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The Islamic dinar as good as gold

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EVER SINCE THE COLLAPSE OF THE gold standard in 1925, increasing turmoil and volatility are evident in world financial markets. It wreaked havoc on the flow of international trade by one-third between 1929 and 1933 and partly contributed to the industrial depression in the United Kingdom in 1926 and the crash of the stock market in the United States in 1929.

The 1997 Asian economic crisis and the Mexican peso debacle in 1991 were two infamous events that mercilessly plunged emerging economies into near bankruptcy. What actually went wrong is no longer a mystery but what ought to be done remains an agenda in which world economies must find common ground.

At least two factors can help explain why financial volatility persists today. The first is the fact that it has a lot to do with excessive money creation and the second is the absence of regulation over the activities of hedge funds. And both are linked to the exchange rate system and monetary order of trading nations.

When major economies adopted the gold standard in 1870, money was created only when enough gold reserves were added to the existing stock. This was because by using a commodity-backed currency, namely money backed by gold, people saw that holding currency was as good as holding gold.

The gold standard system allowed convertibility of currency into gold. Gold was the basis on which the exchange rate of currency between nations was established. But when world monetary order placed the US dollar in place of gold at Bretton Woods and eventually allowed exchange rates to move according to market forces in 1973, it allowed money creation to roam at will since nations could increase the money supply without any need to increase gold reserves.

Excessive money creation creates inflation eventually driving up interest rates. In the economics of capital flows, high interest rates attract foreign portfolio funds, which causes the country's exchange rate to increase. Currency appreciation implies trade deficits when exports become less competitive.

A country can overcome trade deficits if it has enough hard currencies to pay for the increasing imports. Otherwise it will resort to borrowings. If nothing else works, devaluation is the only way out. But devaluing one's currency erodes the trust and confidence other nations place in that country. And when one gets entangled with the International Monetary Fund for help, it can mean less freedom to meet national economic and social objectives.

Notwithstanding IMF's role, the prospect of devaluation invites hedge funds to a country's doorstep as well. By 'buying low and selling high', arbitrageurs seek immediate profits based on exchange rate differentials. Fueled by greed, in the name of market forces they further brought short-selling of the currency. Excessive money creation earlier landed say, the ringgit or baht, in international bank accounts.

Arbitrageurs, namely the international speculators, borrow amounts of these ringgit to sell them back. Oversupply of ringgit sees it plunging further down. By buying ringgit at the lower price and paying a minimal interest charge on the ringgit loan, speculators make money in the billions, leaving the economy bleeding with corporate bankruptcies, rising unemployment and production standstill.

Without any remedial international consensus to regulate hedge funds and

putting a tight control on money creation, returning to the gold standard is one viable option. As nearly all financial crises put the blame on money, either too much or too little of it, controlling the money supply must be a basic necessity. If the power to create money lies in the hands of the state, it can be used as a political tool to garner more power and commit corrupt practices, and when banks are made free to create money by way of deposit creation, it can lead to similar evils.

The Asian economic crisis is clear evidence of banks' destructive capabilities. According to Thomas Jefferson, 'The banking institutions are more dangerous to our freedom than the enemies' armies. The creation of money has to be removed from the banks' hands.'

Under the gold standard concept, countries agree to define their monetary units in terms of a physical amount of pure gold. For example, if the dollar can buy 1/20 of an ounce of gold and a British pound is defined as 1/4 of an ounce of gold, implicitly it means one British pound can be exchanged with five dollars, or 1 British pound = US\$5. Based on mint parities, the exchange rate between dollar, franc, deutsche mark, yen, ringgit and so on can be established.

Central banks should be able to redeem all currencies for the amount of gold they are defined. In this manner, the country's money supply is dependent on the amount of gold reserves the nation's monetary authority has. A ratio of money stock and gold reserves can be then established. For example, between 1879 and 1913, the US money stock was 8.5 times the amount of monetary gold stock. If the supply of gold remains constant, it promotes long-term stability in the money stock and long-run stability in real output, prices and exchange rates.

Without a gold standard, printing money and deposit creation can run out of control. The Bretton Woods system is one step forward to reduce the role of gold in making international trade settlement. Instead the system uses the US dollar to settle cross-border transactions with only a US dollar to gold convertibility.

However, the US abandoned the convertibility of dollar into gold reserves, partly driven by the Vietnam war. Financing the war implied printing more money, which was only possible if it had enough gold to do so. The US also feared foreign governments might sabotage it by presenting their million dollar reserves for gold.

When President Nixon closed the Gold Window in 1971 he said, 'the US would suspend temporarily the convertibility of dollar into gold or other reserves assets, except in amounts and conditions determined to be in the interest of monetary stability and in the best interest of the United States.'

