-monopolizing money and transform the responsibility central banks have to the market. White begins his argument by mentioning that before economies were centralized and governments stepped in forcefully, money was produced and owned by the market namely the banking system. He raises this point to prove that the central bank phenomenon was implemented by the state instead of naturally emerging unlike prior banking system that “clearly would have emerged in the absence of the state interventions of past centuries.” It is then a public central bank run by the authority that required unnatural measures to establish and sustain

because “no private firm under open competition could have monopolized the issue of banknote currency and permanently suspended convertibility for its bank liabilities”⁶² A central bank on the other hand, with the state power, is able to do both things just mentioned.

The core of White’s argument, however, stems from his critique of how money is perceived in our current system. He says what economists use “to justify government production of a good, or regulation of its private production, is to argue that the good in question is a ‘public good’”⁶³ It is then easy for economists who are supportive of government intervention to defend central banks by discussing money in the context of a public commodity. Once that is established it becomes obvious why money should be only handled by a public state owned institution like the Central Bank. However, in reality, according to White it is “obvious that money- being simply an asset generally accepted in payment- is not a public good⁶⁴.” He supports this claim by reviewing the nature of money and showing why it does not fit the definition of a public good. He says:

Money satisfies neither the non-rivalness-in-consumption criterion nor the non-excludability criterion associated with the public goods: The money one individual own is excluded from ownership by anyone else, and the liquidity services provided by that money cannot simultaneously be enjoyed by anyone else.⁶⁵

After he establishes the idea of money as a private commodity like any other goods sold or bought in the market, he proceeds to talk about currency within the context of a free-money system. Within that discussion White shows how money issuance, like any other business in a free competitive market, would only strive to become better. White also recognizes the ambiguity that

⁶² White, Lawrence H. *Competition and Currency: Essays on Free Banking and Money*. New York: New York University Press, 1989, 291

⁶³ Ibid., 293

⁶⁴ Ibid.

⁶⁵ Ibid., 292

comes with a free money economy as several systems might eventually emerge. Although he personally advocates a free banking system producing a unified currency he finds that any model with no money sovereignty would be more beneficial than the current monopolized money system. Once money is viewed as a produced good that is owned and sold privately, it becomes easier to see why the creating of it should be privatized as well. If money was to be left for the market to distribute and produce the nature of the practice would completely change. Currency then becomes a part of the neoclassical model where equilibrium is independently reached and so the invisible hand would eventually dictate the supply and demand of money in the economy. As explained earlier by Dowd; banks will have no incentive to produce more or less than required because they will have the obligation to redeem returned notes. White's faith in free money economies does not only stem from the technicalities of such models but from the general benefit of the free market practice itself. He says "only through the competitive process can we discover what sorts of outside money, and what ways of supplying it, are best suited to consumer preferences"⁶⁶

Lastly, White addresses those who support money monopolization with the argument that only the government has the power to unify money and its forms which is beneficial as that will reduce informational burdens on transistors, to which he counters by saying:

The argument [...] holds equally against proliferation of a variety of products or brands in any industry. It amounts to arguing that too much choice makes life difficult for consumers and ought to be suppressed by governments choosing for them.⁶⁷

It is then obvious now that White finds free competition as the only model in which producing money, like any other commodity, would take its most efficient and creative forms due to the urgent need for businesses, or banks in this case, to constantly do better in order to stay in the

⁶⁶ Ibid., 289

⁶⁷ Ibid., 292

market. The practice of making money might advance to other ways and change models depending on the demand and wants of the public but that will only happen once money cease to be monopolized by the government. And according to White, economists who are supportive of our current model will often “claim that government can produce a money with desired characteristics that private firms cannot produce” he counters, however that “there is no evidence that this is the case, although there is plenty of evidence that a government monopoly can stay in business producing a money worse than any private producer would”⁶⁸

Nevertheless, in her piece *Money, Power, and Monetary Regimes*, Pavlina Tcherneva argues that history tells otherwise. The assumption that economists like Dowd and White so heavily rely on to complete their theory is that money was first created to serve as a medium of exchange and to facilitate barter. This assumption buttresses the orthodox narrative that money was property of the market until governments intervened and monopolized it through force, which consequently proves that money itself is a market phenomenon, and that our current model strips it from its natural trait. There is yet another conclusion that is born out of this assumption, and that “the state’s appropriation of private monies [...] must be constrained at all costs, as the state (it is claimed) has the perverse incentive to overspend and debase the currency”⁶⁹ All these economic myths resurface frequently whenever the economy goes through recession as it gives a chance for mainstream economists to blame the state’s monetary policy. Specifically policies that involve the government running a deficit spending since it is believed to devalue the currency and cause inflation. Arguing against this theory would require debunking the history which forms the

⁶⁸ Ibid.

