ISLAMIC GOLD DINAR: A COMPARATIVE STUDY AND AN ANALYSIS OF PUBLIC CHOICE DIMENSIONS OF DUAL CURRENCY SYSTEM IN MALAYSIA

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ABSTRACT OF THE THESIS

In a quest to find remedy for persistently occurring economic crises, some economists have pinpointed that the root cause is rather implicit in the monetary order of floating rates, interest-based fiat money system. Fragility of the monetary system has echoed the call to reassess and redefine money. Obsess with prosperous period of classical gold standard, debates on gold-based monetary system is a blistering issue in economics today. The emergence of information and communication technologies (ICT) have revolutionized the resurgence of gold currency. It is now available for everybody in the Internet. Gold dinar as the proposed Muslim-currency under the Internet financial service provider (IFSP) model and the Malaysian gold dinar model were compared with the two preceding gold-based international monetary systems, namely, the classical gold standard and the Bretton Woods regime. Analysis of parallel currency approach taken for the implementation of gold dinar in the case of Malaysia found a sound and sufficient support for the gold dinar system to work. Nonetheless, consumer behaviors of hoarding the hard currency and arbitrage under the dual currency system were detrimental for the full-fledged adoption of monetary reform.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Economics.

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Acting Dean
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DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Name: Mohd Nahar Mohd Arshad

Signature: ....

Date: 25 NOV 2002

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Mohd Nahar Mohd Arshad
Kuala Lumpur
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CHAPTER ONE

INTRODUCTION

Monetary system plays a crucial role in maintaining the stability of an economy. Although many studies have been undertaken to understand the workings and impacts of monetary policy, yet many economic problems related to money still occur.

Fiat money as what we have now has been said as the main source of instability in the economy. Since money and gold were separated, the world economy was burdened with problems related to money such as inflation, exchange rate fluctuations, price asset bubble, bank panic and many more.

Fragility of the current system puzzled many economists. Crisis after crisis interchangeably makes economists and policymakers restless thinking about the causes, solutions and prediction of the next coming one.

The interest-based-fractional-reserve-fiat money system has been accused by some economists, both Muslims and non-Muslims, as being unjust, and as the cause of high inflations, constant bump ride of the economic cycle and rising unemployment figures. Concerned with the current troublesome world economy, these economists and even politicians have called for a global financial reform, including an urgent need to redefine money.

The loudly proposed alternative to reform the current international monetary system is to revert to the gold currency – return to the gold dinar as some Muslim economists echoed. Many Islamic economists argue, it is now timely to revive back the glorious era of Islamic dinar and dirham. Both represent gold and silver currencies respectively.

Historically, these two metals had functioned as a symbol of wealth, medium of exchange and store of value. The bimetallic currency is stable (A. Rashid *et. al.* 2002) and it is 100 percent liquids. It is also an interest free system. Both gold and silver are widely accepted as a medium of exchange regardless of its pattern, shape and time of issuance. As long as the currency is made from gold or silver, many are willing to accept it. Therefore, gold and silver currencies are very much different from paper money that we have today.

Praise to the gold standard as the best international monetary system the world ever had, amplified the urgent call of reviving the current monetary regime to gold-based monetary system. Murray Rothbard, a philosopher of liberty and a dean of the Austrian School of economics admits the indispensability of gold-based currency order when he writes,

> ...While the classical gold standard of the nineteenth century was not perfect, and allowed for relatively minor booms and busts, it still provided us with by far the best monetary order the world has ever known, an order which worked, which kept business cycles from getting out of hand, and which enabled the development of free international trade, exchange, and investment.

For millennia, gold has been money. When paper money issued by the governments has been tied to gold, that paper money has held its value. Conversely, when gold was abandoned, that money always lost its value as what has happened to the U.S dollar when Richard Nixon cut its link to gold in 1971.

There are many problems related to fiat paper money and inflation is one of them. Alan Greenspan in his tribute to gold in *Gold and Economic Freedom* jots down,

> ...The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means of unlimited expansion of credit... The law of supply and demand is not to be conned. As the supply of money increases relative to the supply of the tangible assets in the economy, prices must eventually rise... In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value.

Vadillo (1996) condemns the fiat money system as,

> ...If we are forced to use a particular medium of exchange at the same time as this medium is subjected to a permanent devaluation by the various causes of inflation (interest based, fractional reserve and fiat money) we are being cheated. At best, we are being unjustly taxed and at worse, we are being legally robbed.

Gold as money is the best medium of exchange and store of value. Gold coin by itself has full intrinsic value and universally accepted as a medium of exchange – two characteristics of good money. Though recently there were some economists proposing the idea of targeting gold price as a mean to control inflation, instead of hitting the interest rates or money supply targets, this idea is still vulnerable to central banks manipulation, hence not securing total monetary freedom.

