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A Currency Board for Palestine

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Abstract

Several scenarios can be suggested for the introduction of a new currency. The choice of a regime always—independent of the country's specifics—means a policy trade-off. This paper identifies key issues in determining what would be an appropriate exchange rate regime and monetary policy framework for Palestine. It suggests that a currency board arrangement (CBA) is the best of available practical options for Palestine today. The choice of a CBA as a monetary regime is driven by a desire to have a stable domestic currency. The introduction of a currency board must be regarded as a major systemic institutional change. It can be treated as a system of formal rules relating to money supply and monetary behavior that are imposed on all economic agents in Palestine. For success, a broad political consensus must be reached on a necessary framework. This raises, among others, complex political economy issues.

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1. **Following the executive summary below, this paper contains five sections:**

Executive Summary

2. **Compared with alternative monetary regimes, Palestine would benefit from adopting a currency board as a practical choice.** This would be driven by a desire to introduce a stable domestic currency. Such an arrangement would need to be underpinned by certain critical elements:

- Strong and broad domestic political support.
- Strengthened legal and institutional frameworks.
- Commitment to maintaining strict monetary and fiscal discipline.
- Choice of a strong reserve currency to be an anchor—the U.S. dollar.
- Trust of the Palestinian business community and general public at large.
- Steady support by the international community, including Israel.

3. **The introduction of a currency board can be regarded as a key systemic institutional change.** The CBA can be treated as a system of formal rules of money supply and monetary behavior that are imposed on all economic agents in Palestine. This may have far-reaching effects consequences that cannot readily be foreseen. It also raises major issues of a political economy nature that may jeopardize the entire framework.

4. **A currency board would commit the Palestine Monetary Authority (PMA) to maintaining a fixed exchange rate of the new currency by legally binding it to a convertible foreign reserve currency.** The obligation for it to buy or sell its currency at that rate ensures that its foreign currency reserves rise and fall at the same rate as the supply of its own currency.

5. **An advantage of the CBA derives from its legal foundation and, critically, the willingness of the government—the Palestinian Authority—to accept these conditions.** The linchpin is that the currency board rules commit the domestic currency to be fixed to the reserve currency. If the PMA holds 100 percent reserves against the domestic currency, then it is capable of keeping that commitment. With a viable CBA, people and businesses in Palestine and abroad would have confidence in the new currency; if deemed unviable, then not.

6. **It is important that Palestinian laws—on all levels—support the CBA by protecting the PMA from political pressures to lend to the government or to others.** High credibility of such a regime tends to reduce domestic interest rates relative to rates of the reserve currency because the risk that the domestic currency will be devalued or appreciated is sharply reduced.

7. **With an orthodox currency board, inflationary deficit financing becomes impossible.** As long as it is established and operated correctly, the Palestinian fiscal authority cannot force the PMA to buy its debt. In addition, foreign investors will be much easier to attract because of the near complete removal of currency risk due to depreciation or appreciation. In addition, interest rates necessary to attract domestic and foreign capital will fall sharply.

8. **But a price has to be paid for launching and upholding a stable trustworthy domestic currency by means of a currency board.** If domestic currency is used to buy imports, service foreign debt, or invest abroad, payment is made from these foreign exchange reserves, and the domestic money supply declines. Similarly, if foreign exchange is used to buy the country's exports, or to lend to or invest in the country, it increases the money supply when sold to the central bank for domestic currency. This role of the CBA as an "automatic stabilizer" has advantages as well as disadvantages.

9. **The more transparent the rules of the game, the less room for unsound policies.** The CBA is in essence a system for strictly rule-based control of money creation.

I. What Is a Currency Board Arrangement?

10. **A currency board arrangement is one of eight exchange rate regimes recognized by the International Monetary Fund (IMF).** The IMF defines it as:

> **Currency Board Arrangement:**
> "A monetary regime based on an explicit legislative commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate, combined with restrictions on the issuing authority to ensure the fulfillment of its legal obligations."

A. Key Features of Currency Board Arrangements

11. **Attractive features of an orthodox CBA are that the operational rules are simple to follow, and the institutional costs are low.** Streamlining monetary operations under such a regime can highly simplify the system and reduce the need for heavy technical support. Although a CBA against a basket of currencies is feasible, countries tend to establish CBAs against a single convertible currency—the reserve currency that functions as an anchor—because these are technically easier to establish, more transparent, and thus more appealing. In this way, the reserve currency is the currency to which the domestic currency's exchange rate is fixed not just by policy, but by law.

12. **Maintaining a 100 percent reserve currency coverage of backing of the outstanding stock of domestic currency implies that an orthodox currency board passively buys and sells its currency at a fixed exchange rate for its reserve currency in response to market demand.** Because the central bank passively accommodates the needs of the market, there should be no monetary policy to formulate. The demands on the central bank's policy capacity are minimal. The outcome of the process should be predictable by the market.

13. **Such a definition of an orthodox currency board eliminates many traditional central bank functions and leaves little scope for discretionary monetary policy.** No surprise then that, in its earlier history, a CBA was typically run not by a "central bank," but by a "currency board" or a "monetary authority." An orthodox CBA was strictly focused on ensuring that: (i) domestic currency would only be issued against foreign assets; and (ii) domestic currency remained fully backed by foreign assets. All very simple, clear, and practical.

14. **More recently, a number of other modern currency boards are called central banks and are legally bound to currency board rules.** These "currency boards" are central banks because they do accept deposits from banks, which banks use for interbank payments and settlements, and for purchasing and redeeming currency from the central bank.

