

THE
THEFT *of*
NATIONS

RETURNING TO GOLD



AHAMED KAMEEL MYDIN MEERA

PELANDUK

*By the time,
Verily man is in loss
Except such as have Faith,
And do righteous deeds,
And (join together)
In the mutual enjoining
Of Truth, and of
Patience and Constancy.*
— Holy Qur'an, Sura Al-'Asr 103

*To my father
Mydin Meera Allapitchay
and to those who place
Truth above self.*

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Preface

THIS BOOK IS a critique of the interest-based global fiat monetary system. It highlights the many shortcomings inherent in this system, particularly the stability and justness aspects. It then argues in favour of real money systems like the gold dinar that was mooted by the Prime Minister of Malaysia, Dr Mahathir Mohamad, as a solution or a way out from the fiat money debacle. The word *dinar* simply refers to a unit weight of gold, just like the British *sovereign* and other gold coins. Hence, our statements on the gold dinar are equally applicable to all gold coinage or even gold itself.

The book starts off by showing how nations, particularly the developing nations, lose significantly within the global interest-based fiat monetary system. It attempts to reason with the reader why globalization and financial liberalization are akin to colonialism, and why a total cashless society may perfect this colonialism. It also argues why, within the current monetary system, it is impossible for Islamic banks to operate independently from interest rates or *riba* that is strongly condemned in Islam. The book then discusses how the gold dinar may be implemented for settling bilateral and multilateral trade balances and for use in domestic transactions. The many advantages of the gold dinar over the fiat monetary system are also discussed, including its superiority as a hedging tool for managing foreign exchange risk compared with other derivative instruments like currency forward rates, futures and options.

This book is written with the layman in mind and hence avoids complex mathematical models. It does not intend to bog down the reader with statistics and charts but rather invites the reader to ponder over and contemplate things. Nonetheless, the views and opinions presented herein are the author's alone and may not necessarily represent the views and opinions of the Malaysian Premier, the Government or the International Islamic University of Malaysia.

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Kuala Lumpur

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I am also encouraged by the success of my earlier book *The Islamic Gold Dinar* published by Pelanduk Publications and the consequent *2002 International Conference on Stable and Just Global Monetary System* that was held in Kuala Lumpur, Malaysia on August 19-20, 2002. I am particularly indebted to the speakers and participants of the conference for the excellent discussions that surfaced. This includes Tan Sri Dato' Nor Mohamed Yacop, the special economic adviser to the Prime Minister of Malaysia, Prof. Bernard Lietaer (author of the book *The Future of Money*), Tarek el-Diwany (author of the book *The Problem with Interest*), Rev. Peter Challen and Rodney Shakespeare of the Christian Council for Monetary Justice (UK), Prof. Mashudul Alam Choudhury (author of *Money in Islam*), Prof. Kabir Hassan, Dr. Mazhar Iqbal and Prof.

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This list of acknowledgements would be incomplete if I failed to mention my wife Noraini Salleh who certainly deserves a special place for all her encouragement, understanding, support and prayers.

Prologue

THE GOLD DINAR is getting some attention from various quarters including the banking sector, the private sector, governments and academics. The situation in the global monetary system seems to have convinced many, of the problems inherent in the present interest-based fiat monetary system; particularly its unjust and unstable nature. In searching for solutions, many have begun to view gold as a viable and promising alternative, which is also seen as an important missing link in the Islamic banking and finance arena. The current global financial system is on the verge of collapse due to the unsustainable nature of the fiat monetary system. Fiat money has become an excellent tool for speculation, manipulation, rigging, economic dominance and colonization. The history of the Muslim world is a clear example of this. In the Malaysian proposal, the gold dinar is to be initially used for settling bilateral and multilateral trade balances among a group of participating countries. The gold dinar was the currency of the Muslim world until the collapse of the Ottoman caliphate in 1924. Being the single currency of the then Muslim world, the dinar united the Muslim nations as a trade bloc. Trade flourished from Morocco in the West to Malacca in the East. A powerful Muslim rule had then emerged, with Muslim dominance in knowledge, the global economy and politics.

The collapse of the Ottoman caliphate was an unfortunate event in Muslim history. In consequence, the Muslim world found itself disintegrated and colonized. Its monetary system based on gold and silver was then replaced by national currencies that were basically fiat money. For the first time, interest or *riba* entered triumphantly into the Muslim world thereby successfully marginalizing the teachings of all the three Abrahamic faiths — Judaism, Christianity and Islam — that strongly condemned the practice of charging interest. With the adoption of paper money and interest, Muslims became increasingly divided and vulnerable; a glorious civilization that was once endowed with abundance of wealth, knowledge and power, was reduced to one plagued with poverty, high illiteracy, impotence and backwardness, which was subject to wide oppression. Even a great civilization like Egypt, with the Nile still as fertile as ever has now been reduced to a perpetual state of being a “developing nation” within this system. Equipped with little international reserves particularly the US dollar for international trade, many developing nations, including most Muslim nations, are currently in pathetic conditions.

The 1997 East Asian crisis clearly shows how national currencies have become tools for speculation, manipulation and for economic, cultural and political domination. The ringgit was attacked to such an extent that Malaysia was on the verge of total destruction when the government swiftly and boldly nailed down the problem to offshore currency speculation which were simply transfers of ringgit between accounts held in Malaysian banks by

means of simple accounting book entries.¹ Speculative transactions are made even easier by the fact that money today is predominantly nothing but accounting figures in books or computer memory records. Millions and billions can, therefore, be transferred at the stroke of a key on the computer keyboard.

Within this fiat money system, developing nations were, however, able to develop with varying degrees of success. Some countries including Malaysia were fortunate that they were able to develop fairly equitably. But today, the fiat money system has reached a level such that it is no longer advantageous, particularly to developing nations.² In the current era of information technology, globalization and neo-liberalization, developing nations are about to give away their national wealth and sovereignty to the foreign financial masters practically for “free”. Even now, the wealth of weaker nations is being plundered away easily and thereby creating economic destitution in these countries. However, the stakes have never been this great before. In Malaysia for example, even with its bank merger exercises, its financial institutions still cannot match the foreign giants in terms of size. Therefore, the financial liberalization planned to take effect by the year 2007 and thereby the entry of foreign banks into Malaysia is, in fact, a threat. This book partly attempts to reason with the reader why this is so. The current fiat money system is also accused of causing numerous

¹ The term “offshore” is somewhat misleading since it seems to suggest that transactions take place outside the shores of the nation. Nonetheless, the fact is that speculative transactions take place inside the country with ringgit being transferred between accounts held within the local banks.

² The situation in the developed nations too has reached a very unstable position such that the global financial structure seems to be on the verge of collapse. Financial distress and bankruptcies of large corporations and banks are more frequent.

socio-economic problems. On top of that, operating within the current monetary system, Islamic banking also faces problems in attempting to realize its own identity, distinct and independent from the conventional interest-based banking. Islamic banking and finance are linked to the present conventional banking through the fiat money system. Any price differentials between these two banking practices can be arbitrated away easily thereby causing both to converge and become equal in essence. The mechanism of arbitrage and convergence also forces the Islamic banks to incorporate the interest rate factor when pricing their Islamic financial products. While the Islamic bank was established with the objective of providing alternative interest-free banking, in essence this has not been realized yet. Arbitrage and hence convergence between Islamic and conventional banking and finance are discussed further in Chapter 4. In order to solve or minimize the problem or protect oneself from the many negative effects of fiat money, there are proposals that the existing Islamic banking and finance system be complemented with the gold dinar. The gold dinar is nothing more than a gold payment system. The gold dinar is seen as a missing piece in the Islamic banking and finance arena, which is capable of providing unique solutions to many of the problems faced within the fiat monetary system. The gold dinar could bring out the true difference between conventional and Islamic banking, by placing a solid obstacle between the two that prevents arbitrage and convergence and thereby effectively dichotomize both the banking systems.

Accordingly, a return to the gold dinar is viewed as highly desirable and urgent in the current era of globalization, to circumvent the many problems faced within the interest-based fiat

monetary system. Nations may adopt the system and thereby reap its numerous benefits. Gold has, in fact, played the role of money in most civilizations for thousands of years. While many are convinced about the importance and significance of the gold dinar, there are questions that need answers particularly those regarding the implementation of the gold dinar within the present fiat monetary system. An abrupt implementation of the gold dinar is definitely not a wise thing to do, for that can bring about numerous other problems. This book is basically a critique of the fiat money system and argues in favour of the gold dinar, while providing some models and suggestions for its implementation.

This book is written from a Muslim perspective due to the author's inclination towards the strong Islamic tenets that call for abstinence from interest or *riba* and uphold justice among people of all nations, races and creeds. The fiat money system is criticized here primarily from the viewpoint of justice and stability. Nevertheless, the arguments put forward are also applicable for all nations, Muslim or otherwise, many of which are disadvantaged or enslaved by the present monetary system.

The concept of the gold dinar was mooted by the Malaysian Prime Minister, Dr Mahathir Mohamad, calling nations to settle international trade balances in gold. The acceptance of the Malaysian Premier's call is yet to be seen, but the proposal however warrants serious attention particularly from developing nations that are likely to benefit most from a gold payment system in facing the challenges of globalization and neo-liberalization.

PART ONE
THE PROBLEM

Stakes in the Current Global Financial System

If ye do it not (give up usury), take notice of war from Allah and His Messenger.
— Qur'an (Al-Baqarah 2:279)

*The study of money, above all fields in economics, is the one in which complexity is used to disguise truth, or evade truth, not to reveal it*¹ — John Kenneth Galbraith

TODAY'S GLOBAL FINANCIAL system is in a situation it has never been in before. Major economies — the United States, Europe and Japan — are simultaneously showing signs of financial distress or even collapse. The vulnerability of the global monetary system is more obvious and clearer than ever. An impending global recession seems unavoidable — a situation some economists and financial experts predict to be even worse than that of the Great Depressions of the 1930s. Judy Shelton, in her book *Money Meltdown*, predicts that a global monetary collapse is imminent. As a response to or defence against the current financial and economic chaos, there is a growing global movement which is calling for the use of gold as money.² In Malaysia, the Prime Minister,

¹ John Kenneth Galbraith, *Money: Whence it came, Where it went*, Houghton Mifflin Co., Boston, p.5.

² The e-dinar (by the Murabitun Movement), e-gold, goldmoney, goldeconomy etc. are some examples. The World Gold Council had organized at least three international conferences addressing the role of gold in the international monetary system. Other solution providers include The Christian Council for Monetary Justice (United Kingdom), Bernard Lietaer's TERRA project and Zakaria Bavani's

Dr Mahathir Mohamad, has called on countries to use gold for settling international trade balances and thereby introduce some stability and justness into the present system. The benefits of using gold may be appreciated better if one understands why the fiat money system is currently not working to the advantage of countries, particularly the developing nations and why it is likely to collapse due to its very design. This chapter attempts to elaborate on this further.

The Main Features and Stakes in the Current Monetary System

Three main features of the current monetary system pertinent to our discussion are:

1. Interest
2. Fiat money — i.e. money without any intrinsic value. Paper money and bank money (also known as credit money or accounting money)
3. Fractional reserve banking

These three features are well-elaborated in textbooks and are fundamental to the process of money creation by the banking sector. Interest has a number of serious negative effects on the economy, while fiat money and fractional reserve banking allow the creation of bank money or credit money. This book argues that these features are detrimental, particularly to the developing nations from the current era onwards. The following fictitious story may help in expounding the effects of the above three features of the current monetary system on the economy and sovereignty. The ending of the story is something that we

Real Money Unit (RMU). Please see their papers in the *Proceedings of the 2002 International Conference on Stable and Just Global Monetary System*, Kuala Lumpur, August 19-20, 2002.

postulate would be common to developing nations ultimately in the current global monetary system unless something is done about it.

The Story of the Sucus and the Tucus

There were once two neighbouring islands far away in the oceans. One was called Aya and the other Baya. A certain people called the Sucus lived on the island of Aya. It was a fertile island with lush vegetation and tropical fruits. There were numerous waterfalls and rivers that provided the people with clean water and places for family retreats and recreation. The surrounding seas were unpolluted, with abundant fish and other seafood. The island also had gold and the Sucus, particularly the womenfolk, loved gold. They used pieces of gold as money since everyone treasured gold. Their tribal leadership led by a man named Saka, minted the gold coins. They lived a simple cooperative life and there were no interest charges for lending and borrowings among themselves. Occasionally, some tidal waves and strong winds destroy some property, particularly homes, but the community would immediately help themselves to rebuild or repair the damaged property. Other than that, it was a peaceful community of people who went about their life gracefully.

The island of Baya, on the other hand, was inhabited by a people called the Tucus. Their leader was an elderly man named Taka. The island of Baya was fertile too and the Tucus were mostly farmers who worked rice fields or kept cows, sheep and poultry. Some of them were good at handiwork and produced a variety of household items. They too lived a very peaceful and cooperative life, mutually helping each other for survival. The Tucus were, however, not so sophisticated as the Sucus, in that they merely did barter trade. The Tucus realized that the Sucus were much wealthier, healthier and had towns that were much more sophisticated than their own. They had always thought that the Sucus were more gifted and superior beings than themselves. Even though they barter traded their goods occasionally with the

Sukus they never got the idea of money. However, their women-folk too loved gold, particularly the gold jewellery that the Sukus made.

