An Empirical Analysis of the Relationship between Multiple Exchange Rate Volatilities and Macroeconomic Performance in Palestine

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Abstract

This paper analyzes the relationship between exchange rate fluctuations and macroeconomic performance. It is presumed that exchange rate fluctuation effects on real GDP are mainly channeled via trade through: exports and imports. The present study applies this presumption empirically to the state of Palestine, in which has no national currency, by using quarterly data from 2000:Q1 to 2014:Q4. The exchange rate is taken as the independent variable while real GDP is the dependent variable. It uses econometric tools such as: Augmented Dickey Fuller test, Ordinary Least Squares estimation, Johansen Co-integration, Granger Causality, and Impulse Response Function for exploring any relationship that may exist between the chosen variables. The major findings of this study show that: (1) while an appreciation of the Jordanian Dinar and Euro currencies in terms of Israeli Shekels improves the Palestinian economy, an appreciation of the US Dollar negatively impacts the economy by using IRFs analysis; (2) this anomalous phenomenon of asymmetric effects derived from multiple currencies in Palestine forces the economy to be vulnerable to unexpected shocks in exchange rates. Based on these findings, the Palestinian government is strongly advised to implement a national currency pegged to the exchange rate with the most and longest positive effect, which in return will help economic agents to save transaction costs, imposing less uncertainty in the local financial markets and rectify the economy on a path of greater sustained growth.

Keywords: Palestine State Pound, Johansen Co-integration, Granger Causality, Impulse Response Functions, OLS Regression, Exchange rates, Real GDP

1 Introduction

The debate about the relationship between exchange rate volatility and the economy has attracted considerable attention from a wide range of researchers in the discipline of economics over the past years. Scholars who believe in the existence of such a relationship fall into two groups. While one group argues that exchange rate movements induces uncertainty and high risk in capital flows, thus negatively impacting the local economy of a country, the other group believe that there is a positive relationship between them, through reducing imports or increasing exports when certain appreciation or depreciation occur in the local currency and when an increase in local consumption occurs. The key theoretical issue motivating this research is whether or not multiple exchange rates affect the Palestinian

economy measured by real Gross Domestic Product. Palestine¹ presents an interesting case because it has no national currency, which lends this a study motivation and justification, particularly as it is expected to make a good contribution to the literature by extending the type of econometric methods employed to examine the existence of any relationship between the chosen variables on a country's economy that uses multiple currencies on a daily basis.

The Palestinian Economy

According to the Palestinian Central Bureau of Statistics (PCBS), the main sector of the Palestinian economy is the service sector as it contributes 72% of the GDP, followed by the government sector, industry, construction, and agricultural sectors. The Palestinian economy is characterized by unstable political conditions that mainly result from the Israeli military occupation since 1967. In addition, the Palestinian pound was the currency used during the British Mandate of Palestine from 1927 until the Palestinian catastrophe in 1948². Afterwards, the Palestinian pound was replaced by the Jordanian dinar in the West Bank and by the Egyptian pound in the Gaza Strip.

The Palestinian economy has been going through an unsustainable situation even long before the recent clashes. The unemployment rates remain at high levels, reaching up to 41.6% in the Gaza Strip in compared with 16.3% in the West Bank, with the highest rate (22.7%) in Bethlehem City (PCBS 2015). These circumstances are deeply affected and shaped by the policies imposed by the Israelis, which are meant to stifle the Palestinian people and their welfare. Equally important is the fact that Israel controls the water supply and electric power of the Palestinians and rules their mobility inside Palestine (Sleibi 2012). Tax revenues are also collected by the Israeli government on behalf of the Palestinians. The clearance revenue accounts for two thirds of the Palestinian government's total revenue, and has often been withheld by Israel for several months each year (IMF 2015). This is an ongoing occurrence, which makes capital investments, exports, imports and other macroeconomic indicators to be characterized by incalculability and vagueness. As a result, Palestine suffers from the lack of foreign investors' willingness to invest in the West Bank and Gaza Strip. Obviously, the Palestinian economy is mastered by Israel, although some positive developments from the 1993 peace agreement have come to bear, the Palestinian economy is still vulnerable and weak³ (Sarsour 2012).

