

The Palestinian Economy and the Absence of a Monetary Policy

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Abstract

Islam allowed the selling transaction and prohibited the interest rate. So, can an economy function properly and efficiently without an interest rate? In a conventional economy the interest rate is used as a tool to stimulate investment, savings, money supply, exchange rate, and other economic variables. Thus, the concept of an interest rate is deeply embedded, and plays a vital role in an economy. It is not easy to remove this concept from an economy. The purpose of this paper is to demonstrate that an economy can function properly without the use of an interest rate by looking at the Palestinian economy.

The Palestinian economy is a small, open, and semi-independent on the Israeli economy; it is thus unique in nature, where it is an economy that has no local currency. Palestinians use the New Israeli Shekel, US Dollar, Jordanian Dinar, and Euro. So, the Palestine Monetary Authority (PMA) place the role of monitoring the function of the banks, rather than the role of a Central Bank. This is of course due to the absence of a local currency. Therefore, the Palestinian Government has no monetary policy, i.e., monetary policy does not exist in the Palestinian economy. In addition, the concept of an interest rate to an individual Palestinian can be replaced by the concept of profit sharing. That is, a Palestinian can be driven by the concept of profit sharing rather than the concept of an interest rate. This paper concludes by using an empirical example that an economy can function without an interest rate.

Keywords: Islamic Economy, Interest Rate, Monetary Policy, Palestinian Economy.

Introduction

The religion of Islam allows the selling and prohibit the interest. This is one of the fundamentals of the Islamic faith. So as Muslims, we should not deal with interest. A considerable portion of the Palestinian population -as in other Muslim countries- had followed Allah's commandments and dealt only with Islamic banks. In the West Bank there are two Islamic Bank, meanwhile there are four Islamic banks in Gaza. These financial institutions contribute positively to the economic development process (Migdad,2017, p.77).

The Palestinian economy is a small and open economy. It has a number of unique features due to the Israeli occupation's iron grip on both the West Bank and Gaza. These features include the following:

- 1- No control of the borders, Israel has total control of everything that cause in and out. (Khalidi,2017)
- 2- No local currency, Palestinians use the New Israeli Shekel (NIS) for their day-to-day transaction. (Sarsour & Dombrecht, 2016)
- 3- Palestinian supply mostly unskilled labor to Israel. (Agbahey, Siddig and Grethe, 2021)

This makes the Palestinian economy dependent on the Israeli economy, so it is a semi-independent economy.

Can we have an economy with no interest rate? The purpose of this paper is to demonstrate that it is possible to have a functional economy without an interest rate using the Palestinian economy as an empirical example. The importance of this paper lies in the fact that it adds to the current literature that it is possible to have an economy that functions properly without an interest rate. Thus, following Allah commandments will make us better off.

This paper will proceed as follows, the next section will be a brief introduction of how an Islamic economy functions, followed by a discussion of the absence of an interest rate from the Palestinian economy, and finally the conclusion section.

A brief Overview of an Islamic Economy

Several papers had discussed the issues of eliminating interest rates from an economy. Zarqa (1983) demonstrated how the removal of an interest rate would lead to economic stability.

Chapra (1983) asserted how monetary policy is conducted in the absence of interest rate. It showed that the primary function of the central bank in supplying money will be dependent on ensuring a stock of money that meets the money demands, i.e., in still of relying on an interest rate to have equilibrium in the money market. Thus, the central bank will monitor the money demand more carefully and provide the available needed stock of money. In addition, the paper suggested different tools that will ensure the presence of liquidity in the central bank, maintaining its status as a last resort lender to the government and banks.

Mushtaq and Siddiqui (2016) examined the effect of an interest rate on economic performance in both Muslim and Non-Muslim countries. The data was collected for the period from 2005-2013 for 17 non-Muslim countries and 17 Muslim countries. The Random effect system generalized method of moments (GMM) was utilized to analyze the data. The results indicated that citizens of Muslim countries are not affected – i.e., they do not care- by interest rate. Thus, governments of Muslim countries should not implement policies adopted by non-Muslim countries.