One day, two smartly dressed men arrived in a ship on the shores of the island of Aya. Their names were Gago and Sago. The Sukus being a very hospitable people welcomed their new guests. Gago and Sago impressed the Sukus with the stories of their extensive travelling. They showed them some gold coins from other parts of the world and also some printed papers that were apparently used by some far-away people as money. The Sukus had never seen paper before. The paper money even had pictures of bananas on it — their favourite fruit. The two strangers also showed them a machine that prints such money. Wow! That got the Sukus' attention. They were awed because they had never seen anything like that before. The islanders loved Gago and Sago and invited both to live with them on the island.

Gago and Sago convinced the people that an institution called a bank would benefit the people immensely. They explained that a bank would provide a place for keeping their gold money safe while uplifting their economic conditions by making the savings available to others for productive use, which otherwise would remain idle. The Sukus, being a people who loved to help others, thought that was a great idea. Gago and Sago then built a small building structure with a vault in it and started operating the first bank on the island of Aya.

They celebrated the occasion by giving the islanders a great feast along with a colourful festival of events. The people thronged to deposit their gold coins with the bank. Depositors were given a piece of printed paper for every gold coin they deposited, with the assurance that they could redeem a gold coin for every paper they turned in. The people were excited with the paper “money” they got because it even had a picture of their leader Saka beside a banana tree. No doubt Saka was very pleased too!

The people deposited all their gold coins, a total of 100,000 pieces and hence an equivalent number of pieces of paper were given out. Now the people used the paper as money and found that it was much more convenient than the heavier gold coins that they used before. The paper money printed by Gago and Sago, therefore, became the dominant currency of the island. Nobody used the gold coins anymore. The people were pleased with the ease with which they were able to go about doing their businesses. They trusted Gago and Sago very much because each time they brought in a piece of paper for redemption their request was indeed honoured. Gago and Sago became very respected and honoured in their society.

The Tukas who heard about the whole thing became excited and pleaded with Gago and Sago to help them out too. Gago and Sago smiled to each other and told the Tukas that they would indeed be very pleased to do so. They then set up a similar building in Baya, and Sago was placed there as the manager. The difference between Aya and Baya was that in Baya the Tukas had no gold coins to deposit. Sago told them that was alright. He would however, give 1,000 paper notes to each family to use as money. Since there were a hundred families in Baya, so 100,000 paper notes were given out. However, Sago reminded them that at the end of the year each family must return 1,100 paper notes, the 10 per cent extra being a charge for the services he was providing. The Tukas found the paper money truly to be like magic. It made their business dealings so much easier compared to their previous barter trade. People spent much less time looking for counter parties to trade with. Now they were able to specialize in jobs they were good at. Their economy began to grow rapidly.

Now Gago and Sago decided that the time was ripe for them to do their “trick” ... Gago noticed that in Aya, on average only 10 per cent of the gold deposits were redeemed by the Sukas at any particular time. The other 90 per cent remained in the vaults. Noticing that their printed papers were circulating as money, Gago printed an extra 900,000 certificates to be circulated as money too! Gago had calculated

that with the extra papers, a total of 1,000,000 pieces of paper would be outstanding and if the people came to redeem their normal 10 per cent, then the 100,000 original deposit of gold coins would be readily available for redemption.³ Gago loaned out this extra 900,000 paper money to some “needy” Sukus at an interest charge of 15 per cent.

The Sukus suddenly found that the price of things were rising. This baffled them and no one could figure out why.⁴ Some of them who had borrowed money from Gago were not able to pay back their debt even though they worked very hard trying to earn that extra money.⁵ Business became increasingly competitive and the society became less compassionate and less caring towards others than previously.⁶ The Tukus too found similar things happening to them. Initially, they did not notice any price increase but they noticed some behavioural change in their people. They became very competitive in their attitude and less caring towards their fellows. Even with hard work and such competitive behaviour, some of the Tukus still defaulted on their loans. They were not able to acquire enough money to pay back their total debt.⁷ Now Sago began to confiscate real

³ This is how money is created in the current banking system in aggregate. If the reserve requirement is 10 per cent, then for a deposit of 100,000 a total deposit that can be created is given by $100,000/0.10 = 1,000,000$.

⁴ This is easy to see with the help of the equation of exchange, $MV = PY$. The equation of exchange is explained in Appendix A. In this example, with the sudden increase in the money supply M , without a corresponding increase in real output of goods and services Y , the price levels, i.e. P thus tend to increase (the velocity of circulation, V , is assumed unchanged and constant).

⁵ The loan (principle plus interest) is not repayable in aggregate because the interest portion does not exist in the form of money. Notice that the interest of 15% on the 900,000 principal equals 135,000. Therefore the total amount repayable is 1,035,000 but nonetheless, only 1,000,000 exist in total as money in the whole system. Accordingly, some defaults on the loans are sure to take place. This fact is further elaborated later.

⁶ Since interest charges do not exist in the form of money, competition for money therefore ensues, reflected in increased business competition. This fact is also further elaborated later.

⁷ Again, this is because there is not enough money in the system as a whole such that debt is not repayable in aggregate.

wealth from the loan defaulters — like land, cows, sheep, etc. Their elderly leader Taka was among those who defaulted. But Sago gave him and some other Tukas additional paper notes as a rescheduling of their loans. This increased further their indebtedness. Later Taka defaulted again and had his loan rescheduled again. Now Taka began to avoid meetings with Sago. He felt ashamed and found his former power, pride, courage and dignity falling.⁸ On the contrary, he found that Sago was slowly becoming very wealthy by acquiring the people's assets. In fact, he found that the power, pride, courage and dignity that he lost were now enthroned on Sago.

After a number of years, Gago and Sago who once arrived on the shores of the island of Aya with only a printing machine, were now the owners of most of the land and property in both Aya and Baya. The people were reduced to mere workers, some of them now living in poverty. Many worked long hours just to make ends meet. They now had less time for family, friends or for religious activities. Social problems were widespread. People cared less for others. It goes without saying that with poverty, other social ills like crime, prostitution, etc. began to thrive. Their cultures were gradually replaced because Gago and Sago introduced a new “superior” culture of a “superior” people to which they belonged. This was the end of the caring and loving people of the two islands of Aya and Baya, who had earlier lived a peaceful yet graceful life before Gago and Sago arrived with a printing machine.

Gago and Sago did not stop there. They continued to spread their wings to other peoples and societies. Their ultimate dream is to become the Global Supreme Rulers by establishing a single global bank with single global money.

⁸ Imagine that you borrowed RM10,000 from a friend. Do you think your behaviour toward the friend would change, say when you meet the friend in the street? Particularly when the stipulated time for the return of the loan had expired?

We postulate here that in the current global monetary system, developing nations would go through somewhat similar events as pictured above. Let us give a formal explanation for the above effects of the interest-based fiat monetary system. To begin, let us discuss the effects of interest on the economy.

Interest and Its Effects on the Economy

Interest is a prominent feature of the current global monetary system. Currently, it plays a marked role in all societies, including those that apparently profess the three Abrahamic faiths, i.e. Judaism, Christianity and Islam, all of which had strongly condemned interest in their original teachings.⁹ Islam was the last stronghold, resisting interest-based monetary systems for centuries until the collapse of the Ottoman caliphate in 1924, the consequence of which was that interest entered successfully into the Muslim world. Many economists of today regard interest as the price of money or capital. It apparently is the price for parting from its use or benefit. It is therefore legitimate, in their opinion, to charge interest. They argue that it is therefore “erroneous” to prohibit interest charges, for otherwise that would be tantamount to an unfair treatment of the lender. Unfortunately, however, not many people seem to truly understand what interest charges actually do to an economy, particularly within a fiat money system. Some prominent experts on money have clearly identified these effects. Bernard Lietaer¹⁰ and Tarek el-Diwany¹¹ for example,

⁹ Please see Appendix B: *Riba* in the Holy Scriptures.

¹⁰ Bernard Lietaer, *The Future of Money*, Century, 2001, p.50

¹¹ Tarek el-Diwany, “History of Banking: An Analysis”, paper presented at the 2002 *International Conference on Stable and Just Global Monetary System*, Kuala Lumpur, August 19-20, 2002.

have identified, among others, the following three main consequences of interest:

1. Interest requires endless economic growth even when actual standards of living remain constant.
2. Interest encourages competition among participants in the economy.
3. Interest concentrates wealth in the hands of a small minority by taxing the majority.

We shall attempt to explain the above effects using the equation of exchange shown below.

In a fiat money system, we know that money supply increases through multiple deposit creation. How much money creation is possible depends upon the reserve requirement set by the central bank.¹² Money created through multiple deposit creation enters into the economy in the form of loans.¹³ This initial ballooning of money supply can bring about some inflationary pressures. This is easy to see from the equation of exchange. The equation of exchange equates the monetary side of an economy to its real sector. It is something logical in the structure and is, therefore, a mathematical identity.

¹² Standard textbooks on money and banking or macroeconomics normally do cover the topic on money creation through the multiple deposit process. This process is briefly described in Appendix C.

¹³ This bank money is the major component of money supply in most countries. The state money is the other form, i.e. the paper notes and coins issued by the government. However, contrary to what most people would expect, this state money is usually a much smaller component of the total money supply. Most people have the notion that all money is issued by the government, citizens deposit it with banks that pay them some interest, and that the banks would in turn lend the money to others at a higher interest rate. But this is not the truth. Most money is truly created out of thin air (and hence the term ‘fiat’) by the banks and equally surprising is the fact that even governments borrow money from these banks and pay interest on the loans (when they actually have the right to issue money — paper currencies and coins).

$$M V = P Y$$

The left-hand side represents the monetary sector while the right-hand side the real sector.¹⁴ When money supply increases through multiple deposit creation, M increases. If there were no corresponding increase in the real output of goods and services, i.e. Y , the price level P would rise assuming the velocity of circulation, i.e. the V remains constant. However, this new money enters the economy as loans, thereby demanding interest payment on it. This is precisely where a serious problem¹⁵ lies because the interest requirement itself does not exist in the form of money yet. Hence, total debt (principle plus interest) is not repayable in aggregate. The current monetary system can therefore be sustained only in a dynamic fashion by creating more and more money. This is done primarily by creating new debt that gets into the economy as additional money.¹⁶ Some of this, of course, would be used for rescheduling defaulting loans. Accordingly, it is obvious that the mere sustainability of the system requires a continuous growth in money supply. Notice that if we want stable price levels, there needs to be a constant rise in the real output, Y , to match the growing M . This explains why the existence of interest charges requires endless economic growth for actual standards of living to remain constant. This is the first main effect of interest on society. This required increase in real output can take place through an

¹⁴ See Appendix A for a further explanation on the variables in the equation of exchange.

¹⁵ A structural “defect”.

¹⁶ The government could also print paper money and introduce it into the economy by paying for the goods and services it purchases. In this case the new money would be debt-free. In aggregate, debtors can acquire this additional money and use it to service their loans (principle plus interest). However, once this money gets into the banking system, it would also start-off a spiral of credit creation.

increase in population (i.e. labour force) or through an increase in productivity or both. This also explains why in an interest-based economy there is so much emphasis on productivity and growth — i.e. basically to pay for the virtual interest that the financial system creates and charges on the real sector. The fact that total debt is not repayable in the aggregate also causes the society to compete for money, i.e. competing to acquire the cashflow needed to service debt (principle plus interest). Since there is not enough money in the system in total, some borrowers may succeed in repaying but some are sure to default (See Figure 1). Increased competition is the second main effect of interest on society.

Now let us take a look at the link between money creation in the form of loans and its implications on financial management, particularly the general capital structure in the economy.

We saw that the sustainability of the current monetary system requires additional money to be created, which generally takes the form of debt. However, debt in financial management has its limits and implications too. The level of debt a business can bear is constrained by the riskiness of the business itself. Therefore, the constant growth in aggregate debt in the economy makes financial default a certainty. With this, the next section explains why wealth and sovereignty are stakes in the current monetary system.¹⁷

Interest charges also cause wealth to concentrate in the hands of a minority by taxing the majority.¹⁸ Being wealthy, this minority group is likely to have a low marginal propensity to consume. Therefore,

¹⁷ Remember the story of Gago and Sago?