To date there is no national currency in Palestine; instead three currencies are mainly used: the New Israeli Shekel (NIS), which is the most frequently used, especially for daily transactions; the United States Dollar (USD) and the Jordanian Dinar (JD) are mainly used for trade, savings, investment, and wage payments all over Palestine, depending on the affiliation of the institutions and their sectors. In addition to the Euro currency, which is used less frequently. Furthermore, having multiple currencies for daily use is not economically

¹ In most literature the name Palestine is replaced by the West Bank and Gaza Strip.

² The Catastrophe of Palestine in 1948, also known as Nakba, when around 700,000 Palestinian Arabs fled by force and were expelled from their own land and became Palestinian refugees. This was the last time, when the Palestinian pound was used.

³ Since the Israeli occupation in 1967, the Palestinian economy has witnessed four major events: the outbreak of the First Intifada (uprising) in 1987 and 1988, the Oslo Peace Accords between Israel and the Palestinian Liberation Organization (PLO) in 1994, the outbreak of the second Intifada in September 2000, and the permanent separation between the Palestinian cities within the West Bank and between the West Bank and Gaza Strip.

preferable, because individuals who get paid in one currency will have to convert it to another currency, at a certain point, and in each transaction, there will be a loss of money, because of the difference between bid and ask of the exchange rate prices.

The exchange rate regime for the different currencies used in Palestine is flexible against the Israeli Shekels, and the exchange rates are mainly set by the central bank of Israel. This means that the Palestinian Monetary Authority has no control over the exchange rates. The PMA acts as a temporal central bank of Palestine but does not have a full functionality of a normal central bank compared to other central banks in the world. For example, the PMA does not provide facilities such as controlling money supply or act as the lender of last resort.

In view of these facts, the purpose of this paper is to answer the following questions:

1. Are exchange rates and real GDP co-integrated, using the Johansen approach?
2. Do exchange rates Granger cause and forecast GDP?
3. Does real GDP response to shocks from exchange rates, using impulse response functions (IRFs)?

This paper is divided into 4 sections. Section 1 gave a brief overview of the Palestinian economy. Section 2 provides a theoretical framework for the basic relationship between exchange rates and the economy, as well as a review of the previous studies. Section 3 outlines the data sources and provides a definition of the time series variable investigated in this study. Section 4 presents in detail the econometric methodologies employed in the present study, as well as the findings of the empirical analysis. Section 5 summarizes the main conclusions and recommendations of this paper.

2 Literature Review

The possible explanation of the relationship between exchange rates effects on real GDP is based on the work of Mundell (1963) and Fleming (1962). Their model was based on the internationalization of IS-LM model, in which a small, open economy responds to shocks that take the form if internal economics initiatives. The innovation in this approach is that the exchange rate system in a country is a crucial determinant of the policies' effects on economic variables, and specifically on the level of Gross Domestic Product (GDP). (Rosenberg, 2003; Landry 2009). The theoretical foundation of Mundell-Fleming's model suggests that exchange rates have a great effectiveness on GDP through investment as well as trade channels. For example, when the exchange rate appreciates, foreign goods become cheaper compared to domestic goods, and this causes a fall in exports and a rise in imports. On the other hand, when a decrease in the exchange rate occurs, i.e. depreciation, foreign goods become more expensive compared to domestic goods. Consequently, export increases and import falls down, leading to an increase in the level of GDP.

There is a diverse literature on the questions of how and why exchange rate volatility may affect macroeconomic performance measured by real GDP. This issue has attracted considerable attention among academics and policy makers for a long time. The views in this literature are, at best, mixed and there continues to be more research published on this topic. A recent study by A.K Sahoo *et al.* (2014) examined the so called export-led growth hypothesis and observed a long run equilibrium relationship between export and output using

multivariate co-integration technique. Other studies that support this hypothesis include Jordaan and Eita (2007) and Ullah *et al.* (2009). However, other studies disapprove the export-led hypothesis and indicate that export has no causal relationship on a country's output (Ahmad and Kwan, 1991; Sharma and Panagiotidis, 2005).