Contrary to past theoretical literature, this paper attempts to use a practical and existing example in order to demonstrate that an economy can function and grow without the existence of an interest rate.

Palestinian Economy and the Absence of an Interest Rate

Looking at an economy, we can observe that the interest rate is present in both the macroeconomic and microeconomic levels. On the microeconomic level, it provides an incentive for an individual to both invest and save. consumption, investment, and savings are functions of an interest rate, i.e., the interest rate plays a vital role in determining the level of the three macroeconomic variables. In an equilibrium, the interest rate determines the level of savings and investment. In addition, on the macroeconomic level it plays a vital role in monetary policy. The central bank of a given country adjusts the interest rate in order to either stimulate or slow down the economy.

What happens if we remove the interest rate? Taking into account the Palestinian economy, we notice that on the micro level the answer is fairly simple. The interest rate can be replaced by the concept of profit sharing. This had proven to be possible by looking at the number of Islamic banks in both the West Bank and Gaza; where the Palestine Islamic Bank has more than forty branches spread throughout the Palestinian Territories. This proves that the concept of profit sharing can be an incentive for an individual to save or invest. So, on a microeconomic level the problem can be solved easily.

On the macroeconomic level the issue gets to be more complicated. Removing the interest rate from an economy means the absence of monetary policy. Thus, the central bank of a given country will no longer have the ability to affect the performance of an economy. The Palestine Monetary Authority (PMA) shows that scenario, where it acts as a central bank with no monetary policy. Due to the fact that Palestine has no local currency, its central bank has no monetary policy. The PMA's main function is to monitor the performance of the banks and insure stability in the financial market. Stability in the financial market is important for economic growth in Palestine. Nonetheless, interest rate had no significant effect on the growth of the economic growth in Palestine (Abusharbeh, 2017). This is an important finding about the uniqueness of the Palestinian economy, indicating the insignificant role that interest rate plays. This further strengthens our position in extracting an empirical example to demonstrate that an economy can exist and grow without interest rate using the Palestinian scenario.

The Palestinians use NIS, Jordanian Dinar (JD), US Dollar and Euro. All these currencies are stable currencies and create a stable medium for exchange, thus the PMA does not have to worry about ensuring the necessary supply of money to meet the demand. Having a stable currency removes the burden of trying to stabilize the currency from the PMA. So, we notice that the existence of a stable currency as a medium of exchange is an important factor in an economy. It is possible to achieve this goal without an interest rate.

Nonetheless, the absence of the monetary policy from the Palestinian economy did not hinder the development of the economy. This is an empirical evidence that an economy can grow and survive without the presence of an interest rate.

Conclusion

This paper had attempted to demonstrate empirically that an economy can exist, function and grow without the presence of an interest rate. The paper eliminated the interest rate and analyzed its effect on both the macroeconomic and microeconomic levels. The Palestinian economy was used as the empirical example due to its unique nature created by the Israeli occupation. It is surprisingly to find out that the Palestinian economy is close to what is known as an Islamic economy. The interest rate in the Palestinian economy is mostly present on the micro level and its elimination would not be a big deal. Nevertheless, eliminating the interest rate from an economy would create a number of challenges. Most importantly, would the current international system allow for such an economy to exist? The current international system is headed by the World Bank and the International Monetary Fund (IMF), which were both created after the end of World War II. These two institutions designed and implemented the current financial international system. In

addition, they try to monitor and direct the performance of countries throughout the world. So, would they allow for an interest rate free economy to exist?

The second challenge lies in the fact that an interest-based economy had developed and evolved over a long period of time adapting to different economic events. Thus, a lot of work had been placed in evolving an interest-based economy to meet the different arising economic challenges. Meanwhile, the absence of the existence of an Islamic economy did not allow for such an economy to develop and evolve over time. So, can a new economy that is interest rate free withstand the different arising economic fluctuation? The lack of work on an interest rate free economy allows one to wonder if it's possible for such an economy to adapt to the manifesting economic turmoil.

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