¹⁸ Banks are generally in the hands of a minority (who provide the “financial services”), while the rest of the nation work in the real sector producing goods and services. Since the banks create most of the money for a nation in the form of debt, even a

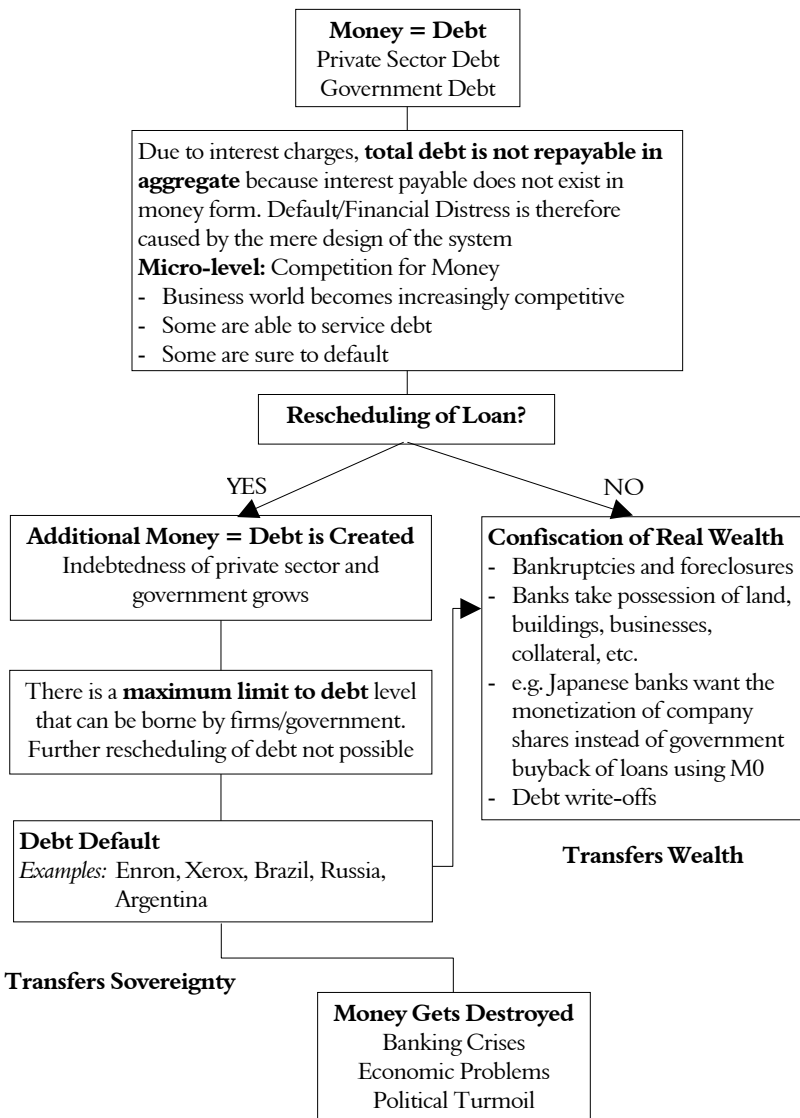


Figure 1: Flowchart Showing Stakes in the Present Monetary System

small interest charge is a charge on almost the entire economic output. In dollar terms this is likely to be huge.

money and wealth would tend to concentrate in their hands, without further circulation in the economy. This is the third main effect of interest on society. This concentration of wealth, in turn, would cause less and less money to circulate in the economy thereby bringing about numerous socio-economic problems associated with low circulation of money that includes unemployment. The society would notice increasing competition for money, whose circulation keeps decreasing.¹⁹ This competition for money is also the second main effect of interest.

In our earlier book, *The Islamic Gold Dinar*, we argued that increasing disparity in income distribution and the creation of poverty are both inbuilt in the interest-based fiat monetary system. While the World Bank was established in 1944, i.e. more than half a century ago, with the motto *Our dream is a world without poverty*, the institution's former chief economist, Nobel Laureate Joseph Stiglitz has the following to say:²⁰

A growing divide between the haves and the have-nots has left increasing numbers in the Third World in dire poverty, living on less than a dollar a day. Despite repeated promises of poverty reduction made over the last decade of the 20th century, the actual number of people living in poverty has actually increased by almost 100 million. This occurred at the same time that total world income actually increased by an average of 2.5 per cent annually.

¹⁹ In our opinion, this is precisely what happens when we say that the business world is becoming increasingly competitive and challenging. It is simply competition for money, brought about by wealth concentration in the hands of a wealthy minority.

²⁰ Joseph Stiglitz, *Globalization and Its Discontents*, London: Penguin, 2002, p.5.

In an interest-based fiat monetary system, such statistics should be expected rather than come as a surprise. Since the World Bank also indirectly creates money,²¹ we contend here that the institution is partly responsible for the creation of world poverty rather than solving the problem. Its motto, therefore, would surely remain a dream forever.

*... In order that it (wealth) may not (merely) make a circuit
between the wealthy among you ... — Qur'an (Al-Hashr
59:7)*

Stakes in the Current Monetary System

In our opinion, money creation through the multiple deposit creation process is no longer desirable particularly for the developing nations in the current era of information and communications technology (ICT) along with globalization and neo-liberalization because you run the risk of a total take-over of your nation by the foreign financial giants.²² Please follow Figure 1 as we give an explanation for this.

Money and Debt — Balance Sheet Counterparts

In the present monetary system, money is created and introduced into the economic system primarily in the form of loans. The commercial banking sector creates money through multiple deposit creation from much smaller initial deposits. With fiat money and fractional reserve system, this is easily accomplished. For example, if the reserve

²¹ For an explanation how the World Bank creates money, please see Michael Rowbotham, *The Grip of Death*, Jon Carpenter, 1998, p.140.

²² Malaysia, for example, is likely to face this risk when foreign banks start operating in 2007, as a result of financial liberalization.

requirement is 10 per cent, for an initial deposit of RM1,000, the system can support a total deposit of RM10,000 (so that 10 per cent of RM10,000 gives the RM1,000 initial deposit held as reserve). This means apart from the original deposit of RM1,000 the banking sector can create additional deposits of RM9,000. This addition is done in the form of loans and checking accounts and introduced into the economic system as money. This explains why money and debt are balance sheet counterparts. This debt shows up in the aggregate economy as private sector and public sector debt. In most countries, a large proportion of money supply is in the form of this bank money comprising simply accounting entries. The rest is paper money and coins issued by the government (statistics for 62 countries are provided in Appendix E).

However, as argued earlier, a very important fact that needs to be noted here is that due to interest charges on loans, the total debt (principal plus interest) is not repayable in aggregate.²³ This is because the interest portion does not exist in the form of money. Therefore, in the aggregate analysis, default is a certainty by the mere design of the system. This can basically lead to two outcomes: (1) Confiscation of real assets (collateral and others), or (2) Rescheduling of the loan. Rescheduling of the loan requires additional money to be introduced into the economy in the form of additional loans. However, this of course would increase the indebtedness of the private sector and the public sector, and thereby in aggregate, essentially defers a higher default amount to a later date. This is the reason why the total debt (private plus public) in any nation (both developing and developed) increases over time. Therefore, the present system can only be

²³ See footnote 5.

sustained dynamically — but only temporarily for a period of time. Temporarily, because debt has financial implications on the capital structure of firms and thus the whole economy.

The reason is this: Money is created and introduced into the economy — a risky world²⁴ — primarily by commercial banks, in the form of loans with some interest charge attached; and demands a payback of the loan plus interest in accordance to a riskless cashflow schedule.²⁵ The pairing of this “riskless” cashflow with the risky business world is a foundational mismatch from the beginning, i.e. a mismatch in the risk profiles.²⁶ Hence the birth of bank money itself is not on a good footing as far as the theory of finance is concerned.²⁷

Debt in Financial Management

Debt or borrowing is a significant means of financing in the present financial system. Individuals, firms and governments borrow from financial institutions to finance their activities — for consumption, investment, public expenditure, etc. Debt financing is particularly attractive to firms because it is generally a cheap form of financing. Issuance of new equity like shares is generally more expensive. Furthermore, interest paid on debt is also tax deductible while dividend paid on equity is not.²⁸ This tax deductibility of interest

²⁴ The business world is, on average, a risky world. However, individual businesses may face different levels of risk, some being riskier than others.

²⁵ Generally, loans are amortized periodically in accordance to legally binding loan contracts, usually on a monthly basis. The cashflow is riskless due to this ‘legally binding’ nature of debt service.

²⁶ This important fact is rarely highlighted even in academic works.

²⁷ You may well call bank money a “misfit” in the economy.

²⁸ Interest payments are recorded as expenses in income statements of firms, before arriving at the taxable income. Dividends are nevertheless deducted from the after tax income. Accordingly, the higher the interest expense, the lower the tax liability;

further reduces the cost of debt. Accordingly, debt financing increases the return on equity (ROE) to existing shareholders.

While debt is attractive, firms will have to carefully balance their capital structure between debt and equity because debt demands its payback according to a stream of riskless cashflow. When money is borrowed from the financial institutions or the public, the borrower promises a schedule of payment generally on a periodic basis as stipulated in the loan contract. The lender's contractual cashflow is protected by law, thus making the position "risk-free". Even in the event of bankruptcies, the debt holders (lenders) enjoy the privilege of being paid first before equity holders. This makes debt instruments attractive to lenders.

If debt is the cheapest form of financing, then why don't firms go for 100 per cent debt financing? The problem or the risk of debt financing is thus the cashflow commitment one has to give to service the debt. Whilst the borrower "guarantees"²⁹ a certain payment periodically, i.e. a riskless cashflow, the cashflow from normal business operations is rather risky. The firm has, therefore, got to match these in order to determine an optimal debt level that can be sustained to maximize firm value. How much debt a firm may go for depends on the business risk of the firm. Businesses with stable cashflows may go for higher debt levels. Examples include utility firms, that supply water and electricity. Cashflows in these sectors are not significantly affected during business cycle phases or seasonal trends. Even during economic downturns people still do want a stable supply of water and electricity.

but the tax liability remains the same irrespective of the dividend amounts. This, of course, gives debt an advantage over equity.

²⁹ Assessing the credit worthiness of borrowers is what rating agencies do.

However, high risk businesses should not go for high debt levels since problems may ensue in servicing the debt particularly during difficult times when cashflows are not good. Electronics and airlines industries are examples of these. A reasonable indicator of business risk is the firm's *beta*, a financial measure that estimates the market risk that a firm bears. Basically, *beta* measures the relationship between a firm's returns to those of the market as a whole. Beta for the market itself is unity, which serves as a benchmark.³⁰ Any firm, industry or portfolio with a beta larger than one is considered riskier than the market while those with betas of less than one are considered less risky relative to the market. As a rule of thumb, therefore, one may say that high beta companies should not go for high debt levels. Nevertheless, it is important to note that on the whole, businesses bear risk that is generally higher than the debt itself since the beta for the "risk-free" debt is zero.

Default is the Default of the Current Monetary System

Having said that money is primarily introduced in the form of loans with some interest payments attached, it is important to recognize that total debt (principal plus the interest) is not repayable in aggregate. This is because the interest that needs to be repaid together with the principal does not exist in the form of money. This fact is very important as it has a number of serious implications.³¹ For example, assume that money supply in the form of loans totals RM10,000, given out at an interest rate of 10 per cent. At the end of the period RM11,000 (i.e. RM10,000 plus interest of RM1,000) is due to be repaid.

³⁰ The stock market index like the Kuala Lumpur Composite Index (KLCI) is generally taken as a proxy for the market.

³¹ Interest charge is therefore another misfit in the economy.

However, only RM10,000 exists in the form of money. The interest portion does not. If additional money to the amount of RM1,000 is not created and introduced into the system, then some borrowers are bound to default on the loan. Therefore, in this system three things may take place in the process of sustaining the monetary system dynamically:

1. Additional money in the form of loans is created and given to those who are defaulting (i.e. reschedule or restructure loans). This would increase the indebtedness of the borrower.
2. Additional paper money and coins are introduced by the government to the extent of the non-existent interest money.
3. The bank confiscates real wealth (collateral and others) from the borrower.

The first two options imply that money supply in the economy continuously grows in order to sustain the system. The third option transfers real wealth from the borrower to the banker. In reality, the second option is hardly the dominant case. Surprisingly, even governments seem to be easily “tricked” into borrowing money from the bankers when, in truth, they have the right to supply money (paper notes and coins). The first and the third are hence the most likely to occur.

The first option causes money to grow in the economy in the form of debt — private sector debt, public sector or both, thereby causing these sectors to become increasingly indebted to the banking sector. The banking sector, having the power to give additional loans, effectively controls the ‘life-line’ of the borrowing units since it can decide which defaulting unit (for some units are sure to default by the design of the system) it would save (by giving additional loans) and which it would let fail. In the event of a failure, the bank may

confiscate real wealth from the defaulter. In Japan lately, for example, while the government suggested the buy back of bad debts with M0, i.e. state money, the bankers opposed it and proposed the monetization of shares instead (that effectively ‘confiscates’ real wealth).

The section on debt in financial management mentioned that there is a maximum limit of debt that business entities or otherwise can bear, depending on their business risk. However, since money grows in the form of loans in the current monetary system simply to sustain it, businesses and governments will, therefore, increasingly become indebted until a level is reached which cannot be borne any longer.³² Notice that this is simply by the design of the system. When firms cannot take it anymore they will collapse. The financial distress of large firms like Enron and Xerox are examples of this. When governments get into such trouble, they too can collapse; and are likely to get replaced. There are many examples of this that include some Latin American and East Asian countries — Argentina is a recent example. The effects of such a collapse are that real wealth and sovereignty will gradually shift to those who control the financial system.

We assert here that the banking and financial problems faced currently in Japan, Europe and the United States are primarily due to the above design of the system that is bound to collapse. Numerous financial crises and crashes have taken place in the past decades but now the global financial system is showing signs of an enormous impending crash because the above major world economies seem to have simultaneously reached “saturation” point. It is not difficult to see that this is because money is introduced into the system as loans through multiple deposit creation, with interest charges attached

³² It is, therefore, not surprising that senior executives of large firms resort to accounting irregularities and basically cheat to portray growth.

which, in turn, brings about further increases in debt until the whole system becomes unsustainable and thus ultimately collapses.³³

The foregoing arguments suggest that continuous rescheduling of loans is impossible and default on debt is therefore unavoidable. Examples of late include the financial distress of Enron, Xerox and countries like Mexico, Brazil, Russia, Turkey and Argentina. Default by firms would transfer real assets to bankers while the default by countries would transfer sovereignty (and ultimately wealth too). In many cases, the foreign financial giants have initiated changes in governments.

