الجامعة الاسلامية العالمية ماليزيا
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
يونيۏرسيتي إسلام انتارابڠسا مليسيا

MASTER OF BUSINESS ADMINISTRATION

MANAGEMENT CENTER
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

APPROVAL

CANDIDATE NAME: ZAINUL ARIFFIN BIN HARUN

MATRIC NO: G 9812161

TITLE OF PROJECT PAPER:

THE PROBLEM OF FIAT MONEY IN MUSLIM NATIONS AND A POSSIBLE SOLUTION.

The undersigned certifies that the above candidate has fulfilled the conditions of the project paper prepared in partial fulfillment of the requirement for the Master of Business Administration (MBA)

Supervisor

DR. AHAMED KAMEEL MEERA

DATE: 17 - 7 - 2002

DR. AHAMED KAMEEL MYDIN MEERA
Head Department of Business Administration
Kulliyyah of Economics and Management Sciences
International Islamic University, Malaysia

DECLARATION

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

Signature :

Name : Zainul Ariffin bin Harun

Date : 16-7-2002

Abstract

The persistent of monetary and economic disorder for the past 15 years has left people to ponder what is actually wrong with the system. This is especially true lately with the widening of income disparity between the rich and poor countries. This problem is further worsen by the huge accumulating and ever increasing debt especially The Third World Countries and the highly turbulence exchange rate which without pity become the biggest robber to the affected countries.

This paper pinpoints the Fiat Monetary System as the root of the economic illness that we are facing today; assessing and exposing the danger and the implication of adopting this system at home. It also highlights the hidden agenda behind the creation of paper money, the conventional banking system and the threat of external debt to Muslim countries.

Finally, this paper calls for the Muslims to adopt the commodity money – Dinar and Dirham as the medium of exchange, which is proven to be fairer and more just compared to fiat money.

Acknowledgement

In the name of Allah, Most Gracious, Most Merciful.

I would like to express my heart-felt appreciation to my supervisor Dr. Ahamed Kameel Meera whose guidance and support has made the completion of this project paper possible. My appreciation also goes to all UIA lecturers who have taught me throughout the two and half years' course. To my fellow course-mates, for your assistance, encouragement and moral support, thank you very much.

My sincere gratitude to my father Tuan Haji Harun Bin Haji Masri and my mother Hajjah Juwariah Bt Hj Salehuddin who have given constant support and prayers, without which it would be almost impossible for me to complete this course. I shall pray for your health and safety in this world and hereafter.

To my colleagues Encik Mohd Yusoff Salleh, for his kindness in providing me with the relevant input and Cik Noradilah Zainal Abidin, who has assisted in re-arranging and compiling the content as well as the tables and charts. I really appreciate it.

Last but not least, I would like to extend a very special thanks to my beloved wife Noor Azah Bt Omar and my kids; Abang Yusuf, Kakak Sarah and Adik Umar for your enduring love, patience and understanding during those periods. I love you so much. May Allah Swt bless all of you, always.

InsyaAllah.

Table of Contents

Contents	page

Tables **page**

Charts

Figure

1.0 Introduction

Money acknowledged as great inventions, constitutes a most fascinating aspect of economics. "Money bewitches people. They fret for it, and they sweat for it. They devise most ingenious way to get it, and most ingenuous ways to get rid of it. Money is the only commodity that is good for nothing but to gotten rid of. It will not feed you, clothe you, shelter you, or amuse you unless you spend it or invest it. It imparts value only in parting. People will do almost anything for money, and money will do almost anything for people. Money is a captivating, circulating, masquerading puzzle"[1]

Money is also one of the most crucial elements of economics. It is much more than a passive component of the economic system – a mere tool for facilitating economy's operation. When operating properly, the monetary system is the lifeblood of the circular flows of income and expenditure which typify all economies. A well-behaved monetary system is conducive to both full production and full employment. Conversely, a malfunction monetary system can make major contributions to severe fluctuations in the economy's level of output, employment, and prices, and can distort the allocation of resources.

---

[1] Source: Mc Graw Hill- Economic 12th Edition adapted from : Federal Reserve Bank of Philadelphia, "Creeping Inflation". Business Review, August 1957, p.3

1.1 Money and concept

This paper begins by briefly explaining the concept of money and the chronology of the world monetary system that shape the present system.