15. **So, over time, CBAs in several countries have evolved beyond those original ideas.** After the collapse of the Soviet Union, it became fashionable and some central banks in Eastern Europe adopted currency board rules that infringed on a variety of key aspects, such as:

- **Coverage of backing**—In Bulgaria, this not only included 100 percent of the monetary base[1], but also the government's fiscal reserves; in Lithuania, it was 100 percent of currency plus the liquid liabilities of the central bank of Lithuania.
- **Monetary control**—For the banks in the three countries, all central banks applied the monetary policy tool of reserve requirements; in the case of Estonia, liquidity requirements were additionally used.
- **Central bank bills**—In Estonia, the central bank, for a time, issued certificates of deposit with a view to increase collateral that could be use in the interbank market.
- **Lender-of-last-resort**—a facility not allowed in an orthodox CBA—was allowed in Lithuania but limited to the amount of foreign exchange in excess of backing requirement. It was allowed also in both Bulgaria and Estonia but restricted to systemic and emergency situations while limited to the amount of foreign exchange in excess of backing requirement.

16. **So, in recent decades, more than one well-defined type of CBA has evolved.** This has also been recognized by the IMF, noting that "…. Some flexibility may still be afforded depending on how strict the banking rules of the specific CBA are…."

B. Problems with Currency Board Arrangements

17. **It must be recognized that there are also risks and problems associated with losing all policy discretion by giving up the ability to intervene and change the exchange rate or to alter domestic liquidity against the market's will.** In a CBA, the central bank loses all ability to control the expansion or contraction of the money supply since the money supply can expand or contract only as foreign exchange is sold to or purchased from the central bank at the initiative of the market. Foreign exchange flows in due to export earnings, capital inflows, and other foreign investment, and out due to imports, capital outflows, or investment abroad. In the case of a loss of export earnings or a capital outflow, the resulting monetary contraction could raise interest rates and cause output to fall and also unemployment to rise.

18. **Furthermore, a risk of an exchange rate collapse—albeit small—remains since a fiscal default could cause the currency board to break its legal commitment to the exchange rate.** For this to happen, the currency board arrangement would either no longer have the support of the government, or if the 100 percent reserve backing is no longer available.

C. Early Currency Boards

19. **In the 19th century, currency boards were common since they were operating in lieu of formal central banks.** At one time, CBAs, existed in over 70 countries and territories.

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[1] The monetary base (M0) includes: (i) total currency in circulation in the public; plus (ii) currency held in vaults of banks; plus (iii) the banks' reserves held in the central bank.

Currency boards became particularly common in the expanding British colonial empire. It became a convenient way for the Bank of England to extend its influence without having to physically locate to distant places. The technique of issuing local currency fully covered by the backing of the British pound sterling as reserve currency was already used by private Scottish and Irish banks in their respective parts of the United Kingdom.

20. **After Palestine was declared a British mandate by the League of Nations after World War I, a formal currency board was established.** The Palestine Currency Board was established in London in June 1926 and stopped operating in May 1948. It issued banknotes and coins as legal tender for Palestine from November 1927 to May 1948; the currency continued in circulation until March 31, 1952. The Palestine pound was at par with the British pound sterling and divided into 1,000 mils. It was abbreviated as £P or LP. Banknotes were issued in six denominations, from 500 mils to £P100; coins in eight denominations, from 1 to 100 mils. All denominations were trilingual in Arabic, English, and Hebrew, as can be seen on the one £P1 banknote depicted below.

D. "Second-Generation" Hybrid Currency Boards

21. **As previously mentioned, CBAs also became interesting and fashionable in Eastern Europe after the collapse of the Soviet Union and the subsequent break-up of Yugoslavia.** Several countries chose CBAs for their new monetary arrangement. Early examples of such countries were Estonia (1992), Lithuania (1994), Bulgaria (1997), and Bosnia and Herzegovina

(1998). Within the "second-generation" CBAs, the scope for discretion stems from the presence of atypical items in the balance sheet and the actual use of monetary policy instruments.

22. **In this, the CBAs adopted by these transition economies differed significantly from orthodox CBAs that were typical of the colonial age.** By preserving some elements of central bank discretionary policy (to various extents), they allowed for deviations from the orthodox framework. In this way, the exchange rate regimes maintained by Bulgaria, Estonia, and Lithuania in the 1990s constituted in some ways a hybrid arrangement with aspects both of a dollarized arrangement and their own currency.

23. **In these three countries, the requirement that commercial banks keep obligatory minimum reserves was maintained, in one form or another, representing another aspect of the hybrid nature" of the "new CBAs."** In Lithuania and Bulgaria, further deviations from the orthodox form of the currency board were significant in that the governments held their accounts at the central banks. This influenced the size of the stock of reserve money, meaning that they conducted a form of quasi-monetary policy. Some economists even denied the existence of the currency board in, for example, Lithuania and saw in essence the Lithuanian system as a normal system of a fixed exchange rate with certain limitations on money supply.

24. **In Estonia in the very early 1990s, a simultaneous introduction of its own currency and the establishment of a currency board enabled the country to move directly from the zone of the Soviet ruble to an independent currency.** The Deutsche mark was used as reserve currency, as later also was the case in Bulgaria. The new currency should have been backed 100 percent by the reserves of the reserve currency, but this was initially not the case. There was no transition period with a discretionary central bank, no active monetary policy, and no parallel and transition currencies as in the other Baltic countries. When Estonia initiated the introduction of a CBA by itself, it was initially opposed by the IMF. On the other hand, when Lithuania, and especially Bulgaria, took steps toward currency board establishment, they were under pressure from the IMF to do so.