The default on debt actually destroys money through the reverse process of money creation and thus is likely to bring about a banking crisis too. This “now-you-see-it-now-you-don’t” feature of fiat money also makes banks very fragile institutions — many banks in Japan, Europe and the United States are now on the verge of such a crisis.

Since banks fail if a significant loan is defaulted, the failure of banks would thus transfer wealth to the bankers through the confiscation of collateral or otherwise. Therefore, while bank failures are bad for economies, they are not necessarily bad for bankers. In fact, this is a process that transforms the mere accounting figures (i.e. fiat money created from nothing by the banks) into real assets. The

³³ Many individuals have even obtained Nobel Prizes, analyzing issues within this interest-based fiat money system. The United States, Europe, Japan, the Muslim world and others have produced many intellectuals and yet this is the kind of financial system we have decided to adopt. John Kenneth Galbraith the famous Harvard economist stated that the process of money creation is so simple that the mind is repelled. Otherwise, what could for example, explain the fact that even countries with more than twenty Nobel Laureates in economics still show signs of serious economic problems? Our personal opinion is that an interest-based fiat monetary system is a tool for controlling resources, wealth and political power for those who defend and implement it, while being an insult to the intelligence of those who accept it willingly.

bankers would acquire the real wealth of defaulters in the process. It's kind of "realizing" the seigniorage of the accounting figures called money which they had created, i.e. from virtual numbers to real assets.

In summary, in this era of globalization and neo-liberalization, interest-based fiat monetary systems no longer work to the advantage of developing nations because they tend to lose wealth and sovereignty to the foreign financial giants.³⁴ Therefore with financial liberalization nations are about to give away their wealth and sovereignty to the powerful financial giants practically for "free". The entire process occurs subtly and gradually since interest is based on time. Therefore, its subtle effects may go unnoticed until the problem suddenly becomes visible.³⁵ The entire system is akin to "slavery" where economic development would still continue but the ownership of assets and sovereignty gradually gets transferred and eroded. The colonial masters when they left the countries after giving them "independence" made sure that interest-based fiat money banking systems were in place. The independent nations are, therefore, bound to ultimately lose their land and sovereignty and be economically colonized again.

By similar reasoning, therefore, in tackling the economic and financial crisis of 1997-98 among the best policies followed by the Malaysian government was that of not accepting the loan offer by the International Monetary Fund (IMF). Malaysia decided to use her own ways of solving the lack of money problem, particularly by making a significant reduction to the reserve requirement ratio and selective

³⁴ This is the reason behind the title of this book 'The Theft of Nations'. In Malaysia foreign banks are expected to make an entry in 2007 due to financial liberalization. Malaysia plans to carry out another merger exercise on its already merged banks in preparation for the anticipated tough competition from the foreign banks. However, this could prove to be futile for the foreign banks are simply huge. The foreign banks are likely to gobble up the tiny local banks.

³⁵ So developing countries, open up your eyes!

capital controls. Even though this brought about a slower economic recovery, it is highly commendable. If Malaysia had accepted the IMF loan, she would have been given nothing but some accounting records (not even paper money) created out of thin air and placed in some computers as “money”. But then Malaysia would have had to accept numerous conditions that would have ultimately transferred some sovereignty into the hands of the IMF.³⁶ In this way, over the years this is likely to result in a total transfer of power when nations fail to pay back their loans (remember that a fiat money loan with interest charges is not repayable in aggregate by the mere design — someone has got to default). So we have noticed many countries, like those in Latin America for example, collapsing financially. In the aggregate analysis, the interest portion has to be repaid ultimately in terms of real wealth through the confiscation of real assets like land, buildings and even firms.

“The United States is seen as a predatory nation, looting the world with its control of the World Bank and the IMF, through its international financial system, through its rigging of currencies, the value of currencies, and so forth. We are living, in the United States, on what we steal, legally, because we make the laws that enable us to steal.”

“Globalization of the World Economy is a Prescription for Disaster” by Lyndon B. LaRouche in the February 14, 2003 issue of *Executive Intelligence Review*.
Source: http://www.larouchepub.com/lar/2003/3006jaipur_univ.html

Interest is prohibited in all the three Abrahamic faiths, i.e. Judaism, Christianity and Islam. God in His absolute Wisdom forbade it for the

³⁶ Some people argue that countries that took IMF loans recovered faster. Sure they did. The analogy is simple: If two persons A and B were financially devastated but A got a handsome loan from C, whose economic wellbeing would be immediately improved? Sure A! But problems will show up when the time comes for A to repay the loan, just as many countries have ultimately experienced. In some cases, the ballooning cumulative interest even exceeds the GDPs of some borrower countries.

sake of justice and the betterment of mankind.³⁷ Nonetheless, it's the lack of faith, greed and sheer ignorance that has made mankind adopt the current unstable and unjust global monetary system that brings about numerous socio-economic problems. This includes even the Muslims who had earlier protected their economic system from *riba* until the collapse of the Ottoman caliphate.

The fiat money interest-based monetary system has numerous socio-economic implications.³⁸ A list of the more important implications is as follows:

1. Amplifies business cycles.
2. Generally inflationary and necessitates the need to control the price of basic necessities, particularly agricultural products.
3. Since the prices of many agricultural produce are somewhat controlled, this sector would be less attractive for investors compared to other sectors like the construction sector, etc. This may bring about land conversions, i.e. from agricultural-land to industrial land, etc.
4. Constant creation of money and over creation of money provide a fertile ground for speculation, manipulation and arbitrage.
5. Causes unemployment during economic downturns due to the destruction of money. The destruction of money causes a lack of money in circulation that, in turn, brings about slower business, business failures, bankruptcies and unemployment. It is the lack of a medium of exchange, therefore, that prevents

³⁷ Appendix B provides some quotations from the Holy Scriptures that forbid interest, also known as *riba* in Islam.

³⁸ For a discussion of the numerous socio-economic implications of the interest-based fiat money system, please see Ahamed Kameel Mydin Meera, *The Islamic Gold Dinar*, Pelanduk Publications, Kuala Lumpur, 2002.

- the exchange of goods and services from taking place (See Box).³⁹
6. Increased disparity in income distribution and hence the creation of poverty.
 7. Since the construction sector is one of the major sectors that absorbs the increasing money supply, prices of homes are bound to increase at a high rate, faster than the increase in income for most people. This also causes the average duration for housing loans to gradually increase.
 8. The creation of income disparity and poverty is likely to bring about numerous direct or indirect effects on society e.g. crime, forced female and child labour, child neglect, poor diet, poor health and education, etc.

Aliens and the Slum Dwellers

Two Aliens land in a slum neighborhood on the outskirts of a city. They are welcomed by the people; and both sides exchange conversations. The Aliens discover that most of the people work in the city; and are interested to know what they do for a living. One informs them that he is a construction worker who mixes concrete and lays clay roofs. Another tells them that he works for the water department that supplies clean, treated water for the people; and yet another works in a furniture factory, just like many of his other friends who work in one factory or another that produce various products. The Aliens also find that some of the people are jobless despite being educated and trained.

The Aliens, however, are puzzled to see that in spite of all the knowledge and skills the people seem to have, the neighborhood is in a rundown condition with shabby homes, filthy streets, a polluted river, etc. Their houses are neither made of concrete nor laid with clay roofs, their water source is untreated water from wells and the polluted river.

³⁹ Four conditions must exist for a paid job to occur, i.e. job to be done, raw materials, people willing to work and money. During a recession, all the conditions exist except that there is generally a lack of money in circulation.

The Aliens ask the construction worker, “Why is it that your home is not made of concrete?”

“I need money,” replies the worker.

The water department worker gives a similar reason for not having treated water for himself. He too needs money.

The Aliens then reason with the people, “Since there is a lot of talent in the neighborhood why doesn’t each of you provide for the needs of each other according to your skills? In that way your standard of living and the environment can be uplifted.”

The villagers again repeat that they are waiting for money.

The perplexed Aliens ask, “Who is this *money* anyway?”

Amused by the question and giggling, one of the villagers’ graduate daughter comes forward and explains “Money is a promise to pay issued by ... bla ... bla ... bla”.

Dumbfounded, the Aliens exclaim, “You are waiting for a promise to solve your problems?!!”

The Aliens look at each other and one whispers to the other, “There seems to be no intelligence on this planet. Let’s go!!”.

And the visitors leave the planet.

*Adapted from “Waiting for Money, or is it Godot?” in Bernard Lietaer,
The Future of Money, Century, p.146.*

Seigniorage — the Instability and Unjustness of the Fiat Monetary System

Quiz: What item that is much loved, desired and striven for by people, whose possession is not a crime...but yet, it is a crime if you produce it? (Answer at the end of Chapter 2)

THERE ARE A number of ways the wealth of nations is “stolen” by the wealthier and more powerful nations using the current global monetary system. This is basically done through the immense seigniorage of fiat money. Seigniorage refers to the difference between the face-value of money and the cost of producing it. For example, assuming that the cost of producing a 100-dollar note is 20 cents then the seigniorage is \$99.80. Seigniorage is a gain to the currency issuer. It’s the benefit one derives from the first use of fiat money. The bankers who create money through multiple deposit creation basically lend out this seigniorage at interest. Most governments get the seigniorage from the issuance of their respective national currencies. The Federal Reserve enjoys huge seigniorage from the issuance of the dollar since the dollar is also currently the dominant international reserve currency. Unlike most other currencies of the world, the dollar has strong purchasing power even outside the United States.

International Reserve Currencies

The stakes in the current monetary system, i.e. wealth and sovereignty, are transferred primarily through this seigniorage. The money created through the fractional reserve requirement system and the interest charges thereupon are basically also seigniorage. In the present global monetary system (that is fundamentally an interest-based fiat money system with floating exchange rates) developing nations lose tremendously from this seigniorage. This is a conscious and systematic act of transferring wealth via a “legal construct” in what would otherwise be an unlawful transaction. Resources of the developing nations are basically being “stolen” through this system, i.e. through the magic of seigniorage. For example, if the United States buys crude oil from Saudi Arabia using newly created fiat money, then the United States gets the benefit out of it. This is because the Saudis would have to give their oil extracted through hard work and huge investments, whereas in return they would most likely get an electronic accounting record placed in some computers. Of course, the Saudis may not lose anything since they can purchase other items with the “accounting money” but the fact remains that the United States was able to obtain the oil with money created out of nothing. This is what seigniorage is about.

A global reserve currency like the dollar, therefore, enjoys immense seigniorage, since it has global purchasing power. An international trade set-up that requires nations to accumulate foreign reserves before trading would greatly benefit the issuers of the international reserve currencies at the expense of other nations. In the case of the dollar, for example, the United States can create additional money for use outside the country without placing undue inflationary pressure domestically. However, if all the dollars around the globe

were to return to the United States, that would surely be hyperinflationary. The dollar's role as the international reserve currency has caused huge trade imbalance between the United States and the rest of the world.¹ In the fiat monetary system, the absence of an automatic adjustment process has enabled the United States to accumulate such trade deficits, which otherwise would have been impossible under the classical gold standard or the Bretton Woods. In those days, deficit countries settled their deficits in gold (that cannot be created) but today deficits can be settled with debt (that can be created).

Hence it is certainly a “good idea” for the United States to call dollar deposits outside the United States Eurodollars,² suggesting that these are different from the dollar itself. In fact, this could be so since the Eurodollar is subject to different regulations from the domestic dollar and even has its own exchange rates and interest rates. Interestingly, Eurodollars always remain in the United States regardless of who owns them or where in the world they were deposited. It's all in accounting, i.e. Eurodollar transactions only transfer ownership of deposits at United States banks. Additionally, reserve requirements are not imposed on Eurodollar deposits, thus enabling the banks to invest every dollar of it. Therefore, the institutions that create the Eurodollars enjoy the huge benefit of seigniorage without causing inflationary pressure in the United States. This free cash flow can be used for financing domestic and international activities. This is shown in Diagram 1 below. In the event

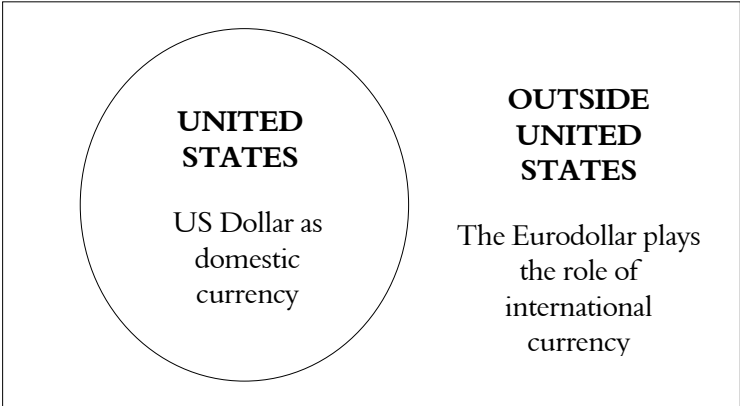
¹ Richard Duncan, *The Dollar Crisis*, John Wiley, 2003 explains this fact well.

² The Eurodollars are dollar deposits placed in foreign banks and foreign branches of US banks, distinct from the euro which is the common currency of twelve European nations.

the euro succeeds in replacing the dollar as the dominant international reserve currency, as the current signs are showing, then the euro, thereafter, will enjoy such enormous seigniorage.

