THE RETURN TO GOLD DINAR: HISTORICAL AND PRACTICAL ANALYSIS

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Abstract

This paper initially discusses the brief history of gold dinar as currency and its flow until it is replaced with the current fiat money system. The objective of this paper is to show that the recent idea in Malaysia to introduce gold dinar as monetary currency in Muslim countries is not a workable idea. Despite the destabilizing potential of the current monetary arrangements in the world, the return to gold dinar is neither desired nor practicable. The proposers of the idea are shown to be talking non-workable idea. This paper argues that the implementation of gold money in Muslim countries is in no way an Islamic compulsion, as there is neither any ruling that says Muslims are required to resort to gold money, nor there is any that says Muslims cannot resort to fiat money. And, even if gold money is enforced, the system is likely to end in a failure. Hence, it is suggested that the public policy must be guided by rationale, and not emotions.

Introduction

After the breakdown of Gold Standard in 1931, the world is faced with an era of freely fluctuating exchange rates between national currencies. The instability did not prove advantageous to the smooth flow of goods and capital across national borders, notwithstanding that the government at that time encouraged and promoted national import and export. Issues on imbalance of payments attacked a number of countries, especially the developing ones. International trade and commerce was much reduced in activity. But there was not much reform until the end of the Second World War in 1945.

The International Monetary Fund (IMF) was established in 1946 to make arrangements for fixing exchange rates among national currencies with some measure of flexibility and help them tie over their balance of payments difficulties. The fixity part of exchange rates regimen was ensured through the agreed parities of various countries money to gold in the IMF scheme. But members could vary the gold parity of their currencies within 10% on either side of the current ratio without prior permission of the IMF. Thus, it was a system of .managed flexibility. The system worked fairly well as the US guaranteed to buy and sell gold at $35 an ounce. But the country faced serious inflationary pressures and balance of payment problems aggravated further by a sharp jump in oil prices in the early 1970s. Eventually, the country had to pull the dollar peg off the yellow metal then.

Once the gold-currency link was pulled off, an era of freely fluctuating exchange rates again followed. The IMF system was perforce reformed and the amended articles became operational in 1978. The new accord allows members to define the value of their currency in terms of criteria other than gold. Many countries now peg their money either to (i) some external currency or (ii) to the special drawing rights (SDRs) of the IMF or (iii) to a basket of other currencies.

After the 1997-98 financial crisis, Malaysia was in particular searching for what could ensure economic stability in the international transactions for the economy in years ahead. To this, the then Prime Minister of Malaysia, Tun Mahathir Mohamad, made a suggestion in early 2002 at a conference organized by Malaysian Securities Commission. He suggested that Muslim countries introduce gold dinar initially as a unit of account for settling foreign payments among themselves. History has shown that gold dinar worked perfectly well in international trades, and it was seen that gold dinar could ensure international exchange rate stability. Since then, many seminars, conferences, talks and briefings were held to analyze and explain the working mechanism and benefits of gold dinar system as opposed to fiat money system.

Idea by the Gold Dinar Proposers

The ball was formally set rolling by Meera, the leading advocate of the idea when he published his book The Islamic Gold Dinar in 2002. He presented a paper *The Islamic Gold Dinar; Socioeconomic Perspectives*, written with Aziz at an international conference held at Kuala Lumpur the same year. This was essentially a preliminary work where the authors attempted to look into the prospects and the challenges of introducing the Islamic gold dinar as a complementary currency within and among Muslim nations in the light of what Malaysia had experienced during the 1997-98 financial crisis (2002). One of the important points by Meera is his claim that a return to gold could alone restore order in an otherwise chaotic exchange arrangement reining the world at present. As a first step in that direction, Muslim countries who are, he thought, the worst victims of the Western exploitation must introduce gold dinar as a unit of account in their payments system.

The writings on gold dinar referred to above have led the deliberations on the subject in two broad directions. First is a fiqhi inquiry: is the using of gold dinar (or gold) as money a Shari'ah obligation for Muslims? Second, is the fiat money system inherently more unstable compared to the gold-based exchange rates? Let us have a look at these strains of argument in the literature.

Haneef and Barakat (2006) present a survey of the fiqhi positions on the use of gold (and silver) as money available in both the Arabic and English writings. They find the fiqhi opinion, past and present, are divided on the issue if gold and silver could alone be Islamic money or it can assume other forms as well? Some of the scholars argued that only gold and silver can be used as money. Others maintain that there is no such compulsion: materials other than gold and silver could also be used as money. They cite the principles of *ibadah* and *maslahah* to invoke the allowance of discretion in the matter.