⁶⁹ Tcherneva, Pavlina R. "Money, Power, and Monetary Regimes." *Levy Economics Institute of Bard College* 861 (March 2016), 2

backbone of the neoclassical school of thought. Through a brief review of history of money and currency Tcherneva was able to illustrate that money is “not only not a ‘creature of the market’ but [...] instead a ‘creature of the state’”⁷⁰

Before elaborating on why money is a public phenomenon here is the definition in which Tcherneva used to carry out her analysis. Coming from a Chartalist approach, she said money is:

A power relationship of a specific kind, namely a social credit-debt relationship, that is codified by some authority or institution of power” later she continues to say “far from being a simple medium of benign exchange, the history of money as a creature of the state indicates that it is instead a *means of distribution*, a tool of transferring real resources from one party to another, subject to the power relationship of the specific historical context⁷¹

There are several key points made by Tcherneva that are vital to address in order to better understand the relationship between money and the state. First, it is important to note that the use of money in past civilizations was mainly due to social (people amongst each other) and political (people with the state) commitments. Discussed in detail by Goodhart in his chapter *Two Concepts of Money: Implications for the Analysis of Optimal Currency*, and briefly touched on by Tcherneva, is how money was mostly used to either meet government or social dues. Goodhart said “money frequently played an initial means-of-payment role in inter-personal social and governmental roles *before* it played a major role as a medium-of-exchange in market transactions.”⁷² He backs this up with a series of examples of different reigns from ancient times to our current day that used money in the form of taxation or used by the people for social purposes. Taking one of Goodhart’s examples for the use of money within social obligations:

⁷⁰ Ibid., 3

⁷¹ Ibid.

⁷² Goodhart, Charles A.e. "The Two Concepts of Money: Implications for the Analysis of Optimal Currency Areas." *European Journal of Political Economy* 14, no. 3 (1998), 418

One early function of money, wergild, was to set a tariff, whereby (the relatives of) the initial offender could recompense the damaged party. This practice spread to other interpersonal relationships, (bride-price, slaves), in some cases before formal markets and the use of money in trade arose.⁷³

Interestingly enough, in some countries, especially the Middle East, people still use money to settle down feud by paying “A’atweh” or compensation money to the families they did wrong, in order to stop further violence. Another monetary phenomenon that illustrates the use of money to pay social debts is the “Mahr” or dowries as a bride-price paid by the future groom to the bride’s family. All these practices did not only survive centuries as part of tradition but they are currently embedded in the constitution for most of these countries. Moreover, with the early beginnings of Islam as a religion which later on opened the way for one of the largest empires in history, the principle of “Zakaat” was introduced as a mandatory practice on every Muslim citizen. Zakat is “an obligatory tax required of Muslims, one of the five Pillars of Islam. The zakat is levied on five categories of property—food grains; fruit; camels, cattle, sheep, and goats; gold and silver; and movable goods—and is payable each year after one year’s possession.”⁷⁴ This example, like many others, supports Tcherneva and Goodhart’s argument that money is a creature of the state rather than a tool born out of markets to facilitate barter. It also sheds light on the role of the state as an agent of coordination as it has the jurisdiction to enforce laws to ensure the settling of these debts. Zakaat was implemented and collected by institutions created by the Caliphate government to enforce and implement the paying of these dues.

The Zakaat is also a prime example of another point mentioned in Bernard Lietaer’s report called *Money and Sustainability: The Missing Link* in which he examines the relationship between

⁷³ Ibid., 413

⁷⁴ “Zakaat.” Encyclopedia Britannica Online. Accessed April 2, 2016.
<http://www.britannica.com/topic/zakat-Islamic-tax>.

the current nature of money and monetary regimes. However, in his analysis of the institutional framework of power he says that “the primary purpose of taxation is to create demand for a currency that has otherwise no intrinsic value”⁷⁵ The same way the Islamic Empire gave value to coins at the time through *Zakaat*; modern states “impose compulsory debts on the population and determine how they will be settled.”⁷⁶ That compulsory debt, like the wealth percentage paid to the Caliphate state more than ten centuries ago, is in the form of taxes in our current economy. This goes to further show that the money has and is a creature of the state. In all these different Islamic traditions where money is used to settle social debts, the respective sovereign power was the one to impose, supervise and facilitate the transaction between one another.