25. **The experience of these three transition economies more generally shows that several motives determine the establishment of a CBA.** It was mainly for the purpose of:

- Building up credibility for a newly created domestic currency, and it enhanced monetary sovereignty after the country left the ruble zone—case Estonia.
- Following other countries with similar economic structures, where this monetary regime had been implemented and operated successfully—case Lithuania.
- Replacing a discretionary central bank in order to restore confidence in the domestic currency and to overcome a deep financial crisis—case Bulgaria.

26. **A key factor in the success of the CBA is fiscal discipline**. Estonia and Bulgaria maintained sound and disciplined fiscal policies, which contributed to the currency board's success while in Lithuania the CBA experienced problems due to loss of fiscal discipline.

C. Legal Requirements

27. **Creating an appropriate legal basis is critical for a sound foundation of a currency board.** The adoption of a new monetary regime should be imbedded into a revised legal framework to be credible. Instruments for consideration include:

- **The Constitution**—Generally speaking, all laws (decrees) passed by the parliament (government) must derive from the constitution, or a similar high legal act. For the issuance of the new legal tender, the constitution should also define some crucial elements of the new currency. This could, for example, include the name of the currency, name of the institution issuing the currency, and official language(s) that need to appear on the banknotes.
- **The Central Bank Law—**This law should regulate the issue of the legal tender currency and the symbol of the central bank that could also be used as a security feature on the banknotes. In addition, it can also regulate issues such as who is in charge of issuing (printing) banknotes and minting coins.
- **Payments Law**—All payment related transactions in the new currency among the central bank, commercial banks, and their clients should be regulated by the law.
- **Law Regulating Changeover**—A separate special law may be needed to regulate all transition related issues such as date, eligibility, overall conditions, etc. In order to minimize the potential negative impacts of the changeover, final details of this law should not be known too early although some level of certainty must be provided.
- **Central bank decrees, instructions, circulars, etc**.—Issuance and withdrawal of banknotes and coins needs to be regulated by separate decrees, etc. published in an Official Gazette.

28. **Since the size of the reserve currency mathematically decides the size of the monetary base, correct accounting is essential in a CBA.** Accordingly, the relevant precise accounting requirements should be regulated in legal instruments.

D. Deciding the Reserve Currency

29. **Only a few major currencies qualify as reserve currency in a CBA.** They need to be:

- Convertible—highly useful in international transactions.
- Stable—ideally with a track record of sustained low domestic inflation.
- Liquid—having a deep resource base and active trading.

30. **In recent history, only very few currencies have been in active use as CBA anchors.** The totally dominant one is the U.S. dollar, with the euro (previously, the Deutsche mark), and the Singapore dollar accounting for less than a handful of countries. Over time, it is not unlikely

that the Chinese yuan may be used for this purpose and perhaps also a future joint currency of the Arab Gulf states.

31. **An accord should be concluded between the two monetary authorities.** This would define the respective expectations in terms of facilities, services, and fees, which would greatly facilitate future smooth operations.

32. **The ratio between the domestic currency and the reserve currency also should be decided.** In some cases a parity of 1-to-1 may be logical as was the case of the erstwhile Palestine pound and the sterling. However, in most cases, differences in average wages and the general cost of living between the two economies may well suggest a different ratio.

E. Exiting a Currency Board Arrangement

33. **Countries exit currency boards for very different reasons, which will not be elaborated upon here.** A quick survey, which makes no claim to being complete, identifies three groups based on type of exits:

- **Forced exits from weakness**—Argentina (1914, 1929, 2001), Sudan (1960), Yemen (1969), and UAE from its pseudo-currency board (1980).
- **Exits under moderate pressure**—Qatar (1973), Fiji (1973), Bahrain (1974), Oman (1975).
- **Voluntary exits**— Ireland (1961), Malaysia (1973), Singapore (1973), Bahamas 1974, Estonia (2011), Latvia (2014), Lithuania (015).

II. What Are Alternative Exchange Regime Options?

34. **Many factors influence the appropriate choice of an exchange rate regime.** There is no single exchange rate regime that is right for all countries and economies at all times. Moreover, the choice of one or another system does not replace the need for consistency in the overall economic policy.

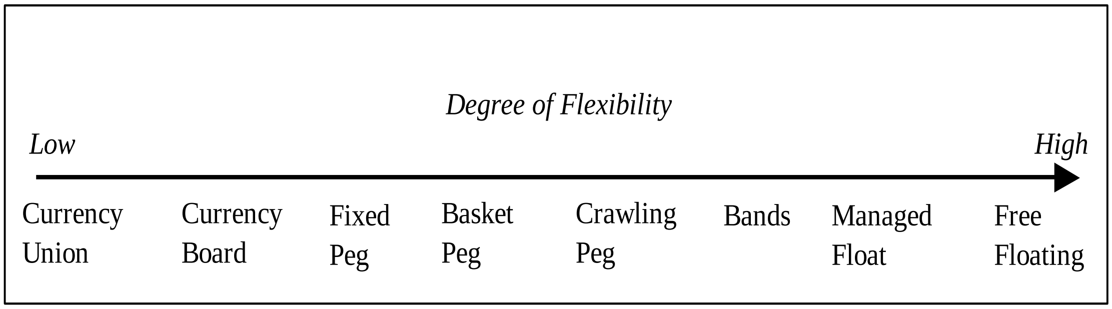
35. **Every country has (at least) one currency—its own or somebody else's.** The technical term for using another country's currency is dollarization—whether or not that particular currency is, for example, the dollar or the euro.