Moreover, exchange rate volatility in floating exchange rate systems is driven mainly by surprises of market forces, in which the rate follows a random walk (Smoluk *et al.* 1998). Mussa (1986) found that floating exchange rate regimes have a higher volatility compared to pegged systems, thus have a larger impact on output. Empirical investigation on the relationship is divided into positive and negative effects from exchange rates towards GDP. For example, Koray and Lastpares (1989) used VAR models on US data between 1961 and 1985 and found a negative impact from exchange rates towards trade. Similarly, De Grauwe and Skudely (2000) tested the effects of exchange rate volatility on intra-EU trade flows, for the 1962-1995 period, using standard regression and lagged dependent variable to capture the history of bilateral flows. They found that whether exchange rate volatility is measured contemporaneously or lagged, it has a negative and significant effect on exports. Other studies found a negative significant effect using similar methodology but applied on different data: Feenstra and Kendall (1991), Savvides (1992), Chowdhry (1993), Caporale and Dorodian (1994), Hook and Boon (2000), Doganlar (2002), Clark *et al.* (2004) Arize *et al.* (2005) and Lee and Saucier (2006).

On the other hand, some studies support the school of thought which says that exchange rate fluctuations and the uncertainty they carry have a positive impact on real GDP through increasing exports. Jin (2008), for example, found that appreciation of the exchange rate increased GDP in Russia but reduced GDP in Japan and China. Another study by Azeez *et al.* (2012) used OLS analysis, Granger Causality and Johansen Co-integration to examine exchange rate volatility and real GDP in Nigeria, covering 25 years (1986-2010). They provided fairly robust evidence on the significance of the exchange rate volatility and its positive relationship with macroeconomic performance both in the long and short run. They also observed that due to exchange rate volatility, investors utilize the opportunity of an appreciating Naira to imports required capital and technology, which explains this positive trend.

In the case of Palestine, there have been very few studies which analyzed empirically the effects of exchange rate on real GDP. Sarsour (2012) studied the transmission mechanisms of monetary policy in Palestine for the period of 2002:Q1 - 2009:Q2. He studied the effects of only one exchange rate (USD/NIS) on GDP and found an insignificant positive impact from the exchange rate of USD on GDP through final consumption using simple OLS estimation. He also found that GDP responded positively to a shock in USD exchange rate for the first five periods, but this effect dies out in the long run. Another paper by Beidas and Kandil (2005) using regression analysis technique, found that an appreciation of the Israeli Shekel would decrease both exports and imports. Their research also suggested a fixed exchange rate system for Palestine.

3 Data

The data in this paper comes from two basic sources. Data on real GDP and inflation was obtained from the Palestinian Central Bureau of Statistics (PCBS), while data on exchange rates was obtained from the Bank of Israel. All data used in the analysis is quarterly and secondary data, covering the period from the first quarter of 2000 to the fourth quarter of 2014; this includes 60 quarterly observations. Quarterly data from this particular period was used because: (1) It is difficult to obtain GDP monthly for developing countries such as Palestine. (2) The data on the GDP of Palestine is only available from year 2000 onward as provided by PCBS.

The following time series variables are analyzed in this paper:

- 1) RGDP: Real Gross Domestic Product is the total value of all final goods and services produced in the economy. It is calculated through the expenditure approach with the base year of 2004.
- 2) Exchange rates: This paper will use two bilateral nominal exchange rates:
 - a. JD/IS: Jordanian Dinar/Israeli Shekel
 - b. USD/IS: United States Dollar/Israeli Shekel
 - c. EUR/IS: Euro/Israeli Shekel
- 3) INF: Inflation rate is the percentage change in the Consumer Price Index of Palestine.

4 Empirical Results

Unit Roots

The possibility of non-constant mean and variance in most macroeconomic variables has often been debated. As a result, and in order to avoid the problem of spurious regression, this paper will use the Augmented Dickey and Fuller (1981) procedure for discovering unit root property. The null hypothesis of the ADF test is that the time series has a unit root. The null hypothesis is rejected if the test value is more negative than the critical value, indicating that the series is stationary. Moreover, any series with a unit root will be differenced in order to remove this property. Consequently, in order to run the ADF test successfully, an appropriate lag length must be chosen. The optimal lag length will be selected through Akaike Information Criterion (AIC).