When we talk about monetary freedom, there is no better way to achieve it except by having a gold based monetary system. This approach will end the long debates on whether central banks should be dependent or independent body from any political influence. Fundamentally, money should be free from any monopoly. Fiat paper money is monopolized by the central banks that have the power to inflate or deflate the economy and also can manipulate the exchange rates of currency. The case is different for bullion money. It is a universal currency and free from any monopoly.

The reintroduction of the gold dinar system revolutionizes the old system of gold currency with the availability of the information technology (IT). In fact, the old idea to have a functionally free monetary system is now possible without any political will. IT gives rise to the new economy and the new economy needs a new regime of monetary.

PROBLEM STATEMENT

The problems that give rise to this study are:

1) What are the differences and niches of the gold dinar system as compared to the classical gold standard and the Bretton Woods regime?

2) The suggestion to introduce gold currency alongside paper money, with the optimism that gold currency will triumph over paper money is investigated. Is this claim true in the case of Malaysia?

3) What are the possible problems in the process of transition period when dual currency approach or parallel currency system is adopted for gold dinar introduction?

We hope to provide answers to these questions and contribute this small effort to the initial process of gold dinar implementation in Malaysia.

OBJECTIVE AND EXPECTED CONTRIBUTION OF THE STUDY

Basically, the objectives of this research paper are two folds. Motivated by the above considerations, this research attempts to evaluate the gold dinar system side by side the previous two gold based international monetary systems, namely the gold standard and the Bretton Woods. The comparative analysis aims to assess the strengths and weaknesses of the gold dinar system. Realizing its strengths, it is hoped the new monetary regime will be an alternative to the current fiat money system. Pinpointing its weaknesses in the early stage will invite new innovations to cover the loopholes.

Dual currency or parallel currency system exists when gold dinar is introduced alongside the fiat money system. This paper also examines Malaysians' preferences between the two currencies. Knowing how Malaysians perceive the new system is the second objective of this research. This in turn will help smooth transition process to the new regime if the authority really serious to espouse it in the near future.

Fulfillments of the objectives of this research will create awareness to many of the indispensability of the gold dinar system. In addition, this study provides the current readiness level of Malaysians to accept the gold dinar and how they will behave in the dual currency system.

The organization of this research is as follows. Chapter one contains the introduction, while chapter two provides the literature review on related issues on the topic concerned. Chapter three presents the methodology of the study. The comparative study comes in the proceeding chapter. The theoretical framework of dual currency system and the empirical results of the questionnaire follow in chapter five. The last chapter provides some recommendations and conclusion of the research.

CHAPTER TWO

LITERATURE REVIEWS

The call for monetary reform begins with growing concerned by many economists, over the inherent systemic problems in fiat monetary system. After decades of experiences under fiat monetary regime, problems like inflation, bank panic, exchange rates uncertainties and fluctuations, all these, have subtly eroded the confidence people have in the current fiat money system.

Conscious about problems arising from the current system, Greenspan provides his view of the possibility of the United States to return to the gold standard in his published article in *Wall Street Journal,* titled "Can the U.S Return to the Gold Standard?" The need to revive the gold-based order is apparent as he mentions,

> ...In years past a desire to return to a monetary system based on gold was perceived as nostalgia for an era when times were simpler, problems less complex and the world not threatened with nuclear annihilation. But after a decade of destabilizing inflation and economic stagnation, the restoration of a gold standard has become an issue that is clearly rising on the economic policy agenda.

Ludwig Von Mises (1912), a great Austrian economist, in *The Theory of Money and Credit* writes that fiat paper money will become worthless. This statement is now visibly understood. Inflation is clearly the nuisance in the present system.

A strong call to abandon the use of fiat paper money came in 1991, when Vadillo, in *Fatwa on Paper-Money* pointed out the usurious elements in the system, which supported the view of some Muslim scholars that argued the use of paper money in any exchange is therefore *haram*[1]. The arguments of the usurious element are

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[1] To limit money to only gold and silver is not a consensus view among Islamic jurists. There are another equally acceptable view that does not see the obligation to limit money to only gold and silver.

anchored in the claim that the legal value of fiat paper money is an imposition by the state on the people and that the production of paper money is a limited monopoly by the state. By these, Vadillo advocates the use of gold dinar and dirham as Muslim-world currencies and he also outlines the steps for the implementation.

Dinar and dirham are the Islamic terms for gold and silver currencies. The terms are mentioned in the Holy Book of Qu'ran and the *hadith* of the Last Prophet, Muhammad (peace be upon him), referring to certain events and occasions of which, dinar and dirham were used at that particular times (see appendix I).

People have used bullion like gold and silver as money for the past millennia due to the fact that gold is universally desirable, valuable, compact and durable. Generations of human beings have found the yellow metal to be of the highest and purest form of money. One crucial reason for this is that, unlike national coinage, the value of gold cannot be diluted away by politicians.