To further study the relationship between money and state sovereignty, we take Colonial America as an example of an emerging government with no sovereign power over its currency. During the British mandate over the Americas, local colonies started printing their own notes. Each state issued its own currency with its respective value. In that time, US colonies enjoyed the freedom of running internal monetary policy which in return made them more independent both politically and economically from Britain. In response, the British government issued the Currency Act of 1751 and 1764 prohibiting American colonies from issuing their own currency. After the French Indian War, the British government wanted to both tighten its grip over its colonies and increase its revenues given the considerable debt it had after the war.⁷⁷ With American colonies printing their own currency, the British government had increasing difficulty raising taxation

⁷⁵ Lietaer, Bernard. "Money and Sustainability – the Missing Link: A Report of the Club of Rome-EU Chapter to Finance Watch and the World Business Academy." *International Journal of Environmental Studies* 73, no. 1 (2015): 157-61.

⁷⁶ Tcherneva, *Money, Power, and Monetary Regimes*, 8

⁷⁷ Finkelstein, S. S. "The Currency Act of 1764: A Quantitative Reappraisal." *The American Economist* 12, no. 2 (1968): 38-47. 39

revenues from the colonies. The American currency also imposed exchange costs as it was used for purchasing imported goods from British merchants. From a political point of view, the issuing of currency by Colonial America was granting it more sovereign powers as it was reducing its dependence on Britain. In the absence of a sovereign currency, Colonial America's only source for pounds was by trading with Britain or borrowing from its banks. Thus, it was in Britain's interest to ban all other currencies but the pound as legal tender for tax payments and trade.⁷⁸ However, it is believed that one of the main reasons behind the American Revolution was the devastation that came with the Currency Act as it left America's economy in a strait jacket. Americans had no cash to trade with one another and taxes were soaring every time the government borrowed money from British banks due to the high interest rates.⁷⁹

Arguably, the case of Colonial America, monetary wise, is very similar to Palestine now. The Palestinian Monetary Authority much like Colonial America, is prohibited from issuing its own currency. The Paris Protocol, listed in it the right for the PMA to be a lender of last resort and to issue Palestinian currency, has slowly transformed into another Currency Act as it limits the duties and discretion of the PMA as a central bank. The current duties of the PMA as seen in the previous chapter mostly revolve around minor regulatory tasks but a central bank as discussed by Goodhart and Gerald Epstein has a lot more to offer. In his piece *Central Banks as Agent of Economic Development*, Epstein discusses the contributions of central banks in developing economies throughout history including first world countries like the United States, Europe, United Kingdom and Japan. He acknowledges the lack of general consensus from economists

⁷⁸ Ibid.

⁷⁹ Ibid.

regarding the functions of a central bank but believes the following are agreed upon by the majority:

(1) unifying and issuing the country's bank notes; (2) acting as the government's bank; (3) acting as the commercial banks' bank; (4) serving as a lender of last resort to the banking and even the financial system as a whole; (5) Conducting monetary policy to manage the foreign exchanges and the price level [...] (6) conducting monetary policy to manage the overall level of economic activity and (7) allocating credit to promote national goals.⁸⁰

The PMA, however, does not have the discretion to carry out any of these functions as it lacks the autonomy to print money or run open market operations. Moreover, in his paper, Epstein discusses how central banks took part in helping states to achieve political and economic sovereignty through acting as "development agents". Such roles include financing the state and its spending needs. Epstein offers examples in which central banks played a key role in financing states in times of war and crisis, such as the Bank of England financing the British government during the Napoleonic Wars. Another example is the period during and after World War II when:

Central banks became, once again, important institutions for financing and managing government debts accumulated during the war; and after the war, central banks also became important tools for rebuilding and restructuring national economies and providing for social needs, often under government's direction.⁸¹

In political circumstances like that in Palestine, a financial role such as this is needed more often than not. In the last five years Palestine had two wars in Gaza which left the population and the city infrastructure devastated. However, the PMA as seen in the previous chapter, was only able to help as much as its mandate allowed. The PMA offered some regulatory easing and minor

⁸⁰ Epstein, Gerald. "Central Banks as Agents of Economic Development." *Political Economy Research Institute*, September 2005.