Table 1. Unit Root Tests

			Equation: Intercept only		Equation: Trend and Intercept	
			Level	First difference	Level	First difference
Series	Min AIC	Lags	ADF t-statistic	ADF t-statistic	ADF t-statistic	ADF t-statistic
GDP	- 2.656091	3	0.134076	- 7.013147**	-3.498000	- 7.100917**
INF	- 6.454666	0	- 5.716160**	- 4.291510**	- 5.412277**	- 4.348214**
USD/IS	- 1.453069	4	-0.960908	- 4.359787**	-3.256285	- 4.314150**
JD/IS	- 0.754688	4	-0.971606	- 4.356526**	-3.260382	- 4.314286**
EUR/IS	- 1.221521	8	- 3.276299*	- -3.381482	- 4.369012**	- 4.183390**
The Critical Values of ADF are: -3.65 (intercept only), -4.26 (with trend) at 1%, -2.96 (intercept only), -3.56 (with trend) at 5% (Mackinnon 1996), * Significant at 1%, ** Significant at 1% and 5%						

Table 1 summarizes the results for unit root tests on levels and in first differences of the data. The estimated equation was first formulated as an intercept only, and then with both trend and intercept. Strong evidence emerges that all the time series are I (1), indicating the same level of integration.

Econometric Model and OLS Regression

The following semi-logged time series model below shows the real Gross Domestic Product as a dependent variable with both exchange rates and inflation rate as independent variables:

$$\text{Log(RGDP)}_t = \alpha + \beta_1(\text{EXR}_1)_t + \beta_2(\text{EXR}_2)_t + \beta_3(\text{EXR}_3)_t + \beta_4(\text{INF})_t + \varepsilon_t \quad (1)$$

Where:

RGDP: Real Gross Domestic Product

EXR₁: The first exchange rate of USD/IS

EXR₂: The second exchange rate of JD/IS

EXR₃: The third exchange rate of EURO/IS

INF: Inflation rate

α : Intercept

β_i : Coefficient of each independent variable

ε_t : Error term

Log: Natural Logarithm

This paper will study the relationship between these variables by observing the adjusted R-squared or the goodness of fit, and understand how much variation in the dependent variable is explained by variation in the independent variables. Moreover, the regression equation is estimated in two cases: the first one with the presence of unit roots, and the second without the presence of unit root. This comparison will allow better judgment on the results.

Table 2. OLS results (Unit Root is present)

Dependent Variable: [LOG(GDP)]				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	8.928227	0.203645	43.84216	0.0000
INF	-5.594789	1.612759	-3.469080	0.0010
USD/IS	-13.56502	5.256728	-2.580507	0.0126
JD/IS	9.262801	3.735277	2.479817	0.0162
EUR/IS	0.062306	0.033819	1.842337	0.0708
R²= 79.52%, $\check{R}^2$= 78.03%, Sig. F (p-value): 0.000				

Table 3. OLS results (Unit Root is removed)

Dependent Variable: Difference [LOG(GDP)]				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.011505	0.007349	1.565464	0.1233
INF	-1.163958	0.653954	-1.779877	0.0807
USD/IS	10.56035	3.861077	2.735079	0.0084
JD/IS	-7.521135	2.720611	-2.764502	0.0078
EUR/IS	-0.051023	0.057091	-0.893706	0.3754
R²= 28.56%, $\check{R}^2$= 23.26%, Sig. F (p-value): 0.000991				

Note. All variables in table 3, have the same level of integration I(1)

In Table 2, the adjusted goodness of fit indicates that the independent variables can explain 78.03% variation in real GDP. The estimation indicates a negative relationship between inflation rate and the exchange rate of USD/IS with GDP, while a positive relation exists between JD/IS as well as EUR/IS with GDP.

Moreover, the significance of regressors: F (p-value) is equal to 0.000, and indicates a rejection of the null hypothesis (H_0) which says that all β 's are simultaneously equal to zero. However, there are two problems in this estimation: (i) whatever the result shows, the unit root is present. (ii) The p-value of EUR/IS variable is not significant, indicating the EUR/IS plays no role in determining GDP in Palestine.

To overcome the problem of spurious regression, OLS estimation was performed again after differencing the data as shown in Table 3. A significant decline in the coefficient of variation to 24.26% was observed. The result shows that USD/IS has a positive impact on GDP with a

significant p-value., while EUR/IS and JD/IS both have a negative impact. However, the result of EUR/IS is not significant as well as inflation rate based on their p-values. Having performed OLS estimation, the analysis is elaborated to include other important methodologies as seen in the following pages.

Johansen Co-integration Test

Following a multivariate approach, and to address the research questions about the relationship between exchange rates and the macroeconomic performance in Palestine, it was decided to proceed with considering the cointegration hypothesis between real GDP and the multiple exchange rates. The cointegration approach accommodates the fact that economic variables may not be a joint covariance stationary in the short run, but will show a long run equilibrium (Johansen 1988). To apply Johansen test, all of the series in this study must be at levels and have the same order of integration, which is I(1). Additionally, the lag length is determined through VAR system equation. The procedure will take into consideration both the max-eigen value and trace statistic tests.