Having high faith in the "Islamic currency", Vadillo (1996) continues his strong condemns on fiat money system and further stresses the agenda of gold dinar and dirham. In *The Return of the Gold Dinar: A Study of Money in Islamic Law*, he explains how the money creation through deposit multiplier as practised in the banking system is the main cause of inflation. He writes, "...It is, therefore, not exact to say that the governments create inflation, they only regulate it, or try to regulate it, but the creation of the credit – most money is credit – is made by banks"[2]. More seriously, he even blames the Islamic banking system, which he describes as a mere duplication of the

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See Haneef, M. Aslam and Barakat, E. Rafiq (2002). *Gold and Silver as Money: A Preliminary Survey of Fiqhi Opinion and Their Implications*. Paper given at International Conference on Stable and Just Global Monetary System – Viability of the Islamic Dinar, Kuala Lumpur.

[2] Vadillo, Umar I., (1996). *The Return of the Gold Dinar: A Study of Money in Islamic Law*, Madinah Press, pp. 4.

conventional banking and therefore is an evil idea.[3] Due to these, he believes that the best modus operandi for the new gold dinar system will be without banks as the tool of its operation. He propagates the use of Internet financial provider (IFSP) model for the introduction and implementation of the new gold dinar system.

Mydin (2002) elaborates the en suite systemic problems in fiat monetary regime. Symptom such as asset price bubble shows how the system's non stopping growth in money supply; exceeding the potential real sector productivity comes as a signal to imminent economic bust. Taking the Asian Economic Crisis in 1997 as his case, Mydin illustrates how money-creating mechanism of fractional reserve fiat money, is the root cause of the turmoil. Therefore, Mydin argues for the urgent need to redefine money and eliminate interest rates from the economy. Specifically, he supports Vadillo when he suggests a promising alternative – "The Islamic Gold Dinar" which he claims capable in overcoming most of the shortcomings and negative effects of fiat money, interest-based system.

Faith in the interest-based, fiat paper money system is also declining among the non-Muslim economists. Bernard Lietaer, President of Belgium's Electronic Payment System (Gelder, 2002, Lietaer and Nerb, 2002) mentions about the possibility for a new kind of currency, better suited to building community and economics sustainability – the Terra[4]. Bernard condemns the concept of positive time value of money. It causes today's monetary system has little to do with the real economy. Bernard further gives examples of some past historical evidences when the use of money was taxed, thus

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[3] Ibid, pp. 8.

[4] For more details on Terra, see Lietaer, B. and Nerb, G. (2002). *Terra: A Counter cyclical Reference Currency to Stabilize the Business Cycle.* Paper given at International Conference on Stable and Just Global Monetary System – Viability of the Islamic Dinar, Kuala Lumpur.

creating a negative time value of money - demurrage. As a result, society that implemented this idea gained high productivity.

Critic to the banking system because of it monopolistic nature was further emphasized by Keynes (1919) in his book, *The Economic Consequences of the Peace.* He writes,

> ...There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.

Hayek (1978) further stresses,

> ...There is no justification in history for the existing position of a government monopoly of issuing money.

Diwany (2002) gives a brief analysis of banking history and he shows how the uncontrollable growth in money supply inherent in fiat money system, gives banks effortless means of generating wealth for those owning them. These status and prestige are abusive to the public when banks inflate the economy for the benefit of few.

A noble price laureate, Robert Mundell (1977) admits the systemic problem when gold link to money is abandoned. He writes,

> ...After 1971, when the Golden Anchor was lifted, inflation control had to depend on the slender reed of Federal Reserve discipline. The result was pandemic inflation that has all the characteristics of becoming a permanent feature that future generations will have to cope with.

Inflation inherent in the current monetary system is termed a 'legal' way of robbery by Vadillo (1996) when he argues,

> ...If we are forced to use a particular medium of exchange at the same time as this medium is subjected to a permanent devaluation by the various causes of inflation, we are being cheated. At best, we are being unjustly taxed and at worse, we are being legally robbed.

Return to gold money was the case in a country facing hyperinflation as Cardenas and Mann (1987) find in the study of the Mexican economy, focusing on the inflationary process, which happened in 1913. The stabilisation efforts to control price and value of Mexican pesos finally led to high demand for gold currency primarily because of the government step to repudiate its own currency by demanding various taxes to be paid in hard currency. As Cardenas and Manns (1987) write:

> ...Shortly after, the government repudiated its own money by demanding that a growing amount of the various taxes to be paid in hard currency; at the same time, some sectors of the economy also demanded their salaries to be paid in gold money. Finally, as if by magic, gold and silver coins returned to circulation... thus stabilizing the exchange rate and the level of prices.