By definition, money is anything that is generally accepted as payment in exchange for goods and services. Although this definition gives us very little information on exactly what money is since it can be anything but it tells us a great deal of what money does. In essence, money is used to facilitate the exchange of good and services.[2]

1.2 Types of money

While the variety of money types is only bounded by the imagination and necessities of an economy, we can classify money into two types, commodity money and fiat money.

Commodity money is any money that has value in use in addition to its value in exchange. Feather, cigarettes, precious metals, and gems are all example of commodity money. In each case the money can be used to facilitate exchange or it can be use as a commodity. For instance cigarettes are smoked and gold, silver and gems are used to make jewelry.

---

[2] According to Islamic Law, no merchandise can be imposed as the only money. Imam Malik defined money as any merchandise commonly accepted as a medium of exchange. That means, people are free to choose their medium of exchange

The second type of money is fiat money. Fiat money is any money that has value in exchange but little or no value in use. The currency or notes and coin issued by most governments today constitute fiat money. The currency issued whether RM 1 or RM 100 is worth very little as commodity. When we consider RM 100 notes has the same paper content as a RM 1 note, it is clear that paper currency has no practical value as commodity.

1.3 How fiat money derive it value

While it is understood how the commodity money derive it value, how about fiat money?

If fiat currency has no intrinsic value and if they are not backed by gold or other precious metals, then why are they money? What gives a RM 10.00 its value? A reasonable answer to these questions involves three points.

1. Acceptability

Notes are money simply because they are accepted as medium of exchange. Suppose we swap a RM 50.00 for a shirt at super market. Why does the merchant accept this piece of paper? The merchant accepts it because he or she is confident that others will also be willing to accept it. In short, we accept paper money because we are confident it will be exchangeable for real goods and services when we choose to spend it.

2. Legal Tender

Our confidence in the acceptability of paper money is partly a matter of law; currency has been designated as a legal tender by government. This means that paper money must be accepted in the payment of a debt. Put more bluntly, the acceptability of paper moneys is bolstered by the fact that government says these papers are money. The general acceptability of currency is also bolstered by the willingness of government to accept it in the payment of taxes.

It should be noted that the fact that paper currency is generally accepted in exchange is decidedly more important than government's legal tender decree in making these paper function as money. Indeed the government has not decreed bank's cheques to be legal tender, but they successfully perform the vast bulk of the economy's exchange of goods, services and resources.

3. Relative Scarcity.

Basically, the value of money, like other commodity value is a supply and demand phenomenon. That is, money derives it value from its scarcity relative to its usefulness. The usefulness of money lies in its unique capacity to be exchanged for goods and services, either now or in the future.

1.4 Fiat money - What constitute money supply

The major components of the money supply are debts or promises to pay. Paper money is the circulating debt of the Bank Negara, in the case of Malaysia, or Federal Reserve Bank in the case the United States of America. Current Account or checkable deposit is debts of commercial banks. A RM 10.00 note is just a piece of paper and current account is merely a bookkeeping entry. And coins have intrinsic value less than their face value. Nor will government redeem the paper money we hold for anything tangible, such as gold.

In other word, fiat money is non-convertible paper money backed only by faith that the monetary authorities will not cheat by issuing more money.

1.5 History of the World Monetary System

Almost from the dawn of history, gold has been used as a medium of exchange because of it desirable properties. It is durable, portable, easily recognized, divisible, and easily standardized. Another valuable attribute of gold is that short-run changes in its stocks are limited by high production costs, making it costly for governments to manipulate. Most importantly, because gold is commodity money, it ensures a long-run tendency toward price stability. The reason is that the purchasing power of an ounce of gold, or what it will buy in terms of all other goods and services, will tend toward equality with its long-run cost of production.

1.6 Muslim Monetary System before World War 1

When the Arabs conquered the Byzantine possession in Syria at the end of the seven-century they took over the "solidus"(see figure1)[3] as their unit of gold, gave it Islamic types and called it a Dinar. The Dinar and Dirham were used as the official Islamic currency beginning with the second Caliphate, 634 – 644 CE. The Islamic Dinar is the weight of gold equivalent to 4.25 grams, whereas the Islamic Dirham is the weight of silver equivalent to 3.00 grams. Their transaction standard by weight was established by the second Caliph Umar Ibn al-Khattab (ra) as "seven Dinars must be equivalent to ten Dirhams." This standard and the use of gold and silver coins remained official currency of Muslim states throughout the centuries until the fall of the caliphate after World War 1.