36. **Generally, a central bank can choose between different types of exchange rate regimes.** The regime choices revolve around the type of commitment the central bank is prepared to make. Such a decision is often not only for a central bank to make since a government typically will ultimately have to approve the type of regime adopted. Moreover, to be successful, the government must be fully committed to whatever exchange rate system is adopted. **The choice of a regime always—independent of the country's specifics—means a policy trade-off.**

A. Policy Trade-Offs

37. **Discussions regarding the choice of an appropriate exchange rate regime have often evolved into a polarized world with either fixed or floating exchange rates.** The “fixed versus floating” exchange rate debate, however, is an oversimplification. There is, in fact, a continuum of flexibility, along which it is possible to place most exchange rate regimes (Figure 1).

Figure 1: Continuum of Exchange Rate Systems



38. **Some of these eight options will be elaborated on in this paper.** A currency board was already discussed in the previous section. The ones briefly covered are the regime offering the lowest degree of flexibility—currency union—followed by dollarization—in important aspects a subform of a currency union—and lastly the one with the highest flexibility—free floating.

39. **A currency union represents the firmest commitment possible to a fixed exchange rate regime.** Here a country or economy does not have a separate legal tender and instead shares the same legal tender with a group of countries, forming a currency union. The adoption of the euro in January 1999, by 11 European economies, is a well-known case. In a currency union, the currency that circulates domestically is literally the same as in another country.

40. **Dollarization can be listed as a special form of currency union.** This is because also in this case, the currency that circulates domestically is literally the same as in another country or economy, but the dollarized country has no control over the currency. Dollarization can also encompass two or more external currencies in a specific country; this is very much the situation in Palestine. A few other examples of currently dollarized economies are those of Kosovo and Montenegro, Timor-Leste, and Ecuador.

41. **Among the exchange rate regimes, dollarization is the least difficult to implement.** The credibility of this regime derives from that of the foreign currency chosen. In either situation—currency union or dollarization—because the authorities eliminate the domestic currency, they effectively do away with an independent monetary policy. The central bank still has important functions to play such as managing the payments system and supervising banks, but it does not issue its own currency and has no need to set an exchange rate.

42. **Free float: under an independently floating exchange rate regime, the exchange rate is freely determined in the foreign exchange market.** A prominent example of an economy with this exchange system is the U.S.A. A free float is rarely absolute, but any official intervention in the foreign exchange market that still may occur is aimed at preventing undue volatility in the exchange rate.

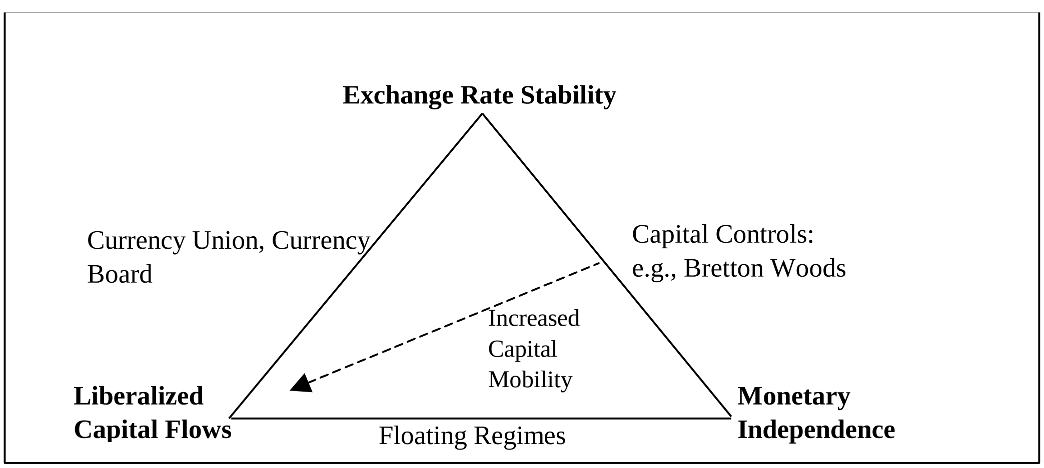
43. **Alternatively, a central bank can commit to a pegged exchange rate regime for its own currency without committing to a currency board.** It can also peg (or target) an exchange rate that it is free to change from time to time depending on circumstances. Another possibility is to target some other nominal policy anchor—such as the quantity of money or inflation directly—and allow the exchange rate to be determined freely in the market.

B. "The Impossible Triangle"

44. **In choosing an exchange rate regime, all central banks and governments face the dilemma that they must choose between two of the three policy goals.** Desired attributes of any exchange system are often identified as exchange rate stability, monetary autonomy, and financial market integration, but all these cannot be achieved simultaneously**.** If countries are open to international capital flows, this policy conflict, which is commonly known as "the impossible trinity," demands a trade-off. This tends to narrow to the choice between exchange rate stability and monetary independence, that is, the degree of exchange rate flexibility.

45. **The problem of choosing an exchange rate regime is schematically illustrated by Figure 2 below.** Each vertex of the triangle shows one desirable feature of an exchange rate regime; each side of the triangle, which corresponds to the choice between two of these three features, indicates a possible regime. The general trend of financial integration along with the abandonment of capital controls has pushed most countries into the left-hand corner of the triangle. If one is at this corner, the choice is limited to a simple decision regarding the degree of exchange rate flexibility.

Figure 2: "The Impossible Trinity"



46. **Some economists see in "the impossible trinity" an explanation for why intermediate regimes between floating and fixed exchange rates have vanished in recent decades.** Large and advanced economies (the U.S., Japan, the Euro Area) and some other advanced economies are reasonably comfortable choosing liberalized capital flows and monetary independence and are, therefore, letting their currency float. The reason is that with small trade shares, little foreign debt, and credible policymakers who make investors trust in the long-term soundness of the economy, these economies can cope with large exchange rate swings. Some smaller advanced economies also seem to be able to deal with this choice, although with some challenges.