Many great economists disappointed with current system give tribute to gold as the best commodity to be used as money. Greenspan, quoting from *Gold and Economic Freedom* writes, "...In the absence of the gold standard, there is no way to protect savings from confiscation through inflation".

Moderately, Greenspan takes a position of using gold price as a target for monetary policy rather than targeting interest rates or money supply, as would the conventional monetarists might suggest. This idea grounded on the fundamental of targeting price stability. Basically, the simplest and most effective way to do that would be to target a single price that would stand as a proxy for all other prices – the price of gold.

Fundamentally, all central banks have to do is to pick a single gold price (say $300 for an ounce of gold) and adjust the money supply to meet the determined price of gold. Too much liquidity in the economy consequently would raise the price of gold denominated in that paper money. This is inflation. Conversely, shortage of liquidity would push down the gold price, which in turn is an indication of deflation.

Arguably, this idea is worst than the Breeton Woods because first, $300 (from the example) is not redeemable for an ounce of gold. Second, history as the best evidence shows how the United States failed to maintain discipline of its Fed during the Bretton Woods to maintain $35 per ounce of gold, in spite of the written policy for the superpower to honor the agreement. Third, a pertinent problem of picking the ideal price of gold as a target will arise. All in all, the best option to reform the monetary system is to return to the gold coinage currency.

Both Muslim and non-Muslim economists agree that gold is the best form of money to ensure stability and freedom of economy. Initial efforts to reform the international monetary system in the new century came in the form of electronic money or better known as e-money.

E-money comes in various forms. Several e-monies backed by gold available (to mention few) are e-dinar, e-gold, goldgrams, e-bullion and many more (see appendix II). The variety of new gold-based e-monies springing up on the Internet marketplace represents a step toward free banking ideal. The economic historian, Larry Schweikart observes,

> ...overall, the combination of state charters and free banks led to one of the most stable and prosperous periods known in American financial history...Contrary to the predictions of some, when money was taken out of the

hands of the government and subjected to a private market, it produced a stable free-market money supply (see Terrell).

Nowadays, people all around the world have options whether to use fiat paper money or gold money to make on-line payments. Gradually, assuming economic agents realize the goodness of hard currency, it is expected that the use of fiat paper money will slowly diminish.

Greenfield and Rockoff (1996) study the possibility of monetary reform; investigating the social-choice dimensions under a currency substitution process. They examine public choice of currency by considering: 1) the relative returns of a currency versus its substitute; 2) a model that consider the cost of issuing notes versus its substitute and 3) a model that stresses legal-tender laws.

In their analysis of relative returns of a currency, they use the Tipping Model of acceptance or rejection by public for a particular currency. The model suggests there are only two possible outcomes – general acceptance or general refusal. If many people use a particular currency, then others also have good reason to use it. Conversely, if most people refuse to accept a particular currency, then others also have good reason not to use it. Basically, this model suggests of no possibility of using two kinds of currencies in an economy.

In their conclusion, Greenfield and Rockoff (1996) find evidence that the Tipping model cannot handle the greenback-yellowback experiment (US Dollar vis-à-vis gold currency). In addition, the model that stresses the cost of issuing notes also ends with the same result. In both cases, gold banks fail in the East but the argument runs aground in California. Only the model that stresses the legal-tender laws successfully explain the greenback's success in the East but not its failure in California.

Undoubtedly, government role in making paper money as legal tender plays a vital part in the success story of paper money implementation. As proposed by Vadillo (1996), gold currency will gradually function as a dominant currency if it is introduced side by side with fiat paper money. This parallel currency approach (Pentecost, 2001) requires government support to recognize gold coin as money[5]. Problems arising under fiat paper money are self-destructive, hence wiping out confidence of public to the system; making them to searching for stable alternative of monetary order – the gold currency[6] (see appendixes III).

In the process of introducing the gold dinar, Vadillo gives four major steps. First is the process of minting the gold and silver currencies. Second, to give total freedom for people to buy, sell and use the currencies in the market. Third, to facilitate transportation and transaction of the currencies for international trade and lastly, to abolish all paper money by replacing it with newly minted dinar and dirham (Vadillo, 1996, pp 59).

Many still doubts the idea of gold dinar. In the case of Malaysia, Prime Minister, Dr. Mahathir shows a deep interest in this idea (see appendix IV). This research seeks the viability of gold dinar in Malaysia. The outcome of the survey of public-choice dimensions of ringgit and gold dinar is hoped to give some indications of public preference in the currency substitution process.

[5] For example, Franklin Roosevelt made the private ownership of gold for monetary purposes illegal.
[6] A Rashid, Hafiz M. *et. al.* (2002) when comparing the gold-based currencies (rate of gold per ounce, Special Drawing Rights and silver per ounce to USD were used as proxies for gold-based currencies)