In the past, Muslims were able to travel throughout the Islamic worlds and trade with Dinars, as they could at home. Paper currencies were only introduced in Muslim lands in the colonial era and continued into post-colonial era. In the Ottoman Empire, paper money was first used in 1840 CE. Later it was given up. It was used in 1843 CE for the second time and in 1854 CE for the third time, each time being superseded some time later. Its fourth monetization took place in 1877 CE under the entitlement of the Ottoman Bank, and from then on it has been use up till now, being changed every so often. In none of the book written or the fatwas given

[3] Source: http://www.the-privateer.com/goldcoin.html – 3/5/01

during that long period has it been said or stated that the Zakat[4] could be given in paper money. People have always given their Zakat in gold or silver.

1.7 Chronology of the World Monetary System

The Classical Gold Standard: 1821 – 1914 (World War 1)

In 1821, after the Napoleonic Wars and their associated inflation, England returned to the gold standard. From 1821 to 1880, more countries joined the gold standard. By 1880 most nations of the world were on some form of gold standard. [5]

The Gold Exchange Standard: 1925 – 1931

The gold standard broke down during the World War I and was briefly reinstated from 1925 to 1931 as the Gold Exchange Standard. Under this standard, the United States and England could hold only gold reserve, but other countries could hold both gold and dollars or pounds as reserve. In 1931, England departed from gold in the face of massive gold and capital flow, owing to an unrealistic exchange rate, the Gold Exchange Standard was finished.

---

[4] The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of poor and the needy.

[5] The gold standard essentially involved a commitment by the participating countries to fix the prices of their domestic currencies in term of specified amount of gold. The countries maintained these price by being willing to buy or sell gold to anyone at that price. For example , from 1821 to 1914, Great Britain maintained a fixed price of gold at Pnd 4.2474 per ounce. The period from 1880 to 1914, during which the classical gold standards prevail in its most pristine form, was a remarkable period in the world history.

To avoid such destructive economic in the future, the Allied Nations agreed to a new postwar monetary system at a conference held in Bretton Woods, New Hampshire, in 1944. The conference also created two new institutions – the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank) – to implement the new system and to promote international financial stability. The IMF was created to promote monetary stability; the World Bank was set up to lend money to countries so they could rebuild their infrastructure that had been destroyed during the war. Both agencies have seen their roles evolve over time

The Bretton Woods System: 1946 – 1971

Under the Bretton Woods Agreement, implemented in 1946, each government pledged to maintain a fixed, or pegged exchange rate for its currency vis a vis the dollar or gold. As an ounce of gold was set equal to $35, fixing a currency's gold price was equivalent to setting it exchange rate relative to dollar. For example, the Deutsche Mark was set equal to 1/140 of an ounce of gold, meaning it was worth $0.25 ($35/140). The exchange rate was allowed to fluctuate only within 1% of its stated par value.

In short, the main features of the Bretton Woods System were the relatively fixed exchange rates of individual currencies in terms of the U.S dollar and the convertibility of the dollar into gold for foreign official institutions. These fixed exchange rates were supposed to reduce the riskiness of international transactions, thus promoting growth in world trade.

However, in the 1971, the Bretton Woods System fell victim to the international monetary turmoil it was designed to avoid. The fixed exchange rate system collapsed with the dissolution of the gold standard.

There are two related reasons for the collapse of the Bretton Woods System. First, inflation reared its ugly head in the United States. In the mid 1960s, the Johnson administration financed the escalating war in Vietnam and its equally expensive Great Society programs by, in effect, printing more money instead of raising taxes. This lack of monetary discipline made it difficult for the United Stated to maintain the price of gold at $35 an ounce.

Second, the fixed exchange-rate system collapsed because some countries – Primarily West Germany, Japan and Switzerland – refused to accept the inflation that a fixed exchange rate with the dollar would impose on them. Thus, the dollar depreciated sharply relative to the currencies of those three countries.

The Post-Bretton Woods System: 1971 to the present

In December 1971, under the Smithsonian Agreement, the dollar was devalued to 1/38 of an ounce of gold, and other currencies were revalued by agreed-on amounts vis a vis the dollar. After months of such last ditch efforts to set new fixed rates, the world officially turned to floating exchange rates in 1973[6].

1.8 Assessment of the present floating rate system

At the time floating rates were adopted in 1973, proponents said that the new system would reduce economic volatility and facilitate free trade. In particular, floating exchange rate would offset international differences in inflation rates so that trade, wages, employment, and output would not have to adjust. High inflation countries would see their currencies depreciate, allowing their firms to stay competitive without having to cut wages and employment and vice versa [7]. However the world is experiencing a reverse effect whereby the exchange rate volatility has actually increased since floating rate system began. To cite an example, the ups and downs of currency had little to do with economic conditions but a lot to do with the expectations of future government policies. One wonders, what actually went wrong with the system !