Table 4. Johansen Cointegration Test [Log(GDP), INF, USDIS, JDIS, EUIS]

r	Trace Test			Maximum Eigenvalue Test		
	Statistic	5% C.V	Prob*	Statistic	5% CV	Prob*
r=0	78.2438 8	69.818 89	0.009 1	29.014 33	33.876 87	0.170 5
r≤1	49.2295 5	47.856 13	0.036 9	23.314 12	27.584 34	0.160 5
r≤2	25.9154 3	29.797 07	0.131 2	15.352 79	21.131 62	0.264 9
r≤3	10.5626 3	15.494 71	0.239 9	8.9138 01	14.264 60	0.293 4

Notes: r: number of co-integrated vectors, figures in bold are significant

***MacKinnon-Haug-Michelis (1999) p-values**

Based on the trace test as shown in Table 4. the null hypothesis (H_0) at $r=0$ (no cointegrated vectors) is rejected, because t-statistic is higher than the critical value at 5% significance level, ($78.23 > 69.81$). Consequently, the alternative hypothesis is considered, which indicates an existence of one cointegrated vector. In parallel, the null hypothesis is also rejected at $r \leq 0$, indicating the existence of two cointegrated vectors for the relationship between exchange rates, inflation and real GDP in Palestine.

Granger Causality

The main purpose of Granger Causality test is to find out whether exchange rates can be used to forecast the GDP or not (Granger 1969). This test also explores how much historical data of exchange rates and inflation can be used to explain the data of GDP. Like other tests, the optimum lag length was also selected based on the minimum of AIC using VAR model system equations. If this test is used on two series, say X and Y: The null hypothesis (H_0) would be: X does not Granger Cause Y, the alternative hypothesis (H_1) would be: X Granger

Cause Y. Determining whether to reject or not to reject the null hypothesis (H_0) depends on the p-value at the level of significance.

Table 5. Granger Causality (Y: GDP)

Sample: 2000-2014 Lags: 2

Null hypothesis	Obs	F-statistic	Probability
GDP does not Granger Cause USD/IS	57	1.35937	0.2658
USD/IS does not Granger Cause GDP	57	1.60076	0.2115
GDP does not Granger Cause JD/IS	57	1.30353	0.2803
JD/IS does not Granger Cause GDP	57	1.64190	0.2035
GDP does not Granger Cause EUR/IS	57	2.07199	0.1362
EUR/IS does not Granger Cause GDP	57	0.66343	0.5194
GDP does not Granger Cause INF	57	1.45653	0.2424
INF does not Granger Cause GDP	57	0.70884	0.4969

As seen in Table 5, in all cases, the null hypothesis (H_0) cannot be rejected for every pairwise of Granger test at the 5% significance level; this is so because the reported probabilities are greater than 5%. Therefore, the hypothesis that exchange rates Granger cause GDP (or vice versa) is not rejected. Although the variables have a long run cointegration as shown in Johansen procedure, this test indicates no causality relationship between exchange rates, inflation and GDP in Palestine.

Impulse Response Functions

Previous methods employed in this paper provided totally different results. Therefore, to broaden the research analysis, it was decided to apply impulse response function (IRF), which emphasizes the dynamics of variables in an indicated model. IRF traces the effect of a one-time shock to one of the innovations on current and future values of the endogenous variables. In this test, shocks will be introduced in exchange rate variables, and response will be observed in GDP. Moreover, IRF requires an appropriate lag length for the tested model, and just as Granger Causality, the lag length for IRF will also be selected based on the minimum of AIC for the model.