This brings us to a third point: the role of seigniorage in a monetary system. The authors mention this issue and it is much talked about in Meera's writings. He has in a recent paper written with Larbani (2006) argued that fiat money system, because of seigniorage plus interest, is not compatible with the objectives of the Islamic shari'ah while commodity money like gold and silver alone is. It may be rewarding to look at the historical origin of the term to understand its import in the current circumstances.

In origin, seigniorage means something claimed by the sovereign or a feudal lord as his prerogative in relation to society. In the context of money, it was the percentage share of the crown in the bullion people brought to the royal mint to get converted into coins. Now-a-days, the term is applied to all money, including the credit created by banks. Such extension of the term is not appropriate. People do not pay for printing of notes that the central bank issues. The initial objective is not to enrich the crown. However, it is undeniable that seigniorage is now one of the sources of revenue for the government. Now, this is the element advocated by

Meera and Larbani (2006) as being incompatible with the objectives of the Islamic shari'ah.

Gold Dinar and Exchange Rate Stability

Return to gold standard is advocated for having exchange rate stability. In practice, not in theory, exchange rates do diverge much among countries, if left unattended to fluctuate. The divergences add to the risks of international trade, its volume suffers. Inter-country loans play a significant role in smooth running of international finance. Loan contracts are usually made in the currency of the creditor country for obvious reasons – to ease enforcement. The debtor remains in the dark as to how much shall be the burden of the principal plus interest in its own currency in the coming years. The risk of international borrowing tends to increase.

Thus, the fluctuating exchange rates seriously hamper international trade and finance. More so in abnormal times as countries tend to engage in competitive currency depreciation to gain or retain the export advantage. If stability does not impose greater costs than gains, it indeed is worth pursuing. However, gold standard was not adopted after any conscious weighing of the advantages and disadvantages of exchange rate stability. It came out naturally from the historical evolution of money. Currencies were initially made of metal; in course of time gold becoming the dominant choice.

Could gold standard as described above ensure price stability at home country? In theory, maybe, but in reality, gold standard does not stabilize price levels as it does not stabilize the volume of currency in a country. It merely stabilizes the relation between the volume of gold and the volume of currency but if the volume of gold itself fluctuates, the domestic gold standard does not stabilize the volume of currency, rather it forces it to fluctuate. Thus, gold standard offers no guarantee for internal price level stability. The history of gold standard confirms this conclusion: it is replete with examples where the influence of gold standard on prices was found wanting: it failed to curb inflation or to prevent depression. Instead, it broke down.

The limitations of domestic gold standard are aggravated if extended to international arena. Its international component is concerned with the external value of a currency. The proposers of gold dinar believe that linkage with gold can ensure its stability, while Mansor (2006) seems to support them by implication. Logic and history both negate their conclusions.

It may be useful to begin with the reiteration that the domestic gold standard was part of the evolution of money, not the result of invention. For example, its extension to external transactions too was part of the same natural process. When gold coins constituted most of the money supply in two countries, there was little room for variations in the exchange rate between them.

So long as the bank deposits in the two countries A and B were freely convertible into gold at fixed prices, the exchange rate between them could not vary from their *mint parity* by more than the small margin of what were called the *gold points*. Any demand for foreign currencies that could not be met in the foreign exchange market at a rate within say 0.5 percent on either side of the *mint par* was shunted out to the gold market. Thus, the demand for any currency in the foreign exchange market always equaled its supply. The gap was covered by the gold movement between the two countries. Figure 2 explains the automatic nature of the balancing mechanism.

Performance of the Gold Linked Money

Stability of exchange rates is desirable, rather necessary, in this era of globalization for promoting free trade and liberalization, but on a return to gold, only the naïve will insist. We have identified a few reasons as to why the return is neither desirable nor practicable. One of these i.e. the issue of internal stability, we have already touched upon. Under the strict rules of the game, it is realistic to assume that the central bank of country A keeps gold in reserve just what is obligatory, say 40% of notes in circulation, to ensure their convertibility.

Suppose now that there is an inflow of gold, ignoring reasons, worth \$ 1 million. This moves into the reserves of the central bank. If it does not, as it cannot, build a buffer stock of gold, it must put additional notes worth \$ 2.5 million in circulation. And if the banking system is to maintain a 10% reserve for credit creation the economy would become awash with a monetary expansion of \$ 25 million. This multiple expansion of money supply may impose inflationary pressures on an otherwise stable economy. You may work out the deflationary potential of gold out flow of a similar magnitude. In fact, gold standard inherently carries a deflationary bias: a country losing gold must contract credit but the one receiving it is under no compulsion to expand credit.