⁸¹ *Ibid.*, 23

financial services to save either the banking system or the public sector. Unlike countries like the United States or any other that faces such tragedy, the Palestinian economy including the government, does not have a financial safety net for urgent aggressive spending. Although both the Paris Protocol and the Palestinian Authority issued Law 1997 recognize the PMA as the governments and commercial banks' bank, it falls short in meeting that responsibility due to its limited jurisdiction. It is thus unable to perform one of the central bank's very core responsibilities and that is to provide liquidity in times of absolute need. This leaves Palestine, both economically and politically under the mercy of outside finance to cover its needs. For example, in 2006, the political party Hamas won in democratic elections for the Palestinian Legislative Council after Fatah had run it for more than twenty years. In retaliation, Israel, along the U.S. and its allies, raised sanctions against the new Palestinian governing party. Israel's sanctions included the holding of Palestinian tax revenues, tightened border movement, and stopped all Israeli bank transaction going to the West Bank, and vice versa. In economic terms, that means the complete freeze of Palestine's main source of Shekels which is the dominant currency in the public sector. Consequently, the Palestinian economy went through a liquidity crisis. That meant the shutting down of most public institutions including ministries, schools and hospitals. To worsen the already tragic situation, the government's main source of income, foreign aid that is, was also ceased. Thus, the Palestinian government went bankrupt as all its means of income were disrupted. According to Mohammad Samhuri:

The decision by Israel in mid-February 2006 to withhold the transfer of Palestinian indirect tax money to Palestinian Authority coffers (an average of about \$60 million a month), along with the suspension by Western donors of their direct financial support of the PA

budget (an average of \$30 million a month), almost overnight resulted in a hefty 50% drop in the total funds available to finance PA monthly expenditures⁸²

This of course, extended the crisis to the private sector as public consumption sunk since most people in Palestine depend on public sector jobs which ceased making wage payment. If the Paris Protocol was to be properly implemented, the PMA would be able to support the Palestinian economy by targeting public consumption through expansionary measures which in return would at least soften the effects of exogenous politics on the Palestinian people's welfare.

Another contribution for central banks in developing economies is their ability to allocate credit and resources to facilitate growth in specific sectors in the industry. Epstein stresses the importance of such role, especially in economies like those of England and the U.S:

All central banks, including the Bank of England and the U.S. Federal Reserve have used direct means to support economic sectors. And this has not simply been a matter of historical aberration, but rather, it has been an essential aspect of their structures and behavior for decades on end. In particular, a crucial role for both the BOE and the Fed has been to promote the financial sector of their economies, and especially, to support the *international role* of their financial services industries. They have done this by using subsidized interest rates, legal restrictions, directed credit and moral suasion to particular markets and institutions⁸³

However, in the case of the PMA such tools are very limited if available at all. The monetary bank figure in Palestine does not have the capabilities to carry out special financial packages to stimulate growth in targeted sectors. Although the PMA has tried several financial easing methods to encourage growth in the banking sector, especially in the times of crisis, it could not provide directed credit or government subsidizes in the times of need. The only monetary transmission

⁸² Samhour, Mohammed. "Looking beyond the numbers: The Palestinian socio-economic crisis of 2006. *Middle East Brief* 16 (2007), 6

⁸³ Epstein, Central Banks as Agents of Economic Development, 5

mechanism the PMA has is its ability to set required reserve ratios for banks. Shaker Sarsour discussed this in depth as he tried to illustrate the relationship between exogenous monetary policies and the real economic indicators in Palestine. First he defined monetary transmission mechanisms as: “the process through which monetary policy actions and decisions are transmitted into changes in output and other economic activities.”⁸⁴ He then proceeds to discuss how the PMA affects real change in the economy through the monetary tools it possesses. Interestingly enough, Epstein touched on the use of variable “asset based reserve requirements” as a widely used method by central banks to conduct monetary policies. He said this “requires bank to observe minimum reserve requirements based on the assets they hold, but the central bank varies these to promote lending to desired sectors. They do this by allowing lower required reserve rates on privileged assets”⁸⁵ According to Article IV of the Paris Protocol, the PMA is the authority with the power to grant and announce liquidity requirements on all deposits in banks operating in Palestine. Thus leaving reserve requirements as the “only possible monetary policy through which the PMA could achieve its ultimate objective of price stability and growth sustainability”⁸⁶