47. **For emerging market economies, the option of a floating exchange rate is becoming far less plausible.** The burden of foreign currency debt and the risk of inflation from massive currency overshooting make the floating regime side of the triangle unacceptable to many small emerging market economies. So, with increased capital mobility, small and open economies are facing a situation wherein they have to decide between two extreme options either completely fixed—currency union or currency board—or flexible exchange rates—managed or free float.

C. Pros and Cons

48. **Determining the advantages and disadvantages of a fixed compared with a flexible exchange rate can be a complex matter.** Structural and economic characteristics of a country have an impact on the choice of what is an appropriate regime. Table 1 below presents a general summary of the advantages and disadvantages of the previously discussed exchange regimes.

Table 1: Pros and Cons of Alternative Exchange Rate Arrangements

(The pros and cons of alternative exchange rate regimes are compared relative to dollarization)

Exchange Rate Arrangements	Advantages	Disadvantages
Dollarization (a variety of currency Union; with dollar)	• High credibility of currency union with a stable currency. • Importing U.S. low inflation. • Reduces severity of shocks. • Reduces trade transactions cost. • Dollar is a better anchor currency since regional economies are largely dollar-based.	• Extra cost for implementation. • No independent monetary policy. • Loss of seigniorage; inability to act as lender-of-last-resort; inability to provide economic stimulus during downturns. • Erosion of external competitiveness, if trading partners maintain relatively flexible exchange rate policies with respect to dollar.

Exchange Rate Arrangements	Advantages	Disadvantages
Currency Board (with dollar)	• Retains all the advantages of dollarization. • Limited seigniorage ability (if currency board is only partial).	• Same as those under dollarization except for seigniorage. • Potentially lesser degree of credibility than full dollarization.
Floating Exchange Rate Regimes (independent float or managed float)	• Autonomous monetary policy. • Exchange rate can automatically adjust to terms-of-trade shocks. • Discourages excessive exchange rate risk taking (more relevant with further development of the financial market).	• Increased uncertainty related to the volatility of the exchange rate. • Risks of high inflation—pass through effects from exchange rate to domestic prices, unless an explicit and credible inflation targeting policy is adopted.

49. **Moreover, the choice of a domestic currency places various degrees of importance on the capacity of the central bank.** It needs to be able to control its balance sheet and to evaluate economic and financial conditions in order to maintain a stable value of the currency if a flexible exchange rate regime is chosen. However, with a currency board arrangement—as well as with dollarization or a currency union—this does not become an issue.

III. Why Choose a Currency Board for Palestine?

A. Key Economic Characteristics

50. **Structurally, the Palestinian economy is small and open, highly dependent on trade with Israel and neighboring economies.** The domestic currencies of those economies—Israel, Jordan, the Gulf states, Egypt—are either pegged to the dollar or regard the dollar as key currency.

51. **The Palestinian financial system is also heavily dependent on remittances, often from the Arab Gulf states, as well as on grants and development assistance from international organizations and western countries.** Those financial inflows are primarily denominated in dollar or euro. Further key characteristics of a country that prominently impact the choice of what is an appropriate exchange rate regime are presented in Table 2.

Table 2: Economic Characteristics and their Implication for the Choice of Monetary Regime

Characteristics of the Economy	Implications for the Desired Degree of Exchange Rate Flexibility
Size of economy	The smaller the economy, the weaker the case for a flexible rate.
Openness	The more open the economy, the less attractive is a flexible exchange rate.
Concentrated export/ production/structure	The more concentrated the economy, the more appropriate is a flexible exchange rate.
Geographic concentration of trade	The larger the proportion of an economy's trade with one large country or a group of countries with currencies pegged to that large country, the greater is the incentive to peg to the currency of that large country.
Divergence of domestic inflation from world inflation	The more divergent a country's inflation rate from that of its main trading partners, the greater is the need for frequent exchange rate adjustments. For a country with high inflation, a fixed exchange rate may provide greater policy discipline and credibility to successfully maintain a stabilization program.
Labor market flexibility	The stickier wages and prices downwardly, the greater is the need for a flexible exchange rate to help the economy to adjust to external shocks.
Capital mobility	The higher the degree of capital mobility, the more vulnerable are rigid exchange rate regimes.
Credibility of policymakers	The lower the anti-inflation credibility of policymakers, the greater is the attractiveness of a fixed exchange rate as a nominal anchor.

52. **The conclusions from Table 2 largely support the choice of a fixed exchange rate regime rather than a flexible one for Palestine.** Other factors also underpin a stand in favor of a currency board for Palestine.

B. Key Points for a Palestinian Currency Board

53. **The six points below summarize the main reasons why a currency board should be chosen for Palestine in combination with the introduction a domestic currency rather than any other exchange regime.** These points are further elaborated upon in the following.

- **A symbol** with overwhelming political support will be created with the launch of a new domestic currency.

- **Stability of the domestic currency** can be expected if the currency board had broad political and public support and was underpinned by legislation.
- **Selecting the dollar as reserve currency** will underpin public confidence in the domestic currency and its unconditional convertibility.
- **Fiscal discipline in government** will strengthen as borrowing from the PMA by the Finance Ministry and state agencies on different levels will not be legal.
- **Administrative simplicity for the PMA** in operating the currency board will be enhanced compared to using alternative exchange regimes.
- **Seigniorage generated**, that is, revenue from the circulation of the domestic currency—banknotes as well as coins; impossible obtain with full dollarization—will benefit the PMA and the budget.

A. Symbol for National Aspirations

54. **The fundamental political argument for introducing a currency board is to realize the symbolic ambition of establishing a domestic currency.** In principle, such an ambition could also be realized by adopting some form of floating exchange rate regime for the new currency. This would require more complex and challenging institutional and technical capacity than is not readily available in Palestine.