... the Federal Reserve System, the greatest engine of inflation ever created. Because there was no other international money, the Fed could now pump out billions and billions of dollars that would be taken up and used as reserves by the rest of the world. — Nobel Laureate, Robert A. Mundell, “The International Monetary System in the 21st Century: Could Gold Make a Comeback?” Lecture delivered at St. Vincent College, Letrobe, Pennsylvania, March 12, 1997.

Diagram 1: Seigniorage of the US Dollar and the Eurodollar



The fact that dollars outside United States are called Eurodollars gives added benefit to the United States. In this way, the Eurodollar can be treated in a different way from the normal dollar as though it were a different currency. The institutions that create the Eurodollar enjoy all the benefits of seigniorage without much effect on domestic inflation (unless the Eurodollar tends to “return” to the US). Such seigniorage is no small amount. Other international currencies like the euro and yen would also enjoy such benefits; a benefit that can provide large but ‘free’ funding for domestic and international agenda.

Colonial Banks

Colonialists were responsible for establishing the banking systems in the countries they colonized. Fiat money, interest charges and the fractional reserve banking system were firmly rooted, including even in the Muslim countries they colonized. Colonized nations must have lost huge amounts of wealth to the colonial masters through the seigniorage of the fiat money banking system. Even when the colonial masters left, they made sure this system was in place. This loss is illustrated in Diagram 2 and explained below:

Assume that before the introduction of banks, a farmer had some land³ on which he planted rice. Now assume further that a single bank was then introduced in his village with a reserve requirement set at 10 per cent.⁴ Now assume that the farmer sells his rice and deposits RM10,000 in the bank. With this new deposit of RM10,000 the bank can create another RM90,000 of deposits in total such that the total sum is RM100,000. The total deposit is created so that 10 per cent of this amount equals the original deposit of RM10,000.⁵ The RM90,000 is given out as loans to borrowers.⁶ This is where the power of the loan officers comes in. The loan officers can pass on the RM90,000 to their “friends” with which they could purchase part or whole of the farmer’s land. The farmer might consider the RM90,000 offer to be a good deal and, therefore, decides to sell off part of the land as illustrated in

³ Or in the aggregate perspective you may consider this as the people’s total assets, which includes land etc.

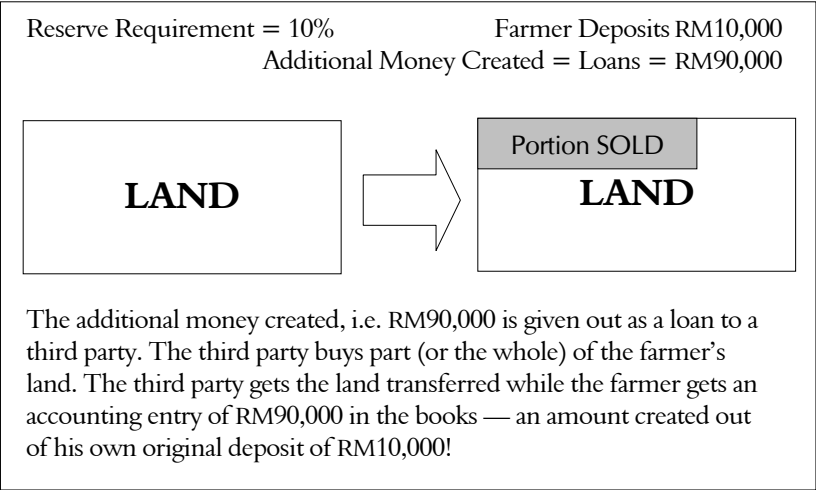
⁴ The reserve requirement is the proportion of deposits the bank must hold as reserves to honor normal demands by the depositors. This requirement is set by the central bank.

⁵ This additional creation of money is done in practice through multiple deposit creation, as illustrated in Appendix C.

⁶ In the modern monetary system this is how most money is born and introduced into the economy. The other money comprises the paper notes and coins issued by the government.

Diagram 2. With the transaction, the ownership of the land is transferred to the officer’s “friends” and the farmer gets merely an accounting entry in the books. While the land is transferred, it is important to note that the creation of the additional RM90,000 was made possible by the farmer’s own original deposit. With such a system, in time it would not be surprising if significant amounts of land fell into the hands of the banker’s “friends”. When the banking industry entered the Muslim world after the collapse of the Ottoman caliphate, for example, Muslims were initially unwilling to work in conventional banks due to their interest-based nature.⁷ Even if they were employed in the banks, they were rarely the loan officers. Nonetheless, Muslims still deposited their savings in the banks, thus enabling the money creation process.

Diagram 2: Transfer of Real Wealth through Seigniorage of Fiat Money



⁷ Even as late as the 1970s one could observe this phenomenon.

Hence even though many Muslims in the colonized countries were hardworking businessmen, considerable amounts of wealth particularly real assets like land, buildings, etc. must have been transferred away from them through the mechanism of the interest-based fiat money system.

Seigniorage and Interest Rates at the International Level

The previous example showed how in the domestic scene real wealth (and sovereignty) gets transferred to those who control the financial sector. The gains would certainly be enormous if the mechanism could be replicated on a global scale. Sure enough, there are international banks that act as the central bank of all central banks, lending fiat money to countries that seek funding or that face financial distress. Yes, lending money that is fiat and imposing interest charges on the loans. From the earlier arguments and the illustrated example, one could easily see that on a global platform, with countries as players, on the aggregate default is a certainty whereas on an individual country basis the probability of default would be high. This is because, for example, say a country, A, takes a loan denominated in dollars from an international banker, in aggregate the system must create additional dollars for otherwise the loan is not repayable (Note that other existing dollars must have also come into existence primarily as loans, therefore, other debtor countries are also in similar positions.). Note that the borrower countries have no power to create the dollar.⁸ Therefore, borrower countries must compete for the existing dollars circulating worldwide. This creates a demand for the dollar like a commodity. One way of acquiring dollars is by exporting goods and services to the

⁸ This is unlike gold, where no country enjoys the monopoly over its production.

United States (where the dollar is the main currency) while another is by trading with other countries that have dollar reserves. Competition for the dollar would ensue and could be tough since there are not many countries anyway. Hence such international borrowing is likely to be “deadly” for most developing nations since their global competitiveness is generally not that good. Therefore, it is argued here that developing nations would lose their wealth and sovereignty easily to these international bankers. These international bankers have a profound knowledge of how the economic and financial systems work. Since the fiat money interest-based system amplifies business cycles, they know when exactly to move in⁹ and offer their “bail-out loan” packages — an act that is sure to ultimately transfer wealth and sovereignty to them through the medium of something that was created out of nothing. And they know that very well.¹⁰

Observed *Modus Operandi* of the International Monetary “Players”

The international bankers and financial institutions seem to work in a well-coordinated way. Among their tools are hedge funds and

⁹ Fiat money is created and destroyed in the accounting records. It gets destroyed when loans are repaid or due to default on loans particularly during recessions. This destruction of money creates many socioeconomic problems including business failures, unemployment and political crises. This “now-you-see-it-now-you-don’t” feature of fiat money has a truly destabilizing effect.

¹⁰ This reminds me of the Walt Disney animation movie *A Bug’s Life*. The international financial institutions are like the grasshoppers in the movie while the third world populations are like the ants. The ants gather food, which periodically the grasshoppers come and take away forcefully. Even though the ants are much larger in number relative to the grasshoppers, keeping the ants “in line” was the objective of the grasshoppers. Just like the ants, in our real-life scenario developing nations desperately need someone who can boldly tell these international financial institutions “the ants gather food, the ants eat the food and the grasshoppers leave!” When the grasshoppers refused to leave and threatened the ants further, the ants closed ranks and were victorious. We recommend this movie for the moral lesson contained therein.

international lending. Hedge funds are huge amounts of short-term money that move between countries within seconds. Being fiat in themselves (i.e. originally created out of nothing) the hedge funds are used for speculation, arbitrage and manipulation that bring in huge profits.¹¹ Apparently, hedge funds are also used to “discipline” governments. But the fact is that these international financial organizations are using the current system to their own benefit by gradually transferring to themselves the sovereignty of world governments, particularly those of the vulnerable and gullible developing nations. This is how we see them do it.

Having a good knowledge of economics, business cycles and financial markets, they destabilize economies using hedge funds movements particularly during the peak of business cycles. This becomes a cause for the turn-around for the ballooned economies, which thereby fall into recession — a period when fiat money gets destroyed which, in turn, translates into failing business, unemployment¹² and political problems. At this juncture, the

¹¹ Speculators attack currencies one at a time so as to maximize their profits. If they attacked currencies simultaneously, they may make their speculative profits but might not make much on the arbitrage side. When only one currency is attacked, its movement relative to other currencies would bring about the best arbitrage opportunities and profits. While we believe this is done intentionally to maximize profits, they call the “domino” collapse of currencies the contagion effect. Many economists do carry out contagion effect studies. There may be some truth in it though.

¹² As mentioned earlier, for a paid employment to take place, four conditions are necessary, i.e. 1) job to be done 2) labour willing to work 3) raw material and 4) money. Notice that during a recession all the conditions exist except money that becomes increasingly scarce due to its destruction in that period. As for raw materials, there will be excess supply of it together with excess production capacities unlike during the peak of business cycles when there will be a shortage of both. Bernard Lietaer’s TERRA project (a commodity money) is based on this fact. Please see Bernard Lietaer, *The Future of Money*, Century, p.249, and the *Proceedings of the 2002 International Conference on Stable and Just Global Monetary System*, International Islamic University Malaysia, p.35.

international financial institutions come in with their “bail-out” loan packages¹³ while blaming the governments and corporations for mismanagement.¹⁴ Prior to giving the loans, they would also prescribe significant interest rate hikes that are likely to bring about further business failures and unemployment.¹⁵ Note that at this point, lack of money is really the problem. Hence money inflow into the economy through loans from the international financial institutions would seem as though it is truly helping the economies to recover since this new money would be able to bring together, to some extent, the unemployed people on the street and the excess capacity of businesses. But, of course, the “bail-outs” do not come without strings attached — a host of conditions are imposed that effectively transfer some sovereignty to the international financial institutions. In many cases, they also institute changes in the governments themselves, who are accused of “mismanaging” the economy. The new governments would be obedient and subservient to their lending masters. Hence one could imagine the amount of wealth and sovereignty that would be transferred on a global scale to these international financial institutions through seigniorage and interest charges. Isn’t that an excellent strategy to gain power over all peoples of all nations on earth — using the means of something that was created out of nothing?¹⁶ The governments of many nations have been changed in this manner. ‘Regime Change’ is their term. Some Latin American and Asian

¹³ An interesting fact to note is that the leaders of these international financial institutions apparently seem to possess pleasant personalities.

¹⁴ In our opinion, the true mismanagement of governments is having the fiat money interest-based system itself — a system championed by the international financial institutions themselves.

¹⁵ And thereby bringing people to the streets to protest against their governments.

¹⁶ Even David Copperfield would envy this for he has to work hard to create his magical illusions to make a living out of it.

countries are clear victims of this. The reader may analyze and decide whether the list includes Indonesia, Thailand and South Korea. Malaysia survived because it simply refused their “loan”. With sovereignty lost, then politics, education, law, culture and the religion of the people would all be at stake.¹⁷ This is a gradual process but surely it is the final destination of the dynamics of the system.

*...The true injustice of Third World debt, and the unwarranted basis of the power of the IMF and World Bank, only become apparent when the fraudulent nature of these ‘loans’ is understood, and how they relate to the debt-based banking system...It is an injustice amounting to international slavery and extortion; it is an aggressive injustice, involving the subjugation of whole nations and their sovereign peoples, operated on a scale that exceeds the total of all the more obvious efforts at dominance by individual nations indulging in warfare over the centuries. Directed against vulnerable peoples and executed under the banner of ‘aid’, it is an injustice so profound and total and shameful that it is quite without any parallel in the history of human affairs. — Michael Rowbotham, *The Grip of Death*, Jon Carpenter, 1998, pp.147-148.*

In this respect, some developments taking place within Malaysia’s financial architecture need further attention. These are, for example:

1. Issuance of Bankcards and the movement towards a cashless society in the near future. Even though a cashless society may sound very modern, advanced and impressive, numerous problems may crop up:

¹⁷ What are the signs when sovereignty is lost — and religion and culture are at stake? If, for example, Muslim sovereignty is lost, then a woman walking half-naked in the street may not bother the “new rulers” but one who decides to cover modestly with a *hijab* may bother them. Similarly, traffic noise may be dismissed as a price for development, but a call for prayers from the minaret of mosques may be regarded as noise pollution and, therefore, be required to be stopped!

- A total monopoly of what money is and its issuance by the banking sector. In other words, the issuance of the small proportion of currency and coins by the governments, i.e. state money, may also be totally “hijacked”, thus effectively removing from governments the right they have over the issuance of state money.¹⁸
 - The system can be abused to “punish” or discipline anyone since there are no other types of money.
 - Confidentiality of peoples’ incomes, spending and savings can be totally “robbed”.
 - The entire economic, financial and political power will ultimately rest in the hands of those who control the financial system.
2. The coming of the giant foreign financial institutions into Malaysia in 2007 due to financial liberalization. If this happens, all the concerns mentioned above can effectively fall into the hands of these giant foreign financial institutions. Even with bank mergers, all local banks — conventional and Islamic banks — are likely to be gobbled up “lock, stock and barrel”.
 3. The inauguration of the Islamic Financial Services Board (IFSB). While the formation of the IFSB is commendable, one needs to be wary of its relation to the international financial institutions. It should not in any way become an arm of the international financial institutions, for that might put it under the purview of rules and regulations that would undermine its purpose.