Unlike all the different central bank roles Epstein discussed in his paper, from credit control, distribution of sources and allocation, the PMA can only perform a fraction of that. The PMA cannot set interest rates through discount rates or carry out open market operations, but it could encourage lending through minimizing the required reserve ratio. Of course, if it wants to decrease lending due to inflation targeting measures, it would increase the required reserve ratio thus leaving banks less margin to make deposits. However, according to the endogenous theory of

⁸⁴ Sarsour, Shaker. "Analyzing the Transmission Mechanisms of Monetary Policy in the Absence of a National Currency." *Middle East Development Journal*. Accessed February 12, 2014, 1

⁸⁵ Epstein, Central Banks as Agents of Economic Development, 14

⁸⁶ Shaker, Analyzing the Transmission Mechanisms of Monetary Policy in the Absence of a National Currency, 6

money, banking activities, including lending and borrowing, are independent from available reserves. Although the PMA uses this tool to the best of its ability, it however does not have the discretion to carry out the most basic central bank duties. According to Goodhart, the “essence of Central Banking lies in its power to create liquidity by manipulating its own balance sheet”⁸⁷ The PMA is then lacking the very essence of a central bank figure and that is the freedom and leverage to control its liabilities and credit distribution. Consequently, it is unable to conduct monetary policies, maintain price stability and control inflation, tackle unemployment, and most importantly “support the State’s financing needs at times of crisis.”⁸⁸

The Paris Protocol, an unfair marriage between Palestine and Israel in all means, was obviously structured to compromise the sovereignty of both Palestine’s political and economic affairs. It is important to draw the relationship between political independency and currency sovereignty. Similar to Colonial America, the British mandate declared the Currency Act for numerous political and economic motifs that are all summed up in its interest to control its American colonies by first establishing an economic dependence on the British economy and second by assuring the inability of America to run its internal affairs. This applies to every country that went through colonization including India, Syria and Palestine included. All these countries, except Palestine who is still suffering the repercussions of colonialism till this day, succeeded in breaking free from its colonial power. However, in most cases, the decolonization was rather complicated and that could be seen by the sequence of monetary regimes these countries adopted throughout the process. The reason behind such complications is due to the attempts by the colonial

⁸⁷ Goodhart, Charles A.E. "The Changing Role of Central Banks." *Financial Markets Group, London School of Economics*, 19

⁸⁸ *Ibid.*, 2

power to prolong its hegemony. Tcherneva said “often, the former colonial power would slow down the process of political independence [...] by instituting monetary arrangements that would undermine it”⁸⁹ She illustrated such tactics by examining the case of India which used its own issued currency, rupees, since 1862. Until the British mandate fully dissolved, India, like most colonized countries then, functioned under a currency board that would peg its currency to the Pound sterling. However, looking at all these examples, it becomes obvious that nothing short of state’s full currency sovereignty will grant a country’s political independence. As Tcherneva noted:

The very formation of the modern nation state has been inextricably linked with the process of establishing a unified sovereign national currency, which underscores the salience of having the ability to conduct the internal affairs of a nation, independently from external influence⁹⁰

It thus becomes evident that the purpose of the Paris Protocol was far from the intention to “establish a sound economic base for Israel and Palestine [...] by the principles of mutual respect of each other’s economic interests, reciprocity, equity and fairness.”⁹¹ On the contrary of laying “the groundwork for strengthening the economic base of the Palestinian side and for exercising its *right* of economic decision making”, the Annex designed a Palestinian economy where the government along its monetary authority are completely reliant on Israel’s political and monetary sphere. The absence of a Palestinian currency is one of many symptoms of a colonized country.

⁸⁹ Tcherneva, *Money, Power, and Monetary Regimes*, 11

⁹⁰ *Ibid.*

⁹¹ Paris Protocol, Preamble, 1994

Policy Implication

As concluded earlier, the monetary case of Palestine is very political in its nature. Thus, when discussing policy implications, one cannot ignore the sovereign limitations imposed on Palestine. A lot of literature offers alternative monetary regimes for the Palestinian economy but few take into consideration the lack of discretion the government has to implement such changes. Under the Oslo Agreements “the Palestine Authority is debarred from issuing its own currency as is constrained to remain dependent on a number of externally issued currencies”⁹² For this reason, we rule out whether Palestine is better off with a national currency or not, but rather, we examine possible alternative monetary regimes which the Palestinian Authority has the jurisdiction to implement. Such scenarios include functioning under a currency board, which would leave the Palestinian economy in a very colonialist-like structure, and thus defeating the very purpose of adopting new regimes. Another plan would be for the Palestinian government to fully dollarize its economy similar to countries like Ecuador or El Salvador. Although such arrangement would not necessarily grant the Palestine Authority more freedom to operate and run its internal affairs, it however softens the impacts of not being able to do so. Nevertheless for the purpose of weighing the different outcomes for such monetary regimes, we start with the latter, dollarization that is.