It is estimated that the volume of money involved in foreign exchange spot transaction alone is 70 times of the money value of world's real output. Supply of money tied to gold would fail to meet the money requirements of the modern age. One may be fond of day dreaming but return to gold is not even worth that dream. Today, financial transactions are an ocean wherein real transactions are just a tiny island. Return to gold is not possible.

1. Gold linkage is not enough for ensuring stability of exchange rate; it must fluctuate with changes in the price of gold in the two countries. The equation between currencies can be maintained only when sale and purchase of the metal at a fixed price is part of the scheme. Without this measure even the denomination of trade in gold / gold dinar instead of paper currency hardly serves any useful purpose. It will only add to the complexities of bilateral trade agreements.

2. Converting exports and import first into gold and the balance into US dollars is a cumbersome process. It is frivolous and will add to trade risks.

One risk is due to fluctuation in the relative price of gold in the two countries. Another is related to the conversion of gold balance back into US dollars as, unlike the assumption in the example, that currency (USD) is not linked to gold. The time interval involved in each conversion and between them is of crucial importance. A better course of action would probably be to convert the import and export values expressed in local currencies into US dollar directly.

3. However, if any of the countries - Malaysia or Pakistan - decides to buy and sell gold at a fixed price, it may set into motion international arbitrage operations, even if clandestine, and may play havoc with the smooth running of the economy. As Muslim countries share among themselves a meager portion of their aggregate foreign trade to not more than 15% presumably and have an overall deficit with the rest of the world, the scheme brings us face to face with the peril of draining gold out from the Muslims to the rest of the world. The fact that Muslim countries produce annually less than 10% of total output of the yellow metal cannot be over looked in this context. The gold dinar proposers seldom take note of these facts.

It is instructive to note that in a not too old empirical study Retner (1992) finds that gold prices have shown much erratic behavior since 1972 which is difficult to explain. The author uses relevant data for the period June 1973 to December 1988. He concludes on the basis of his test results that gold functioned as a weak hedge against inflation until 1979, and in the following periods it could provide no protection against rising prices. Gold prices were also regressed on the dollar foreign exchange rates of six major industrial countries - Canada, France, Italy, Japan, West Germany, or the United Kingdom. It was found that here also gold provided no hedge against the decline of US dollar vis-à-vis these currencies.

The gold dinar proposers here may want to undertake a similar exercise for Malaysia.

Conclusion

Much of the present paper talked of gold standard from a historical perspective. In that we can claim little that is original. However, it was needed to remove many cobwebs in the thinking on gold dinar as a cure-all to all economic difficulties that Muslims are currently facing. One problem with the proposers is that they do not stick to what they say even for a moment. Do they want a return back to gold as money in Muslim countries? Is it their position that having gold dinar as currency is a shari'ah imperative for Muslims? Is it gold or gold dinar that they argue for standard at the international level? Are they saying that gold dinar should be used in bilateral trade agreements? The answers cannot be definite nor satisfactory.

Our literary research and legal and banking framework observation has brought forward the following findings:-

1. Return to gold standard at the international level is not considered either desirable or practicable for some strong reasons. These were clearly spelled out by J. M .Keynes in his position paper of 1938 quoted in Halm (1956) The managed currency system of the IMF enforced in 1946 did maintain the gold linkage of national currencies, but diluted the rules of the old game considerably. The 1978 amendments to the IMF articles specifically forbade members to express the value of their currencies in terms of gold. This realization presumably is the reason why the gold dinar proposers no longer talk of returning to gold standard.

2. Unless gold standard is international, there is no point in having domestic gold standard. It is found working neither as a hedge against inflation nor as a better investment alternative. In a world conceived of as a global village, gold-link may create more problems than it may resolve; even if restricted to bilateral trade only.

3. Having gold dinar as money is not a Shari'ah requirement. The Fiqh Academy is not opposed to the use of fiat money in Muslim countries. The gold dinar proposers may like to seek confirmation on the point. The use of seigniorage notion to attack the fiat money is untenable; rather inapplicable.

4. The issue in monetary economics is to keep the supply of money under control, not of its being made of something valuable as a commodity. Using gold for the purpose is akin to a blind man leaning against the lamp post for rest not for illumination. Alert and efficient management of money supply with adequate credit and capital controls in place can and is delivering results e.g. in China and India. Manage the economy properly, keep a watch on domestic prices, and build strong diversified foreign exchange reserves. You can ensure stability of both the price level and the exchange rate. Let it be known that fiat money is not an exclusive terrain for corruption to thrive, the history of gold standard bears ample evidence that the abuse of the system was not entirely absent then too.

In light of the above, we submit that despite its idea is backed up by historical success; gold dinar system is not workable or desirable given the current legal and banking framework.

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