[6] An exchange rate whose value is determined in the foreign exchange market or market forces.

[7] Purchasing Power Parity (PPP) – The exchange rate between the home currency and any foreign currency will adjust to reflect changes in the price level of the two countries. For example, if inflation is 5% in United States and 1% in Japan, then the dollar value of the Japanese yen must rise by about 4% to equalize the dollar price of goods in the two countries.

2.0 Objective and Methodology

The objective of this paper is to convince the Muslim of the danger of using fiat monetary system at home. By letting this system to rule our lives, Muslim economic and political power is at stake. Furthermore, Islam strongly condemns the usurious element of this monetary system, our beloved Prophet SAW cursed the practitioners and Allah SWT Himself declared war against them.

The paper also proposes for the introduction of a single currency for the Muslim.

Secondary data has been extensively used to support the arguments laid down in this paper. In fact, almost all the data that has been collected is compiled from journals, numerous reports, newspaper cutting as well as Statistical Yearbook. This paper took a composition of OIC countries the sample for observation.[8]

3.0 The most common economic problems

The monetary and economic disorders of the past fifteen years....are a reaction to a world monetary system that has no historical precedent. We

[8] The composition of the sample size may differ depending on the availability of data

have been sailing an uncharted waters and it has been taking time to learn the safest routes.[9]

3.1 The first problem – The ever increasing inflation rate.

Today, more and more families require two incomes just to get by. Those with only one income frequently find themselves unable to sustain a middle-class lifestyle. To put it simply, the purchasing power of the money has declined and is still declining.

Looking back in time, there was a remarkable long-run price stability in the period before World War I, during which most countries were using the gold standard. Table 1 shows that the price levels at the start of World War I were roughly the same as they had been in the late 1700s before the Napoleonic Wars began.

This record is all the more remarkable when contrasted with the post-World War II inflation experience of the industrialized nations of Europe and North America. As shown in table 2, 1995 price levels in all these nations were several times higher than they were in 1950.

Comparing this figure with the value of the Islamic bimetallic currency, for example a chicken at the time of the Prophet SAW, cost one Dirham, today about 1400 years later, a chicken costs approximately one Dirham.

[9] Source: Multinational Financial management, 6th Edition. Adapted from Milton Friedmon – Winner of Nobel prize in economics

In 1,400 years inflation is zero.[10] Could we say the same about the dollar or any other paper currency in the last 15 years?

Now look at the inflation rate of some OIC countries[11] (see table 3). For the past 15 years from 1984 to 1999, the average change in consumer price is 14.8 percent per year. Thus for every subsequent 7 year-period, the consumers actually pay double for the same goods they bought seven years ago.

3.2 The second problem – The highly volatile exchange rate

One does not have to look far behind to understand the problem of exchange rate. The Asian financial crisis 1997 is enough to convince us the danger of foreign exchange. In the case of Malaysia, just because the market forces loss confidence, we lost billions of Ringgit. During the crisis, Malaysian Ringgit was devalued by 50 % against US dollar. Malaysia's per capita income before devaluation was US$5,000. A 50 % devaluation reduced the per capita to US$ 2,500. In GDP terms, Malaysia with a population of 20 million has lost US$ 50 billion in purchasing power.

But the loss due to the fall in share prices when investors sold off their shares and took the money out of the country is even more. Malaysia had the biggest stock market in Southeast Asia, capitalized at about 900

[10] Source: http:// www.murabitun.org/WITO/white.html – 3/22/01
[11] OIC is stand for Oganisation of Islamic countries

billion Ringgit. When the Ringgit was 2.50 to one US dollar the capitalization was equal to US$ 360 billion. A fall of 50% in share value means market capitalization is reduced to 450 billion Ringgit. But today the US dollar is equal to RM 3.80 and therefore market capitalization in US dollar is 118 billion - only 30% of what it were before. Malaysia lost another US$242 billion.

Adding up the devaluation loss to market capitalization loss, the total loss is about US$290 billion, in round figures.

This is a real loss of wealth, wealth accumulated over years of hard work. It took Malaysian about 20 years to push per capita income from US$2,500 to US$5,000. It was taken away in less than six months.