Figure 1. Impulse responses from Real GDP

Based on the cumulative figure above, a one standard deviation (SD) positive shock in USD/IS exchange rate elicits a negative response from GDP, and this response does not die

out in the long run, and shows a significant decrease until the end of observed period. This indicates that an increase in the exchange rate of USD/IS, i.e. an appreciation of the US dollar in terms of the Israeli Shekel will negatively affect the Palestinian economy measured by real output. The following is an interpretation of this negative result: (i) an appreciation of the USD will cause domestic goods to become more expensive. Therefore, traders will take an advantage to import more goods, this will also cause an increase in import figures, especially from Israel, where goods are cheaper, and which contributes to 72% of the total imports into Palestine. However, it is not accurate to make a final judgment on exports because the Palestinian economy relies heavily on imports rather than on exports. This finding satisfies Mundell-Fleming model. (ii) An increase in the prices of domestic goods will negatively affect the purchasing power of households, especially those who get paid in Israeli Shekels currency, therefore consumption will decrease. Regarding the relation between JD/IS and GDP, from period 1 to period 7, the appreciation of the Jordanian Dinar affected negatively GDP, after period 7 and until the observed period, the effect becomes positive. Moreover, GDP responded positively to an appreciation in EUR/IS along the entire period when introducing a shock in the exchange rate of EUR/IS. The positive effect of the Euro is due to the large amounts of donations and foreign aid made to the Palestinian government in Euros, which in return will have a higher purchasing volume when it appreciates against the Israeli Shekels, especially when the government spends on construction and public services, and in return pays for these goods and services in Israeli Shekels.

Table 6. Summary of Empirical Results

Method	Result of Exchange Rate Effects on Real GDP	Significance	Mundell-Fleming Model Satisfaction
OLS estimation	-With unit root: USD (-), JD and EURO (+) -Without unit root: USD (+), JD and EURO (-)	Not significant	-With Unit root: USD (yes), JD and EURO (no) -Without Unit root: USD (no), JD and EURO (yes)
Cointgration	All variables share a long run relationship	Yes, at 5% sign. level	-
Causality	No causality found	-	-
IRFs	USD (-), JD (mixed), EURO (+)	-	USD (yes), JD (mixed), EURO (yes)

The table above summarizes the results of all empirical methods employed in this paper. It is worth mentioning that there is no overwhelming evidence on the judgment of each method and its satisfaction of Mundell-Fleming model, because none of the currencies used in Palestine is considered a national currency.

5 Conclusion

In this study, I have examined the effects of three exchange rate volatilities on the macroeconomic performance in Palestine using data from 2000 to 2014 under the existing economic and political conditions. The motivation for undertaking this research was that by identifying the type and nature of these effects, policy makers would be better able to choose an exchange rate regime for the Palestinian Pound, the future national currency of Palestine. To achieve the purposes of this research, various relevant economic methods were employed. ADF test was performed in testing for stationarity of the chosen variables; the hypothesis of non stationarity was rejected after performing the first difference. OLS results were mixed and not significant. Johansen multivariate cointegration technique showed that exchange rates and output share a long run equilibrium relationship at 5% significance level. However, Granger Causality results showed that there is no single direction of causality from exchange rates to output. An important observation was obtained using Impulse Response Functions (IRFs) analysis, which revealed the fact that USD/IS exchange rate affects the Palestinian economy negatively; that is, whenever the US Dollar gets stronger in terms of the Israeli Shekel, the Palestinian economy goes down. This may slow down the local economic growth over time. The other significant result from IRFs showed a positive effect from the exchange rates JD/IS and EUR/IS towards output, which is a completely different result compared to USD/IS exchange rate. Ultimately, this interesting phenomenon leaves the level of output fragile in terms of growth and development, more specifically against population growth and major political obstacles in such turbulent circumstances. In this regards, the policy implication of the present study holds that the government should be aware that using different currencies in Palestine is harmful for the economy, and implementing the Palestinian Pound should be utilized not only as a symbol for the state of Palestine but also as a tool for economic pickup, especially when its exchange rate is pegged to the Jordanian Dinar or Euro currencies. However, two major points should be carefully considered when a Palestinian currency is introduced:

- (i) Achieving a sustainable macroeconomic balance when transmitting to a new single national currency is a must. However, it should be taken into account that there are large differences in the unemployment rates, business cycles and the structure of the economy among the West Bank and Gaza Strip under the present political conditions. This exposure to irregular and different shocks makes it difficult to imagine a single currency in Palestine, especially if the central bank decides to introduce a restrictive monetary policy to ensure an acceptable level of inflation rate.
- (ii) A fully functional central bank with the prospect of printing money can somehow be doubtful in the Palestinian case, because it is known that the Palestinian government suffers from constant budget deficits, and if the government takes advantage of this tool to cover its debt, i.e. increasing money supply without a parallel increase in economic output; an increase in price levels will occur, leading to a high level of inflation.

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