¹⁸ Simple transactions like lending money to a friend or helping someone with a few bucks or even giving alms can become difficult or cumbersome under a cashless system.

Measures Developing Nations Can Take

Here are some measures developing nations can take in order to protect themselves from the ravaging forces of financial liberalization and their effects on national wealth and sovereignty. The following actions are important in our opinion to prevent developing nations from becoming mere “slaves” of economic colonialism; thereby protecting their sovereignty, culture and religion:

1. **Do not implement a totally cashless society**, particularly when money is fiat. Here total money supply might come from the banking system alone unless the government takes control of it. Abuse of the system is likely to happen and may prove difficult to solve or reverse thereafter.
2. **Prevent financial liberalization** from taking root in your land. In a fiat monetary system, the advent of foreign financial giants simply equals the giving away of a nation and its sovereignty to them practically for “free”. It is not through the benevolence of foreigners that a nation is developed. A country is developed only by its own people. Foreigners should, however, be allowed to come in only with real capital, expertise, technology or otherwise and thereby legitimately and justly take a share in the economic pie. But definitely NOT come in with fiat money which is created out of thin air. In fact, you may even consider the **nationalization of banks** so that total power to create money rests with the government alone.
3. **Allow complementary currencies** like the gold dinar and other forms of real money to coexist along with the national currency. These real monies are by design inflation-free and bring stability into the economy. Complementary currencies can be used to achieve certain economic objectives without being inflationary.

Answer to Quiz: Money! If you produce it, it is called counterfeiting. Fiat money gives an “unfair” advantage, i.e. the seigniorage, to one who creates it and hence it is an offence to counterfeit.

Chapter 3

The Theft of Nations

*If you provide some happiness, some comfort to others, then your life becomes meaningful.
If your life creates problems or suffering to others, then there is no meaning to your
existence. — Dalai Lama, Reader's Digest, July 2003*

HAVING DISCUSSED SEIGNIORAGE in general in the last chapter, this chapter gives some specific ways nations may lose out further within this system.

Currency Pegging and Seigniorage

A country may be on the losing side if it pegs its national currency to a foreign currency and at the same time allows the foreign currency to be used in domestic transactions. Here is an example: The currency of an oil-producing developing nation is pegged to the currency of its more affluent and developed neighbouring country. Both the currencies are exchangeable dollar for a dollar, and can also be used interchangeably in both countries. In their arrangement, the banking system in the developing country is not permitted to create money in the normal multiple deposit creation method — rather a creation that is only slightly more than the original deposit is allowed. The neighbour country nevertheless creates money in the normal multiple

deposit creation way. This is illustrated in panel A of Diagram 3. Money for both the countries is, therefore, basically created in the neighbour country! With this newly created money the neighbour could purchase oil and other things from that poorer developing nation — this is huge seigniorage.¹

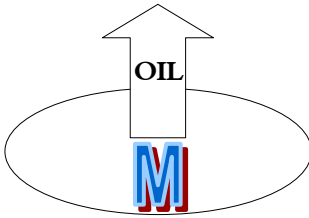
Even without pegging, if a country allows the currency of other nations to be used in its land then that country also loses due to seigniorage. This is illustrated in panel B of Diagram 3. Some developing nations do allow other international currencies or a neighbour's currency to be used in their land. In some instances the alien currency even becomes the dominant or preferred currency. Significant losses could be incurred from this. The foreign country could easily create and circulate additional currency of its own in the developing nation.

Fiat Money, Currency Speculation and Arbitrage

In a fiat money system currency speculation and arbitrage thrive. Of the trillions of dollars of daily foreign exchange dealings, only a minor portion is actually meant for real transactions. The rest are for speculative, arbitrage and hedging purposes. Currency speculators make billions of dollars of profit from manipulation, speculation and arbitrage. Since currency transactions are zero-sum games, in truth the people's work and sweat, i.e. their real wealth, gets transferred to the speculators and arbitrageurs. The 1997-98 financial crisis almost impoverished the Malaysian public.²

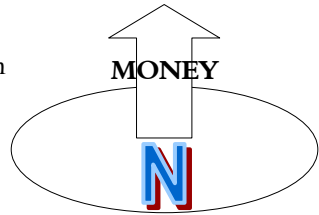
¹ Similarly, seigniorage is also the gain to currency counterfeiters. Counterfeiters gain from the first use of counterfeit money.

² Appendix D shows how speculative and arbitrage profits are made in the currency market.

Diagram 3: Currency Pegging and Seigniorage**Panel A**

Country M **NOT** allowed to create money in the normal multiple deposit creation way

$M\$1 = N\1
Both currencies
may be used
interchangeably in
both countries

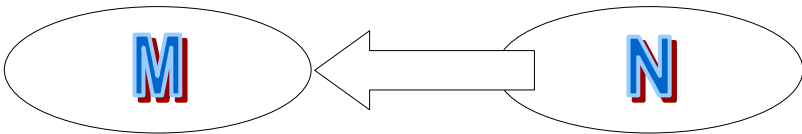


Country N creates money in the normal multiple deposit creation way

If the currencies of two countries are usable interchangeably in both countries with a fixed exchange rate, then the benefit of seigniorage would accrue relatively more to the country that creates the more money. In the above example, country M loses out significantly to country N since money creation is effectively denied.

Panel B

Currency of country N can be used in country M but not vice versa



If a country allows a foreign currency to be usable in its land, then the foreign country reaps the rewards of the seigniorage. In the above example, if the currency of country N can be used in country M but not vice versa, then N gains from seigniorage while M loses. In this case, country N can create additional amounts of its currency (out of thin air, of course) to be circulated in country M without being inflationary domestically.

Protecting against the “Theft”

Having discussed how nations could lose due to seigniorage and interest-based loans; we provide here a summary of how the “theft” of nations could occur and some action that may prevent this.

The following are means by which a nation can enjoy the goods and services that it wants:

1. Produce itself the goods and services it wants and/or trade with others. This is the fairest and noblest way of all.
2. Consume the savings of other nations. Importing more than exporting, this would show up in the form of trade deficits. Some countries produce more than they consume, like Japan for example. Therefore, another nation could borrow from such “surplus” countries and consume away their saved produce. The United States have been doing this for the past few decades.
3. “Cheat” by means of lending fiat money to other countries with interest charges attached. We categorize lending money at interest as cheating because the public and even leaders of nations are generally gullible and are not aware that money lent to them is simply created out of nothing. However, we argued earlier that the fiat money interest-based systems gradually transfer wealth and sovereignty to the lender.
4. “Steal” by means of seigniorage for example. A country or a party may attempt to make its fiat currency an international currency or make it a ‘legal tender’ in other countries, etc.³

³ A current example is the invasion of Iraq by the United States of America. In October 2000, Saddam Hussein had announced that Iraqi oil would be priced in euros instead of the dollar. Other OPEC countries were expected to follow suit since Europe is a major trading partner of the Middle East that imports more oil than the US. These developments were expected to strengthen the euro further and challenge the dollar’s position as the dominant international reserve currency. The seigniorage of the dollar is so huge that the US is likely to go to war to defend it. Some quarters assert that one of the main objectives of the American invasion of Iraq is to protect the dollar’s position as the international reserve currency. Note that being a fiat currency the Iraqi dinar is likely to depreciate enormously after the

- Another way is to establish “foreign banks” in other countries and thereby create the money of the nations where they operate (as allowed through multiple deposit expansion).
5. Rob or extort from others forcefully by taking away the wealth, resources and sovereignty of other nations, by means of war for instance.⁴

Many developing nations of the so-called Third World, instead of using their resources for developing themselves, actually further enrich the “wealthy” nations by losing their wealth and sovereignty to them in the above mentioned ways. As such, some countries were able to acquire considerable wealth from other countries and thereby appear wealthy, mighty and powerful. This, in turn, seems to have also caused the brain drain from developing nations that saw their professionals, scientists and technical experts migrating to the wealthier nations. There are a number of ways developing nations may prevent the above, and thereby protect themselves. These are provided in Table 1.

It would be best if the savings of a nation were utilized for the development and benefit of its people. In the real economy, savings are things produced but not consumed. In the fiat money system, a country may continuously run trade deficits in order to consume the savings of other nations. The country with a trade deficit would acquire the real goods and services while the country with a trade surplus would simply accumulate financial assets. For example, when the United States runs continuous trade deficits with Japan, then Japan

invasion. The US, on the other hand, is likely to introduce the dollar into Iraq, and reinstate the pricing of oil in dollars. Even if a new Iraqi currency is issued, the US would still enjoy its seigniorage. Such a currency may also be pegged to the dollar for that would effectively make it similar to the dollar.

⁴ The war booty from the invasion of Iraq for example, is enormous, for Iraq sits on the second largest oil reserves in the world, with an estimated potential of 112 billion barrels.

Table 1: Protecting against the “Theft” of Nations

Means of “Theft”	Protection
1. Savings of Nation	Use savings for domestic development as much as possible. Evaluate carefully when buying financial assets like bonds issued by another country or depositing savings there. Buying foreign financial assets can entail the outflow of domestic real goods and services.
2. Seigniorage	<ul style="list-style-type: none">• Prevent foreign commercial banks from operating in the nation since a fiat money interest-based system allows them to create the money of the nation.• Do not price and sell goods and services in foreign currencies. Insist on national currency or, even better, insist on real money rather than fiat money.• Use a common currency or gold for international trade settlements (in lieu of international reserve currencies)• Do not allow foreign currencies to be legal tender or usable domestically.• The gold dinar, other commodity monies and complementary currencies are some means of protecting against loss through seigniorage.
3. Lending Money at Interest	Do not borrow money at interest, particularly in the currency of another country. By borrowing in a foreign currency you effectively pass your “life-line” into the hands of that country or the institution that lends the money.
4. War	Prepare yourself militarily with the best of weapons so as to command wholesome respect rather than inviting oppression and aggression from potential enemies and predators.

accumulates financial assets while exporting away its goods to the United States.⁵ If the exports of Japan are priced in dollars then Japan loses to seigniorage. Accordingly, it may be better if a savings surplus country invests the savings within the country or invests in another country in the form of FDI's instead of accumulating financial assets like bonds.

To prevent loss through seigniorage, firstly, a country should, where possible, prevent foreign commercial banks from operating in its land.⁶ In a fiat money interest-based system, the foreign commercial banks would enjoy the right to create the currency of the nation. This is tantamount to giving away the wealth of the nation practically for “free”. Secondly, for international trade, do not price exports in a foreign currency for otherwise the alien country will enjoy the seigniorage. With electronic money, creating new money is no feat after all! Thirdly, never allow foreign currencies to be legal tender or to be usable domestically for otherwise the foreign countries will enjoy immense benefits from the seigniorage. They could even buy real property like land, buildings, businesses, etc. just by creating extra currencies and making them usable in the other country. Fourthly, do consider the option of allowing the use of real monies — precious metals like gold and silver, other commodity monies and complementary currencies.⁷

⁵ An interesting analogy for this was recently given by an anonymous writer: Its like a shopkeeper who keeps lending money to his customers so that they could keep patronizing his shop!

⁶ This proposition comes from the author's belief that the right to create money (in a fiat monetary system) must rest with the government. If this is not practical, then other action should be taken concurrently, like allowing other forms of money like complementary currencies and the gold dinar.

⁷ The website www.transaction.net/money/community/ is a good source of information on complementary currencies.

As for lending and borrowing at interest, a country should be wise enough not to borrow foreign fiat money at interest. By borrowing internationally at interest a country effectively passes its “life-line” to the lender country. As discussed earlier, in the aggregate sense, only the foreign country or other empowered institutions can actually create the extra money needed to service the interest portion. Hence it is never a good idea to borrow from international financial institutions like the International Monetary Fund (IMF), the World Bank, etc.⁸ Let foreign institutions and countries take a share in national output only when they come in with real capital, knowledge, skill, expertise, etc. and not through lending money created out of thin air.

As for war, the author is not an expert on this. However, we believe that every nation must be prepared militarily to defend itself against the threat, aggression and oppression of others.⁹ It is better to live our one life in rightfulness and dignity than to pass it away as a slave of others.

If our hypothesis on the “theft of nations” is true, then the international financial institutions (and wealthy nations) may attempt to prevent at least the following two from materializing:

⁸ Consider a country like Mali that claims to be among the top gold producing countries in Africa. Yet it keeps borrowing from the IMF for its economic development programs. All that Mali would get from the IMF is some accounting entry as money, yet it would be repaying with its national wealth and resources including its gold. For dollar denoted loans, its life-line would be practically in the hands of the IMF or the United States that has the right to create that extra US dollar needed to service the debt. Such debt is likely to spiral into an ever-growing international indebtedness that significantly shifts wealth and power into the hands of the IMF.

⁹ Note the following Qur’anic verse: “Muster against them whatever you are able of force and tethers (ropes) of horses, so that you strike terror into the enemies of God and your enemy, and others besides them whom you do not know but God does...” (Al-Anfal 8:60)

1. Gold as a medium of exchange and its use for settling international trade balances.
2. Bilateral and Multilateral Trade Arrangements (BPAs and MPAs) between nations particularly between the weaker developing nations.