3.3 The third problem - the acute income disparity

The United States known for and is in fact, proud of their capitalist economic system, but look at the result. The United States is the most unequal industrialized nation in the world in term of income and wealth.[12] The top 1% receives a disproportionate share of total income, and they already own nearly 40 % of the nation's total net worth – more than is owned by the entire bottom 90 % of U.S households. The economic elite own 49% of all publicly held stock, 62% of all business assets, 78% of bond and trusts, and 45% of non-residential real estate – for the net worth

[12]Source: Busines Ethic, 3rd Edition .Adapted from Keith Bradsher, "As U.S Urges Free Markets, Its trade barriers are many," New York Times, February 7, 1992, A1.

of US$5.7 trillion. It would, for example, take a city of more than quarter-million average Americans – the size of Rochester, New York – to equal the net worth of Bill Gates alone. The top 10% have 68% of the nation's wealth in their hands. If we leave out homes and real estate, those making up the bottom 55% have zero or negative financial assets. About half of the country's top wealth holders inherited their wealth. In the very wealthiest group, 98% are white.[13] Are we supposed to follow their footsteps?

The fact that Muslim Countries are still far behind in everything is hard to deny. According to the United Nation, in 1950 the average gap of income between the rich countries and poor countries is 35:1 but in 1992 the gap has become wider to 72:1. In 1998, 1.2 billion people live below the poverty line with income less than US$1. The worst part is that, most of the poor countries are populated by our Muslim brothers.

Six out of ten countries, which had the lowest per capita income in 1996, are Muslim countries. For example in Sudan, the per capita income is only US$63, in Somalia it is US$ 78, Mozambique US$ 81, Ethiopia US$ 102, Afghanistan US$111 and Sierra Leone US$145. These figure are far less compared to the chart leaders: Switzerland US$36,399, Luxembourg US$35,583 and Japan US$ 31,451.

[13] Source: Business Ethics , 3rd Edition. Adapted from Robert Reich, The Next American Frontier (New York: Penguin Books, 1983) 174, 178. See also Benjamin M. Friedman, Day of Reckoning (New York: Vintage Book, 1989), 57-58.

4.0 Analyzing the economic problems

4.1 The Inflation

Defining inflation as a sustained general price advance does not commit one to any specific cause. However, to substantiate the above defination, some dictionaries do clearly define the meaning of inflation. For example, in one, inflation is defined as an abnormal increases in available currency and credit beyond the proportion of available goods resulting in a sharp and continuing rise in price level.[14]

Of course, many theories can be proposed about inflation but one can not be wrong to say that, excessive monetary growth has always been the cause of the world hyperinflation. The 100% profit margin on issuing new fiat money has proved to be an irresistible temptation for most governments.

No government willingly accepts the responsibility for producing inflation even in moderate degree, let alone at hyperinflationary rates. Some commons excuses for inflation are greedy businessmen, grasping trade unions, spendthrift consumers, Arab sheiks, bad weather, or anything else that seem remotely plausible. No doubt, any of these can produce high prices for individual items. They can also cause temporary

[14]Source: American Heritage dictionary , 1969. The original meaning of "inflation" in economics was a swelling of the money supply, like swelling of inflation of a bag or alloon with gas. Webster's 1884 – undue expansion or increase from over issue said of currency.

ups and downs in the rate of inflation. But they cannot produce continuing inflation, for a very simple reason, not one of the alleged culprits possesses a printing press on which it can legally churn out those pieces of paper money, none can legally authorize a book keeper to make entries on ledgers that are the equivalent of those pieces of paper.

Outputs on the other hand are limited by the physical and human resources available and by the degree of knowledge and capacity for using those resources. At best, output can grow somewhat slowly. Over the past century, output in the United States grew at average rate of about 3 percent a year. Even at the height of Japan's most rapid growth after World War II, its output never grew at much above 10 percent a year. Paper money does not have such limitation. Most of the Islamic countries experiencing double digit growth in M1 and M2[15] for the past 10 years from 1990 to 1999 (see table 4 & table 5). Some countries like Indonesian, Nigeria, Suriname and Turkey experienced constant growth of M1 of more that 100% every year.

Today, electronic banking and fund transfer systems are giving money an unparalleled and dangerous importance. Because of the speed of electronic system, the same amount of money now is estimated to support five times as many transactions as before. Thus the speeding up of money

[15] M1 is currency plus checkable deposit, M2 is M1 plus Non-checkable saving, small time deposit, money market deposit accounts, and individual money market mutual fund balances.