However, with the slowing down of the US economy, people may find it less worthy to hold the dollar as it may lose value over time. The yen too is not spared with the Japanese economy still in the doldrums after a decade of recession. In Malaysia, the prospect of a depreciating dollar would also mean a falling ringgit if the country continues to peg the ringgit to the greenback. Malaysia may run a huge trade deficit in view of its high dependence on capital and intermediate imports.

What we fear is that no currency will be worth holding because it is worth nothing. Money as legal tender is a promise of payment but now it is not convertible into gold, nor guarantees a tangible conversion. Economies may resort to the barter system and even use commodity money to settle economic transactions.

Abu Bakr ibn Abi Maryam reported that he heard the Messenger of Allah, may Allah bless him and grant him peace, say, 'A time is certainly coming over Mankind in which there will be nothing (left) which will be of use save a dinar and a dirham' (The Musnad of Imam Ahmad ibn Hanbal).

The Islamic dinar is a specific weight of gold equivalent to 4.3 grams. Returning to the gold standard can mean adopting the dinar standard or the mint standard of the early gold exchange rate system. On these grounds, the Islamic dinar must take the form of a commodity-backed money rather than a commodity money, although the latter can be used on a limited basis involving cross-border transactions.

The Islamic dinar can help control the supply of money by way of changes in gold reserves similar to the gold standard. In this manner, the role of the central bank can be made redundant since money supply is no longer determined by size of monetary base but by the amount of gold reserves. An increase in the money supply is a reflection of real growth arising from more exports. No longer would it come into being by way of artificial demand arising from speculative purchases in real estate and shares.

As the Shariah serves to protect common interest, the prohibition of riba (interest) must accompany the Dinar system. It is a monetary order that establishes the framework within which individuals conduct and settle transactions. Without an order, that is, laws and regulations, it is impossible to see how justice can be promoted effectively.

For example, in the Islamic Dinar Order, both debtor and creditor can be protected from the evils of inflation and recession. In the case of inflation, it is normal that a creditor gains while a debtor loses out. In the Islamic Dinar Order, loans given out in currency, say three-year RM5,000 ringgit personal loan is pegged to the dinar. The contract of loan thus is based on dinar and not ringgit. If one dinar is equivalent to RM500, then the loan made is 50 dinars which the debtor must pay at the same amount upon maturity.

If the price level increases on payment day where he has to pay, say, RM6,000 to buy 50 dinars, he must do so. In this manner the creditor is protected from monetary depreciation since he receives 50 dinars but enjoys higher amount in currency. This is not riba, since the contract is not based on currency but dinar. As the Prophet (pbuh) says, 'Gold for gold, silver for silver, like for like.' It is a natural process of indexation that serves to protect the creditor in time of inflation.

The call by Prime Minister Datuk Seri Dr Mahathir Mohamad to revamp existing international monetary order is timely and the Islamic dinar can play a meaningful role, at least among Muslim countries. Before that, it is crucial to determine the mint parity of one dinar for each of the Organisation of Islamic Conference (OIC) member countries' mint parity.

To maintain the mint parity, that is, the exchange value of the nation's currency with gold, the country must condition its money stock on the level of its gold reserves. Doing so will see hedge funds unable to find enough money to execute short-selling activities. In short, the value of a nation's currency is now dependent on gold and not market forces. In some sense, market forces are necessary to guarantee efficiency, but they are also open to manipulation.

On this point, the 11th century Islamic jurist Ibn Taimiyyah in his fatawa said 'The rise and fall in prices is always due to injustice (zulm) of some people. Sometimes its reason is deficiency in production or a decline in imports of the goods in demand. Thus, if the desire for goods increases while their supply decreases, their price rises. On the other hand, if availability of the goods increases and the desire for them decreases, the price comes down. This scarcity or abundance may not be caused by the action of any people; it may be due to a cause not involving any injustice or, sometimes, it may have a cause that involves injustice. It is Allah the Almighty Who creates desires in the hearts of people.'

Thus, markets are simply tools to be made subservient to the desire of people. When markets are exposed to skilful manipulation of hedge funds,

prices are no longer equitable and this invites volatility. In the Islamic dinar system, Malaysia can sell oil palm to Saudi Arabia paid in riyal, which Malaysia can convert into the Islamic dinar on call. Thus, there is less to worry about currency fluctuation and the need to hedge against adverse price movements.

Lastly, in the Islamic dinar system the role of fiat money as a medium of exchange will be replaced by dinar-backed money. By definition, fiat money is money not redeemable for any commodity and its status as money is conferred by the government. In Islamic history, the introduction of copper coins or fulus as money by the Mamluks (648/1250) coupled with famine created a period of high inflation or ghala', leading to its downfall. The fulus unlike the dinar can easily be produced at will. Without control, excessive supply of copper fulus leads to spiraling inflation. The same applies in modern times when excessive fiat money creation created overspending and asset bubbles.