B. Stability of the Domestic Currency

55. **Choosing a floating regime will, however, generate considerable risks with respect to the exchange rate stability of that new domestic currency.** On the other hand, establishing a currency board and following its orthodox rules without exception will, per definition, provide the domestic currency stability vis-à-vis the chosen reserve currency.

56. **Using a foreign currency imports the track record of stability of the currency chosen.** This can establish currency stability immediately and without the need for domestic monetary policy capabilities**.** The credibility of the monetary regime is established almost immediately with a very high degree of public confidence.

C. Selecting the U.S. Dollar as Reserve Currency

57. **The dollar would be the best choice as the reserve currency to anchor the currency board.** In the West Asia region and beyond, it is widely recognized as the strongest and most liquid international currency. The euro could be a candidate, but that currency is far less used in Palestine and the general region. A future joint currency for the Arab Gulf countries could be very interesting but remains today just a project. The use of the dollar would ensure a stable value for the currency without concern for any lack of domestic data and/or capacity in the central bank. It is an automatic, market driven system, which is one of its greatest attractions.

D. Fiscal Discipline in Government

58. **Operating an orthodox currency board removes any possibility for financing government expenditures by printing money.** This is almost universally considered an advantage because the possibility of central bank lending to the government has historically often proven an irresistible temptation with well-known inflationary consequences. With deficit financing made impossible, inflationary expectations would be reduced.

59. **The authorities should be recommended to reject establishing a "second-generation" CBA or to consider or operate any other hybrid form of currency board.** This is because of the risks to the public confidence in the exchange rate regime and to the perception of its effect on the stability of the domestic currency.

E. Administrative Simplicity for the PMA

60. **A primary advantage of central banks with currency board rules is the ease with which they can be administered, requiring very little capacity, which would greatly benefit the PMA.** A system with flexible exchange rates would demand complex monetary policy considerations to control its balance sheet and to evaluate economic and financial conditions in order to maintain a stable value of the currency. The PMA, at present, has no experience of this. Moreover, many smaller central banks around the world find those tasks extremely challenging. Often, they fail, destabilizing not only the domestic currency but also the economy at large.

F. Seigniorage Generated

61. **In its simplest form, seigniorage can be viewed as the difference between the value of money and the cost to produce it**. In this way, seigniorage may be considered as revenue for a central bank or government when the money that is created is worth more than the cost of producing it. This revenue is often used by central banks to finance a portion of their expenditures and by governments to do the same without having to collect taxes.

62. **Expressed differently, seigniorage can be seen as the amount of real purchasing power that a government can extract from the public by printing money**. This view is based on the following reasoning. When a central bank issues its own currency, it is in essence borrowing interest-free since it receives value in exchange for its liabilities (money) and must accept the money in return only at some future time. It may have further gains if issuing new money reduces through inflation the value of old money by reducing the liability that the old money represents. These gains to a money-issuing authority are seigniorage revenue.

63. **Seigniorage is measured differently for coins than for banknotes.** Seigniorage derived from coins arises from the difference between the face value of a coin and the cost of producing, distributing and eventually retiring it from circulation. As banknotes exist as a demand liability

on the central bank's accounts, the seigniorage derived from them is the difference between the interest earned on the asset portfolio backing the banknotes in circulation, and the costs of producing, storing, and distributing banknotes.

64. **With a currency board, the PMA will be able to accumulate seigniorage—the greater the amount as the use of the domestic currency increases.** In the existing situation in Palestine of total dollarization with several competing foreign currencies, the PMA is attracting no seigniorage at all. In the past, there have existed examples of countries where the value of seigniorage has amounted to several percent of the gross domestic product. Even if such numbers should not be expected for the PMA, this is still a major additional reason why establishing a currency board would make sense for Palestine.

G. Currencies Co-Circulating in Palestine

65. **Today, the exchange regime in Palestine can best be characterized as *de facto* dollarized with not one but several foreign currencies actively co-circulating.** The four key foreign currencies are:

- **The Israeli shekel**, which is typically used for most transactions, especially retail. It is now the main currency used in Gaza, where previously the Egyptian pound dominated and is the most important cash currency in circulation in the West Bank.
- **The Jordanian dinar**, which is often used for durable goods transactions and for savings. It is also used in payments for border trade with Jordan and in financial contacts with the sizeable Palestinian diaspora in that country.
- **The U.S. dollar**, which is used as a store of value and for purchases of foreign goods. It is often the ultimate unit of account when setting prices for transactions in other co-circulating currencies. It dominates in international capital transfers to Palestine and is used for the overwhelming majority of transactions overseen by the PMA.
- **The euro**, which plays a more modest role but, over time, is increasing in importance. It is often used for trade with countries in the Euro Area and for remittances from Europe.

66. **For the Palestinian economy, actively dealing with as many as four competing foreign currencies is not optimal from an efficacy point of view.** An introduction of a domestic currency as part of a currency board with the most commonly used reserve currency as anchor would raise the promise of streamlining the use of cash currency, and also simplifying noncash payments systems.

IV. How to Establish A Currency Board in Palestine?

67. **For years, many Palestinians have aspired to have a currency of their own**. Around the world, a currency is often seen as a powerful symbol for the land and its people. A stable, respected currency is a major public good and critical for development of economic and social

life. It also holds the promise of bringing an amount of confidence and trust in the economy and the future. The motivation for a new currency may often be the result of political rather than economic considerations, but in the case of Palestine the two combine.