Dollarizing the Palestinian Economy

According to Karnovitz, the “concept of dollarization [...] refers to the full and official adoption of the United States Dollar as the currency used as legal tender for public, private

⁹² Karnovitz, An Assessment of Alternative Monetary Regimes for a Future Palestinian State: Dollarization versus a National Currency, 1

transactions, contracts, and bank accounts”⁹³ Then, for a dollarized Palestinian economy, the government has to declare the U.S. dollar as legal tender and most importantly as tax currency. However, if one is to observe other dollarized economies, a very unique feature surfaces regarding the case of Palestine. Countries like Ecuador and El Salvador who have been running under a dollarized regime for nearly two decades now, were both very interconnected with the United States’ economy prior to the dollarization act. Ecuador, for instance, exports most of its oil to the United States and thus receives all its payments in dollars. On the other hand, El Salvador is not closely tied to the United States by trade agreements but “a large component of its GDP derives from dollar denominated remittances.”⁹⁴ Which acts as a main component for dollar income. Those two examples do not apply to Palestine since it neither has trade agreements with the United States nor does it receive considerable amounts of dollar denominated remittances. However, the Palestinian Authority receives all of its foreign grants in dollars which contributed to approximately 36.7% of its total revenue in the year 2014. The lack of a central bank figure or any sort of monopoly over currency makes Palestine a unique case of economic independence. Ecuador and El Salvador both had their sovereign currencies prior to the dollarization act, whereas Palestine has never been granted such freedom so far. Consequently, the Palestinian Authority has been dependent on dollar denominated foreign aid since its establishment in 1994. Although such reliance hurts the fiscal stability of Palestine, it however, adds to the dollarization rationale since the income of dollars in Palestine has been somewhat consistent. Karnovitz presented a list of advantages and disadvantages for dollarization in general. Starting with the benefits of dollarization, they can be listed as such:

⁹³ Ibid., 3

⁹⁴ Ibid., 4

- **Reduced administrative costs** although such costs are not overwhelmingly high in the current framework the PMA functions under since it lacks the discretion to fully administrate its economy. However, if the Palestinian economy was to be dollarized it will ultimately rule out the ambiguity in the PMA's confused mandate.
- **Reduced risk of inflation** Palestine has been importing its inflation from Israel since the Paris Protocol. This perpetuated Israel's influence on Palestine as it further compromises the PMA's ability to carry out inflation targeting policies. As Sarsour stated, "inflation in Palestine is partially a function of Israeli prices. Hence, inflation targeting policies in Israel transmit themselves in the Palestinian economy."⁹⁵ Although dollarization will not necessarily change such phenomenon, since Palestine will remain importing its prices and inflation variable from exogenous monetary policies. However, as Karnovitz put it: "assuming the continued stability if not robustness of the US dollar, a dollarized economy would eliminate currency exchange risk and would send a strong signal to foreign investors that government policy is geared to long term growth and stability"⁹⁶
- **Reduced interest rates** having a three currency system with constant fluctuation among their values push banks to charge higher interest rates to compensate the risk of lending or holding deposits. Sarsour mentioned:

Rates are high compared to deposit lending rates in USA, Jordan, and Israel. This high margin is justified by the fact that there is no national currency and so the PMA cannot affect and does not intervene determining the interest rate; banks claim to be facing high risks therefore they increase the interest rate on loans and offer a low rate on deposits.⁹⁷

⁹⁵ Shaker, Analyzing the Transmission Mechanisms of Monetary Policy in the Absence of a National Currency, 4

⁹⁶ Karnovitz, An Assessment of Alternative Monetary Regimes for a Future Palestinian State: Dollarization versus a National Currency, 10

⁹⁷ Ibid., 11

However Karnovitz argued that “the adoption of a more stable currency would eliminate currency risk and result in lower costs of borrowed capital, and could serve to promote additional investment and economic growth”⁹⁸ Then one could assume that dollarizing the Palestinian economy would help eliminate risks associated with currency exchange which in return would reduce interest rates in the banking system.