The reason why the international financial institutions and wealthy nations may try to prevent the above two is because both independently but significantly reduce the reliance of developing nations on foreign reserve currencies like the dollar for settling trade balances.

As for gold, one action group based in the United States, called the Gold Anti-Trust Action (GATA) group claims that it has evidence of gold price collusion by the international financial institutions. The Gold Anti-Trust Action Committee was established in January 1999 as a Delaware corporation to advocate and bring suits against the financial institutions involved in the collusion against gold. According to the group, GATA was established to expose this manipulation of the gold market by a gold cartel consisting of financial giants like Goldman Sachs, J.P. Morgan Chase, Deutsche Bank, the Bank for International Settlements, the U.S. Treasury and the Federal Reserve Bank of the United States.¹⁰

¹⁰ Source: www.gata.com

Chapter 4

Islamic Banks and the Fiat Monetary System

... *For Falsehood is (by its nature) bound to perish.* — Qur'an (Al-Isra' 17:81)

The Law of One Price

IN OUR EARLIER book, *The Islamic Gold Dinar*, we briefly mentioned that in the present interest-based fiat monetary system, Islamic banks cannot be totally independent from interest rates and the conventional banks. In fact, the pricing of Islamic financial products is likely to be tied to the market interest rates. This is because if there are price differences between the two, then arbitrage opportunities would set in, thereby enabling market participants to make easy profits. Arbitrage between the two banking systems would, in turn, bring about a convergence between the two banking systems. This convergence is of no fault of the Islamic bank, but rather is a result of its co-existence with the conventional banks, both of which are linked through the fiat money interest-based system. Since its inception in Malaysia in 1983, for example, both the Islamic banking and the conventional banking systems have responded to each other and thereby attained some degree of convergence.

An example of the convergence is home financing. In the initial phase of Islamic banking, a house buyer would start paying the instalments for home finance only after the house was completed, i.e. about two years from the time of signing the sales and purchase agreement. The buyer need not pay any interim payments as is the case with conventional financing. The interim payments are indeed interest charges for the progressive payments made by the bank to the developer during the house construction period. During this phase of Islamic Banking, the non-existence of interim payments in Islamic home financing made it cheaper than the conventional one, thereby increasing the demand for such financing.¹ This increase in demand, of course, put pressure on the Islamic bank to increase its rate. Currently, those wishing to finance homes using Islamic principles would have to pay an initial deposit equal to three-months payment into an investment account² and are additionally also required to pay the first instalment in the month immediately after the bank releases the first payment to the housing developer. This first payment is usually about 10 per cent of the total price of the house, paid when the foundation for the house had been completed. These changes to the financing conditions made Islamic financing more expensive than its conventional counterpart and thereby made people opt for conventional financing or attempt to refinance the existing ones. This is an example of how the two banking systems moved towards convergence.

Another example of possible arbitrage between Islamic banking and conventional banking is as follows. This example is the application

¹ In fact, many non-Muslim buyers financed their homes using the Islamic mode during this period. At times the number of non-Muslims who financed their homes using Islamic modes exceeded that of even the Muslims!

² That pays a return lower than the cost of financing.

of rate swaps between the two markets. Today, Islamic banking is predominantly a fixed rate market while conventional banking is characterized by variable rates. The difference in financing costs for borrowers in both markets would create arbitrage opportunities. Consider two corporations, A and B, that are faced with the following financing costs in the Islamic fixed rate market and the conventional floating rate market (See Diagram 4). Corporation A that enjoys a better credit rating can borrow more cheaply from both the fixed and floating rate markets compared with corporation B. In the Islamic fixed rate market A can borrow at 8 per cent per annum while B can borrow at 9 per cent, a difference of 1 percentage point. In the conventional floating rate market, A can borrow at KLIBOR³ plus 0.5 per cent while B can borrow at KLIBOR plus 3.5 per cent, a difference of 3 percentage points. Therefore, corporation A enjoys an absolute advantage in both markets relative to corporation B, but a comparative advantage in the floating rate market where it can borrow at a much lower rate than corporation B. This inversely gives corporation B a comparative advantage in the Islamic fixed rate market. The existence of comparative advantages makes it possible for arbitrage profits to be made by means of rate swaps between the Islamic and conventional markets.⁴ The way to do this is shown below.

Assume that an investment banker is aware of the above borrowing costs of its two client corporations, A and B. Additionally,

³ Kuala Lumpur Interbank Offer Rate.

⁴ With the difference in credit worthiness among corporations and thereby credit ratings by rating agencies, absolute advantages and comparative advantages are likely to occur. On top of that, in the present dual system many corporations are indifferent between borrowing in the Islamic fixed rate market or the conventional floating rate market. Therefore, corporations may engage in rate swaps in order to benefit from the difference, a transaction that may even be assisted by bankers themselves for a share in the pie.

the banker has ascertained that each party would be indifferent to borrowing fixed or floating and will sign a rate swap agreement if offered a 0.5% benefit.

Diagram 4: Arbitrage between the “Islamic” Fixed Rate Market and the Conventional Floating Rate Market

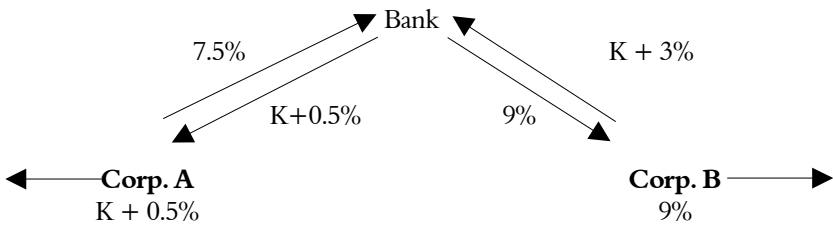
Corp.	Islamic Financing Fixed rate	Conventional Financing Floating rate
A	8%	KLIBOR + 0.5%
B	9%	KLIBOR + 3.5%
Difference	1%	3%
A enjoys absolute advantages in both markets	The difference between the two here is 2 per cent. Since A can borrow much more cheaply in the floating rate market, it therefore has a comparative advantage in the floating rate market.	

The difference between the differences is $3\% - 1\% = 2\%$. This 2-percentage point is the arbitrage “pie” that can be shared between the bank and both the corporations A and B in terms of lower borrowing costs.

The way to go about this is by first determining which corporation has a comparative advantage in which market. In our example, corporation A has a comparative advantage in the floating rate market while corporation B in the fixed rate market. Therefore, corporation A will borrow funds in the floating rate market at a rate of KLIBOR + 0.5% while B borrows from the fixed rate market at 9 per cent (See Diagram 5). Since both the parties are willing to sign a swap agreement if given a benefit of 0.5 per cent, the end result after the swap is that corporation A will end with a fixed rate but with a 0.5 per cent benefit

(i.e. $8 - 0.5 = 7.5$ per cent) while B will end with a floating rate but again with a 0.5 per cent benefit (i.e. $\text{KLIBOR} + 3\%$). The bank may then arrange for swap agreements to be signed as shown in Diagram 5.

Diagram 5: Rate Swaps between the “Islamic” Fixed Rate Market and the Conventional Floating Rate Market



Borrowing Cost after swap:

A: 7.5 per cent

B: $K + 3$ per cent

Corporation A borrows from the floating rate market at $\text{KLIBOR} + 0.5\%$ and then signs a swap agreement with the bank where the bank will pay Corporation A the $\text{KLIBOR} + 0.5\%$ while A pays the bank 7.5%. Therefore, the net cost to A is 7.5% fixed. Note that in swapping no actual principal amount is involved. Only the difference in the rates will be settled among them.

Corporation B borrows from the Islamic fixed rate market at 9 per cent and then signs a swap agreement with the bank where the bank will pay Corporation B the 9 per cent, while B pays the bank $\text{KLIBOR} + 3$, so that the net cost to B is $\text{KLIBOR} + 3$ per cent.

Note that while corporations A and B were able to reduce their borrowing costs by 0.5 per cent each by means of swapping, the bank made a spread of 1 per cent from the swap agreements (the bank paid $\text{KLIBOR} + 0.5$ and 9 per cent but received 7.5 per cent and $\text{KLIBOR} +$

3). Therefore, all the three parties were able to benefit from this arbitrage rate swap.⁵

This example shows the link between the fixed rate market and the floating rate market. Such arbitrage between the markets is likely to contribute towards a convergence between the Islamic and conventional banking systems. Note the dynamics of the Islamic banking system from its inception. Originally, it was meant to be a profit sharing banking. But later it concentrated on basically contracts that ‘lend’ money — *murabahah*, *ijarah*, etc. But to differentiate itself from conventional banking, it adopted fixed rate lending. Nonetheless, further convergence is forcing Islamic banks to move towards variable rate lending. Currently, Islamic banking seems to be concentrating on *bay ad-dayn*, i.e. the buying and selling of debt. As a person trained in finance, I view this as the ultimate convergence of Islamic banking with its conventional counterpart.⁶ It is, therefore, not a surprise that when the interest rate changes, the Islamic bank changes its “profit” rate. Since the Islamic banking system is relatively much smaller compared to conventional banking, it is likely that the Islamic banking system will converge towards the floating rate market.

Operating within the fiat money and fractional reserve requirement system, the Islamic banks also do create money out of thin air but, nevertheless, lend out the money using Islamic principles.

⁵ This principle is similar to the application of the concepts of absolute advantage and comparative advantage in international trade. Countries are to produce items in which they have comparative advantage and then exchange them through trade. Such specialization and exchange benefits all parties.

⁶ Could we have talked about *bay ad-dayn* in 1983 during the initial phases of Islamic banking? I tell my students that such arbitrage between the two banking systems would ultimately bring about identical twins. With banks offering both conventional and Islamic windows, we should not be surprised if they take advantage of the differences by arbitraging them away behind the windows. In this case we would have not only twins but Siamese twins.

Therefore, Islamic banks are also partly responsible for the numerous socio-economic problems created by the fiat monetary system, instead of being solution providers.

Summary of Part One

Part One basically pointed out that there is an inherent structural flaw in the current global fiat monetary system that is at the root of its instability and unjustness. The structural flaw is associated with the following three features of the current monetary system: 1) Fiat money, 2) Fractional reserve requirement, and 3) Interest. Fiat money is money that is created out of nothing. It has neither intrinsic value of its own nor is backed by gold as it was in the gold standard. Since the collapse of Bretton Woods in 1971, all global currencies are fiat and are no longer backed by gold. The ability to create money out of nothing gives immense benefit to both the domestic and international financial institutions. The financial institutions create money out of nothing but lend it out at interest. This characteristic of fiat money called seigniorage is at the root of financial crises, monetary instability and unjustness. The fractional reserve requirement also makes possible the creation of additional money through multiple deposit creation. All this has brought about huge liquidity into the global monetary system which is responsible for the huge asset price bubbles faced in many countries. The Japanese bubble during the mid 80s and the Asian Miracle of the 90s are examples of this. The burst of such economic bubbles, of course, brings about a contraction of the economy with a host of other problems. While amplifying economic cycles along with their negative attributes like business failures, unemployment, etc. the fiat monetary system is also at the root of many social evils. At the international level, the fiat monetary system is a powerful tool for

acquiring the wealth and sovereignty of nations unjustly, i.e. a tool for economic domination and colonization. While such is the characteristic of the fiat monetary system, it is kept silent by both domestic and international financial institutions since the financial sector is the main beneficiary of the fiat money system. There are different ways this seigniorage of fiat money is used in the “theft” of nations.

Money created through the multiple deposit creation (i.e. credit creation) by the banking sector is introduced into the economy as debt — i.e. money equals debt — that carries interest charges. This, in turn, requires money stock (and thus debt) to constantly grow simply to sustain the system. Nonetheless, debt has implications for financial management particularly on corporate capital structure. Only a certain maximum debt level is bearable, thereby placing the current global fiat monetary system on weak foundations that are bound to collapse.

The dollar that has played the role of the international reserve currency for the last few decades is now on the verge of collapse. This is because while a gigantic economic bubble has been created from its role as a reserve currency, the creditworthiness of the United States is being questioned in the wake of record bankruptcies, corporate frauds and accounting irregularities that have marred corporate America in recent years. If the dollar collapses, a global monetary meltdown as predicted by some monetary experts may be inevitable, which, in turn, could push the world economy into its worst economic downturn in history.

Part Two discusses a way out for nations from the present unstable global financial and economic scenario. The idea is simple, i.e. to use the opposite of fiat money, that is money that has intrinsic value of its own — real money or commodity money. A commodity that has a natural tendency to evolve as global money is gold. Gold had been used as money in one way or another since time immemorial until the

breakdown of Bretton Woods in 1971. Nobel Laureate Robert Mundell predicted that gold would again return as an international monetary unit in the 21st century. Accordingly, Part Two discusses models of gold payment systems for domestic use and international settlements. It argues that gold is capable of providing the stability and justice that are lacking in the fiat monetary system while at the same time providing a way for nations, particularly developing nations, to protect themselves from the “theft of nations” as discussed in Part One.