68. **A currency of one's own can provide a unifying symbol, which can contribute to strengthening the sense of identity**. Policies that establish a stable and predictable value for the currency facilitate economic recovery and development and the efficient allocation of resources. A stable currency and efficient payment systems contribute to the ability to engage in commerce throughout an economy, which may contribute to nation-building.

69. **A stable currency is also a reflection of the rule of law and contributes to confidence in the state.** The failure to achieve this objective undermines recovery and economic development, but because of its highly visible and fundamental nature as a basic function of a state, such failure can undermine efforts to establish or reestablish a credible state more directly.

70. **In principle, the move to a currency board is a relatively easy step from dollarization.** A currency board has virtually the same inflation and discipline advantages as dollarization but allows the country to capture the seigniorage profits from issuing its currency. Such a move will not happen by itself, however, but only after planning and preparations.

A. Change Process

71. **The functioning and especially the introduction of a currency board needs to be looked at from a political economy perspective .** Currency board introduction itself is an extreme institutional change, which should be seen not only in financial and macroeconomic terms. This change can be regarded as a struggle between different groups of economic agents striving to impose an institutional framework that supplies them with the greater part of the wealth of the economy. The currency board provides a convenient "laboratory" opportunity for exploring the impulses for, and the dynamics of, an institutional change in the monetary regime.

72. **The successful adoption of such a currency will depend on the confidence that key groups have in the stability of its value.** These include the general public, the business community, and the financial sector in Palestine but also the international community at large. It will also depend on how well the public has been informed about the exchange regime and the terms and arrangements for the use of the domestic currency vis-à-vis other existing currencies in general circulation in Palestine.

73. **A decision to launch a domestic currency, as one part of establishing a currency board, must be a national choice**. The choice of a CBA as regime is usually driven by the desire to introduce a stable domestic currency. This can be perceived as a symbol of national aspirations and a breakaway from the existing financial, economic, and political framework. Overwhelming political support must be secured, which may take considerable time. To be

successful, those discussions in political circles should be supported by technical presentation of alternatives.

74. **The PMA should be in charge of most of that technical work.** This, in turn, could be underpinned by external technical assistance on an as-needed basis. The Monetary and Capital Markets Department of the IMF would be well-suited to provide such advice both on the steps necessary for introducing a currency board as well as launching a new domestic currency.

75. **The general population and the business sector and local financial system must be part of this change process.** The CBA can be treated as a system of formal rules of money supply and monetary behavior that are imposed on all economic agents in Palestine. One aspect to keep in mind is that the maximum efficient functioning of the currency board requires full liberalization of the economy. That is a tall task to manage in any country around the world.

76. **The introduction of a currency board combined with a new currency should also be regarded as a fundamental systemic institutional change.** It should be noted that the introduction of a currency board will be perceived by some as a means to establish and strengthen financial discipline in the public sector and the economy as a whole—and correctly so. At the same time, the successful provision of a stable currency and the promotion of an efficient means of payment will lend credibility to the Palestinian Authority. It should also be underscored that a future introduction of a currency board combined with the new domestic currency *de facto* will bring a new source of income—seigniorage.

77. **In preparation for the introduction of a domestic currency as part of a CBA, the authorities need to take a number of steps in various areas.** Four of these are discussed here.

B. Legislative Framework

78. **Strengthen the legal base of the Palestine Monetary Authority.** The PMA was not established by a constitution, but originally by presidential order of Yasser Arafat—the 1997 Law on the Palestine Monetary Authority. Under Article 5, sub. 1 of the 1997 Law, the PMA is empowered to: "….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 reserve….". It is not clear that a 'law on issuing currency and securing the required cash reserve' was ever promulgated. If that were the case, it can be questioned if Article 5, sub 1 itself provides a sufficient legal basis to issue a PMA regulation on the handling of domestic cash currency.

79. **A subsequent Basic Law of 2003 (with amendments up to 2005) provided further clarifications of PMA's task, but the legal base remained rather weak for a modern monetary authority.** The institutional framework should be enhanced prior to the introduction of a new currency and a strict legal framework of the currency board's operations in Palestine.

80. **Draft laws and regulations should be prepared to ensure that domestic currency can be used as:**

- **A unit of account in the budget of the Palestinian Authority and in its fiscal records.** It should be a requirement for all public sector entities. The private sector should have freedom of choice combined with a requirement that financial accounting for activities subject to taxation by the Palestine authorities must also be presented in the domestic currency. In addition, retail prices must also be set in that currency.
- **A medium of exchange in official payments.** The Palestinian Authority should use the domestic currency in its fiscal operations (some exceptions may be permitted). Payments from the budget in the domestic currency should prominently include payments of public sector wages and salaries, public procurements, etc.
- **For obligatory payments.** All compulsory payments from the public should be made in the domestic currency. These will include items such as taxes of all types, public fees, utility charges, penalties, etc. An exception could be made for customs duties, where a continued future inflow of revenue in the reserve currency as well as other convertible currencies could be secured.

81. **As a prerequisite for having the new currency broadly accepted in the Palestine economy, the government and the PMA should declare the domestic currency "legal tender."** This means that in Palestine the settlement of a debt through payment of this currency cannot legally be refused. But the parties could voluntarily agree to make the payment through the use of other currencies, should individuals or corporate entities so choose.

C. Future Use of Foreign Currencies

82. **When the domestic currency has been launched, one should not expect that the use of other currencies would disappear, or even that their direct role perhaps may quickly and dramatically diminish.** To outright ban, or formally restrict, the use of other currencies would be contrary to strengthening the open character of the Palestinian economy.

83. **Maintaining "freedom of choice" with respect to the use of any currency** for people as well as the business community would importantly indicate a strong commitment to a future open, market-based Palestine economy.