- **Stability and integration** Palestine would benefit much more integrating its economy had it established any trading agreements with the United States. Dollarizing facilitates exports going to the United States and vice versa.

While the costs attributed to dollarization can be seen as:

- Loss of seigniorage benefits
- Loss of independent monetary policy
- Diminished role in preventing domestic bank failures
- Political and other symbolic costs

All the setbacks mentioned by Karnovitz following dollarization are being experienced with the current monetary regime. The PMA does not collect seigniorage from neither the Jordanian Dinar nor the Israeli Shekel circulating in the West Bank and Gaza strip. As mentioned before, the PMA cannot act as a lender of last resort or manipulate discount rates, which would completely limit its ability to prevent domestic bank failures. The PMA cannot properly conduct monetary policy either. As discussed by Sarsour earlier the PMA’s only monetary transmission

⁹⁸ Karnovitz, An Assessment of Alternative Monetary Regimes for a Future Palestinian State: Dollarization versus a National Currency, 6

mechanism is its ability to determine required reserve ratios which, according to the post-Keynesian school of thought, is ineffective.

Currency Board System

The Palestine-Israel Journal reviewed the history of the Palestinian monetary system for the purpose of comparing the current model to monetary regimes prior to the Israeli Occupation. In British-Mandated Palestine, a currency board system (CBS) was constructed and the Palestine Pound was issued against 100% sterling reserves. According to PIJ, Palestine had more monetary freedom functioning under a CBS than the current Paris Protocol produced system. They said, “The Palestinians have established the Palestinian Monetary Authority (PMA) which, according to the Paris Economic Protocol, is less than a Palestinian currency board system.”⁹⁹ The PIJ reviews the period when colonized countries like India and Palestine functioned under a currency board system. During those times, the British provision over the CBS to maintain full and free convertibility for the local currency into sterling, according to the PIJ was “extremely effective in preventing governments from resorting to domestic borrowing in order to finance their expenditure and, hence, contributed to the economic stability of countries under the CBS” (insert footnote, website) Although such limitations might protect Palestine from undergoing inflation caused by poorly executed expansionary measures, it however, keeps the PMA’s framework compromised and restrained. The PIJ acknowledges some of these setbacks, they said:

From the view point of the currency-issuing country, some disadvantages can be found from adopting the CBS. The monetary authority would be deprived of any authority to issue currency on discretion, or to control the activities of commercial banks, since most of these would be in favor of keeping most of their deposits in foreign assets abroad. The

⁹⁹ "Palestine - Israel Journal of Politics, Economics and Culture." Palestine - Israel Journal of Politics, Economics and Culture. Accessed May 03, 2016. <http://www.pij.org/>.

100% reserve requirement would also deprive the country of using its reserve abroad in executing development projects.¹⁰⁰

However, as mentioned before, these restrictions would have been highly considered had Palestine currently enjoyed full monetary sovereignty. Instead, with the limitation of a currency board system included, Palestine would still have more leverage in conducting monetary policy than the present regime. Thus, if Palestine was to hypothetically construct a CBS and adopt the Jordanian Dinar as the reserve currency it would benefit in several ways. First, if the Jordanian Dinar is stable, which it has been in the last decade, the Palestine Currency Board currency would be stable as well. This would boost confidence in the currency and thus encourage local investments and financing. Secondly, unlike any other monetary arrangement (with the exception of issuing a national currency) the currency board system would be able to extract some of the seigniorage which would be otherwise collected by the Central Bank of Jordan. The topic revolving seigniorage has been widely discussed by economists who studied the Palestinian monetary system. Numerous economists attempted to estimate the seigniorage revenues extracted from the circulation of the dinar and shekel in Gaza Strip by the Central Bank of Israel and the Central Bank of Jordan. All these different studies agree that if Palestine was to collect some of the seigniorage revenues made by the currencies circulating the West Bank and Gaza Strip, it would greatly add to the government's revenue which in return would increase its ability to expand its development budget. Thirdly, a PCB would gradually increase public confidence in Palestine issued notes, which in the long run would set the infrastructure for a fully sovereign national currency. The rationale behind constructing a currency board system is that it would not only grant relatively more freedom to implement monetary policy but to prepare and bring Palestine a step closer to

¹⁰⁰ Ibid.