D. Role of the Palestine Monetary Authority

84. **A future orthodox currency board in Palestine should be based on five main pillars:**

- A fixed exchange rate of the domestic currency and the reference currency, the dollar, at a ratio to be decided.
- A 100 percent backing of foreign assets for the currency board's liabilities; the net domestic currency issued by the PMA.

- The PMA's willingness and unconditional ability to maintain the official rate of conversion between the domestic currency and the reference currency.
- The combined Palestine authorities' unwavering support of the CBA.
- Full convertibility/free reversibility of the domestic currency to the reserve currency.

85. **To lay the foundations for the operations of a new domestic currency, the PMA will need to negotiate early accords with two central banks: the U.S. Federal Reserve and the Bank of Israel.** With the U.S. dollar as the reserve currency, an agreement with the Fed is likely to also involve the U.S. Department of the Treasury directly. The negotiations with the Bank of Israel will be key for dealing with the future relationship between the existing key transaction currency, the shekel, and the new domestic currency. Both agreements would define the respective expectations in terms of facilities, services, and fees, which would greatly facilitate smooth operations in the future.

86. **It is reasonable to expect that the PMA will manage the new exchange rate regime and the monetary framework.** The PMA should be legally obliged, upon demand, to provide dollars both for banknotes issued by it and for all the other liquid liabilities of the PMA. Those include reserves and deposits of commercial banks, government deposits, and correspondent balances of other central banks. This should be inscribed in the PMA Law, to be further elaborated in PMA regulations and decisions.

E. PMA's Decisions on Cash Currency

87. **The PMA should clarify, to the extent possible, the political realities and constraints under which it must plan for the new currency.** How each of these is answered will provide more insight into the practical advice that is required to establish a new monetary regime.

88. **Since the PMA has not in the past been involved in procuring its own domestic cash currency, it will need to establish an internal organization for handling such operational tasks.** This will include, for banknotes and coins, such activities as deciding on, for example:

- Denomination structure.
- Denomination sizes.
- Substrate for banknotes: cotton-based, polymer, hybrids.
- Design, layout structure, symbols.
- Security features: open and hidden.
- Procurement technique.
- Logistics.
- Storage.
- Lodgment.
- Invalidation/destruction of unfit banknotes.
- Calculation of seigniorage.

F. Two Concluding Issues

89. **First, do the authorities in Palestine have the right to introduce a domestic currency?** This fundamental matter was dealt with in the Paris Economic Protocol,[2] which was signed in April 1994, and became an annex to the Oslo Accord of 1993. Its Article I (1) states that: "….This 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….".

90. **Article IV section b then states that: "Both sides will continue to discuss, through the JEC [Joint Economic Committee], the possibility of introducing mutually agreed Palestinian currency or temporary alternative currency arrangements for the Palestinian Authority….".** This can be interpreted to mean that the Palestinian authorities, in effect, are not allowed to independently introduce a separate Palestinian currency; that the approval by Israel is required for such an action. **That issue, which contains many complex aspects, is worthy of further deliberations during this symposium.**

91. **Second, how have currency boards performed in recent years?** According to the IMF, it has become evident, over time, that modern central banks bound by currency board rules generally performed better than the average country during the early international financial crisis in the 2000s. The reason for this was not solely attributed to the exchange regime chosen, but in part because they had forced greater financial discipline on their governments.

92. **In this fashion, following currency board rules can perhaps be said to have had an important positive catalytic effect.** To be able to replicate that would be highly desirable not only in Palestine but in most other parts of the world.

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[2] ANNEX IV Protocol on Economic Relations between the Government of the State of Israel and the P.L.O., representing the Palestinian people.

V. Areas for Further Discussions

94. **The analyses of the preceding sections have shown that many factors influence the appropriate choice of an exchange rate regime.** Also, it has become clear that there is no single exchange rate regime that is right for all countries at all times. Moreover, the choice of one or the other system does not replace the need for consistency in overall economic policy**.**

Can Palestinian leaders in the spheres of politics and business have what it takes to achieve the necessary consensus and agree to a framework for a consistent exchange rate regime?

95. **The political will to maintain the currency board must be underpinned by an über-strict legal framework governing the currency board's operations and also institutionally strengthening the PMA.** Without these the system will collapse with a probable uneven burden-sharing of massive financial losses. This would be in addition to considerable loss in credibility of the viability of any future Palestine domestic currency, of whatever exchange rate regime.

What laws and regulations must be amended or issued, and is there a reasonable basis for assuming that such necessary legislation would be enacted and likely not reversed?

96. **The "second-generation" currency boards differ significantly from the first, orthodox generation: the latter being completely free from government presence and leaving no possibility for government intervention**. However, the legal characteristics and design of the "new" CBAs in Bulgaria, Estonia, and Lithuania provided scope for the pursuit of discretionary monetary policy and for exercising the lender-of-last-resort function. Still, the Lithuanian regime was credible, in part, due to an exceptional willingness by monetary and financial institutions in the West to support that country.

Is it likely that key Palestinian decision-makers may prefer to try a "second-generation" currency board or a hybrid currency board arrangement with their "greater flexibility?" And what are the potential advantages or dangers of so doing?

97. **Political economy aspects of institutional changes.** The transition to a CBA is a change that also should be analyzed in the context of a conflict of interests of economic and political groups that determine the supply of and demand for institutional change. This is particularly important as the introduction of a CBA can be regarded as one of the main systemic institutional changes. The CBA can be treated as a system of formal rules of money supply and monetary behavior that are imposed on *all* economic agents in Palestine. It is important to keep in mind that an efficient functioning of the currency board requires full liberalization of the economy.

Is there a framework for examining the political economy of institutional changes with respect to the adoption and maintenance of a currency board arrangement?