issuing a national currency. If the same efforts shown by the PMA now to prove its competence amongst international institutions, was put in running a currency board, then it would gradually gain it more discretion as it proves itself trustworthy. PIJ noted that:

Once this system is established and proves efficient, it would be made more flexible by allowing the reserve requirements to be less than 100%. In such a case, the PCB, defacto the PMA, would be able to extend credit to banks and to issue notes with some discretion, i.e., the PCB would gradually turn into a monetary authority in the tradition of central banks. Even though such a flexibility of the PCB to create money would be limited, it would control inflation which prevents the need for devaluation and speculative attacks on the PCB's notes¹⁰¹

Thus, if the PCB continues to show consistent progress it has the potential to ultimately become a central bank in the same manner former currency board systems did. Nevertheless, such monetary transition will require much more than just decent performance since, as shown earlier, a lot of politics is involved when it comes to either the political or economic sovereignty of Palestine.

There is no definite policy the PMA can adopt to better the current monetary system since all these alternatives fall short into fitting the Occupation's political discourse. For this discussion to become more fruitful, a political reform, starting with the Paris Economic Protocol, should be implemented. As the PIJ stated: "A national currency issued and controlled by the Palestinian Monetary Authority is the only way out."¹⁰² In respect to ultimately fulfilling that objective, establishing a currency board system seems to be the most strategic monetary regime. Unlike a dollarization plan, the PCB can be abandoned if it turns out to be a failure, while dollarizing the Palestinian economy is a much greater commitment. As Karnovitz noted: "Because of the large impediments to reverse course once it is implemented, official or full dollarization is considered a

¹⁰¹ Ibid.

¹⁰² Ibid.

permanent decision”¹⁰³ A PCB is far from perfect, but it at least sets the course for a potential sovereign monetary system in the future.

¹⁰³ Karnovitz, *An Assessment of Alternative Monetary Regimes for a Future Palestinian State: Dollarization versus a National Currency*, 5

Conclusion

When I first decided to pursue research to seeking answers to questions few have asked, I did not know what to expect. I was certain of one thing: I was embarking on a challenge to find truths about a reality that I, and hundreds of thousands of others, share. Finding empirical data and evidence about monetary policies in Palestine was difficult, but confronting the results was even more difficult. Many times I doubted the purpose of this research. Not out of principle, but out of mere helplessness.

When people think of oppression, they think of the tangible realities that manifest themselves in apparent violence. It is true, the Occupation has erased most of Palestine and its history. It took land, dispersed people, imposed segregation, set checkpoints, and continues to strip every bit of identity a Palestinian has. But it did more than that. As history taught us, oppression comes in infinite shapes and forms. Beyond the bloodshed and violence is a system that defines the living standards of every Palestinian. Ours is an economic system designed and tailored by the Occupation to assure the stagnation of an entire civilization, with the intention to perpetuate its hegemony and domination.

Never had I thought about how oddly alien the idea of having a national currency is for the average Palestinian, because I dreamt about it too. Only when I came to the United States did I realize that, just like in any sovereign country, a currency is something everyone enjoyed the liberty of having – a liberty unfortunately not shared by the Palestinian people. This research, however, allowed me to view currency beyond just a symbol of statehood. Having a national currency is one of the many imperative components for economic prosperity. For decades now, Palestine's economy has been a bubble, inflated and burst in accordance with the will of others. The Paris Protocol was written to create a Palestine with no economic backbone. It struck the

perfect balance between giving Palestine just enough discretion with a half-baked central bank, combined with a cocktail of currencies to make its economy run, while absolving Israel from responsibility for its stability, but not enough discretion to allow it to thrive.

There is a reason why all past colonial powers compromised their mandated countries' ability to print their own currency or conduct monetary policy. It is the same reason why every colonized country sought the freedom to do so. As shown earlier, a state's sovereignty goes hand-in-hand with its monetary independence. A government cannot function without having a central bank figure to support its finances in times of need. Furthermore, a central bank needs a sovereign government for it to have the discretion to operate at its maximum capacity. If it is true that history repeats itself, then similarly to the American Revolution against the British Mandate and every other country that had to settle with anything short of full monetary and fiscal autonomy, Palestine should and will demand for a reform, starting with the Paris Protocol. As rooted and institutionalized as the Occupation is, time will call for a drastic change, as the current colonial regime only continues to provide the harshest of economic circumstances to Palestinians.

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