PART TWO
A SOLUTION

Chapter 5

The Gold Dinar Solution

Verily with every difficulty there is relief. — Holy Qur'an (Sura Al-Inshirah, 94:6)

THE PREVIOUS CHAPTERS highlighted the many problems faced in present day economies particularly by developing nations due to the very definition and nature of money — i.e. fiat money. Since fiat money comprises primarily accounting entries that have no intrinsic value, it is created easily and in certain circumstances is also destroyed easily. This “now-you-see-it-now-you-don’t” feature of fiat money causes numerous problems for the economy particularly in the context of the stability and justice of the system. However, this system is beneficial to the minority in whose hands the control of the financial institutions rests. The system gradually accumulates wealth and sovereignty into their hands. Interest rates also pose structural problems in that they necessitate more and more fiat money to be created in order to sustain the system, apart from causing wealth to circulate among the rich in the society. Some of the socio-economic problems caused or worsened by the fiat money interest-based system are mentioned on page 26.

Can we solve the above problems, minimize or reduce their effects and thereby protect ourselves? Our answer is “YES”. If one analyzes the situation carefully, the source of all the above problems seems to be rooted in the fiat nature of money (i.e. money that is created out of nothing and hence has no intrinsic value) and interest rates, i.e. the seigniorage basically. Therefore, solutions must address both of these. Before we proceed further, it may be better to discuss the following: (a) the first principles, (b) the ideals and (c) the practicalities.

The First Principles¹

Trade, no doubt improves the economic well-being of mankind. With trade one is able to enjoy goods and services which otherwise one may not be able to produce oneself. A barter economy² poses a number of problems. Double coincidence of wants is one of them. This refers to the problem of the need for one party to find a counter party who is willing to accept what one has and in return gives what one wants, in agreed proportions. Money solves the problems inherent in barter trade, promotes specialization, encourages trade and improves the overall well-being of people.

Money is generally anything that is accepted as payment for goods and services or debt. Normally, people only refer to currency (consisting of paper notes and coins) as money but technically it is anything that is accepted for payment. In ancient times, people even used rocks, leather, salt, shells, etc. as money. These were later replaced by precious metals like gold and silver which played the role of money

¹ This section draws from the chapter “A Primer on Money and Economic Development” in Ahamed Kameel Mydin Meera, *The Islamic Gold Dinar*, Pelanduk Publications, 2002.

² A barter economy is an economy without money where goods and services are exchanged directly for some other goods and services.

better. Since the demise of Bretton Woods in 1971, paper money and electronic money have become the dominant forms of money.

The primary function of money in the economy is as a medium of exchange, i.e. money is used for paying for goods and services. This simple function is responsible for promoting specialization and accelerating trade among people; and thereby elevating their standard of living. The function of money as a medium of exchange brings about a high degree of economic efficiency. In a barter economy efficiency is much suppressed and thus the standard of living would be low. People in a barter economy get to enjoy very few things in life. Most of their time and economic activities would be directed towards the production of the basic necessities of life.

With the introduction of money, the problem of ‘double coincidence of wants’ is eliminated. One sells goods or services for money then uses it to buy whatever goods and services one wants. Since money is divisible it makes the exchange of different quantities of items possible and simple. Money thus allows one to specialize in whatever one does best. This increases the productivity, quality and quantity of goods and services produced and exchanged in the economy.

For an item to function effectively as money, it has to have the following five criteria:

- i. Standardizable such that its value can be ascertained easily.
- ii. Must be widely accepted. This function needs money to be something rare with its own intrinsic value (or something made to be a legal tender).
- iii. Easily divisible.
- iv. Easy to carry around, and
- v. Must not deteriorate quickly.

A good monetary system should encourage the circulation of money rather than encouraging hoarding. In normal circumstances, the high velocity of money circulation would encourage increased production. Hoarding, on the contrary may slacken economic activity which may show up in the form of poor demand, low business profitability, unemployment, etc.

The second function of money is as a unit of account. Basically, this refers to its use as a measure of value in the economy, e.g. the price of a shirt is RM45 or you owe me RM100 and so on. Money measures value just like the kilogram measures weight or the meter measures length. This is also an important function since it eliminates the need to quote barter exchange prices between every pair of goods and services that exist in the economy.³

The third function of money is as a store of value. This basically refers to the purchasing power of money over time. If money is a good store of value, then its purchasing power is preserved from the time money is received until it is spent. If RM1,000 today can buy a basket of goods, and if a year later it can buy the same basket of goods, then money has been a good store of value in that year. Other items apart from money are also used as stores of value, e.g. investment in stocks, property like houses and land, artworks, etc. In fact, many of these are better stores of value than money itself since they usually give better returns than money. In contemporary financial systems, money is not a good store of value since its value generally falls over time, i.e. its purchasing power erodes due to inflation.

³ In a barter economy, if there are one hundred goods, 4,950 pairs of prices need to be quoted. With money, however, the 100 items will have a price each, i.e. only 100 prices in total.

The Ideals

Part One of this book highlighted the problems inherent in the current monetary system. We postulated that the following characteristics, i.e. fiat money, the fractional reserve requirement and interest are at the root of the instability and unjustness of the fiat monetary system. The opposites of those three characteristics are of course: real money, 100 per cent reserve requirement and a negative interest rate (e.g. a demurrage charge). A negative interest rate encourages money to be spent and kept in circulation rather than being hoarded.⁴ The concept of the 100 per cent reserve requirement is also compatible with the concept of real money. A monetary system that adopts real money, like the gold dinar, and a negative interest rate is likely to alleviate the numerous socio-economic problems inherent in the interest-based fiat monetary system. This is discussed in the next section, but the real challenge is identifying and implementing actions and policies that can move us away from the present fiat money system to the ideal situation in a smooth manner without abruptly rocking the present set-up.

Gold as Money

The opposite to fiat money is, of course, real money, i.e. money that has intrinsic value. This necessarily has to be commodity money, i.e. money which itself is a commodity valued by people or money that is backed by such commodities. Therefore, the solution to the problems of the fiat monetary system seems to lie in commodity money. A

⁴ Note that this concept is embedded in the Islamic principle of *zakat*. *Zakat* is a levy imposed on a Muslim's wealth (above a certain minimum) that has been in his or her possession for a whole year. For example, the *Zakat* for 20 dinars that have been in a Muslim's possession for a whole year is half a dinar. This levy encourages the Muslim to invest and circulate the money. *Zakat* also increases aggregate demand in the economy because it is given to the poorer sections of the economy that have a higher marginal propensity to consume.

number of solutions are currently being discussed examples of which include: (1) gold and silver money, (2) a basket of commodities as money,⁵ (3) complementary currencies⁶ and (4) Real Money Units (RMU).⁷ In our opinion, any real money would, in one way or another, provide some solutions to the above problems. However, the most well-known commodity monies in the history of mankind are gold and silver. This book intends to discuss these, particularly gold, as a solution. There are some suggestions, though, to bring about stability by means of a basket of currencies. We shall briefly discuss this first.

A Basket of Currencies

Yes, a basket of currencies as a unit of account can be expected to bring about some degree of stability. This is because the volatility of a currency may be divided into two parts: one is due to internal factors, i.e. factors unique to the issuer country, while the other is due to factors common among countries. In a basket of currencies, the unique factors tend to cancel each other out providing diversification benefits similar to those of a portfolio of shares. In a well-diversified basket of currencies, only the common factors may affect the volatility. Therefore, a basket of currencies is likely to be more stable through

⁵ Like Bernard Lietaer's TERRA project. See Bernard Lietaer, and Gernot Nerb, "Terra: A Countercyclical Reference Currency to Stabilize the Business Cycle" in the *Proceedings of the 2002 International Conference on Stable and Just Global Monetary System* (Kuala Lumpur, August 19-20, 2002), International Islamic University Malaysia.

⁶ Examples include the Austrian Worgle, Thai Bia, German WARA, Swiss WIR, New Zealand 'Green Dollar' and Local Exchange Trading Systems (LETS). For a discussion of these, see Bernard Lietaer, *The Future of Money*, Century, 2001.

⁷ See Zakaria A. Bawany, "Interest and Loan Free International Trade Import & Exports through R.M.U.," in the *Proceedings of the 2002 International Conference on Stable and Just Global Monetary System* (Kuala Lumpur, August 19-20, 2002), International Islamic University Malaysia.

lower volatility (See Diagram 6). A common currency like the euro may be expected to enjoy this since it can be viewed as a basket of currencies. However, as long as the currencies in the basket are fiat, the problems faced due to the fiat nature of money will still be present. If the basket of currencies exists together with other national currencies, then some exchange rates between them will be defined and hence still make speculation, arbitrage, etc. possible. Gold on the contrary, is like a unified currency of all nations. Thus, while providing a greater degree of diversification, it also solves the numerous problems faced in a fiat monetary system.

Gold has played the role of money for many centuries in almost all civilizations. In fact, people of every race, creed and nationality have accepted it as the international medium of exchange that has intrinsic value of its own. However, before gold, some civilizations used many other items as money — cowry shells, leather and even salt to name a few. However, an interesting point to note is that in the passage of time, gold dominated all other forms of money, thereby taking on the position as the international unit of money. This is because gold possesses many characteristics that make it an ideal candidate for money:⁸

- Gold has intrinsic value such that people of every race, creed and nationality desire it for its own sake. One just has to look at the obsession humanity has had for this metal throughout history.
- Rare. To be money, an item has got to be “rare” — something not easily obtained from nature or otherwise.⁹ For example,

⁸ For other basic facts about gold including its chemical and physical properties please see Appendix G.

⁹ On the contrary, today’s fiat money is easily created at “the stroke of a pen”. Today’s printing technology is also so advanced that counterfeiting can be easy too.

while the cowry shell was used as money by civilizations where it was rare, it did not play the role of money in this part of the world where the shells were found in abundance.

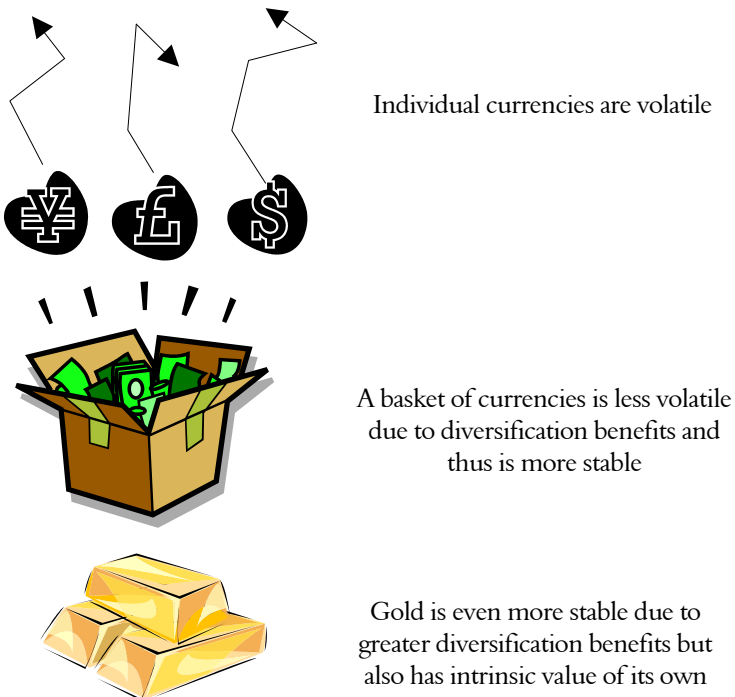
- Gold is compact. A small amount of gold has big value. Therefore, one needs only small amounts for even large purchases.¹⁰
- Gold is stable and durable. The chemical property of gold is such that it rarely reacts with any other element or compound. It is such an inactive metal that it is even extracted from the earth as gold itself (unlike iron, for example, that is obtained from the earth as iron oxide, which is then processed to extract the iron). Gold does not oxidize easily and, therefore, does not get rusty. It remains stable and durable for very long periods. Even gold treasures buried in the salty seawater for many centuries remain in their pure form.
- Gold is homogenous and divisible. This characteristic is important since it allows the pricing of a whole range of values. It is homogenous in the sense that if a gold bar is cut into two halves, one need not choose between the two for they are simply equal. This splitting can go on until each unit is very small in weight. Gold is also homogenous in the sense that gold extracted from different parts of the world are practically substitutable for each other.¹¹
- Gold is storable. Therefore, it is an ideal store of value, i.e. something that can be saved for future use, even far into the future. Many fiat paper currencies and coins have become obsolete with the passage of time, but gold coins, on the contrary, not only maintained their intrinsic value, but they become more valuable over the years due to their numismatic value.

¹⁰ That it is cumbersome to carry gold around is not something to be truly concerned about. If a gold chain worn around the neck is not a 'pain-in-the-neck', surely carrying it in the pocket shouldn't be a problem.

¹¹ Sometimes people are concerned about the fact that gold from different parts of the world has different colours. This difference in colour is basically due to the other metals added in order to form gold alloys. Please see Appendix G on "Some Basic Facts about Gold".

- Gold is mobile. It can be moved between places easily and, therefore, be used as money in different localities, e.g. for international trade.
- Gold is not destroyed or consumed away in the process of its use. If people were to use wheat as money, for example, then when one consumes the wheat, money gets destroyed; this poses potential problems for the economy.
- Gold can neither be created nor destroyed. If money can be created or destroyed (as fiat money is) then it is certainly a potential problem for the economy. Inflationary problems may crop up when it is created, while recessions and unemployment occur when it gets destroyed. This is particularly the case with fiat money since it is created by the banking sector and gets destroyed in certain circumstances.

Diagram 6: Stability of Gold Relative to Individual Currencies and a Basket of Currencies



It is not surprising, therefore, that with the above characteristics gold naturally dominated as the global currency in history. No one had to force others to accept gold as money unlike fiat money that had to be made a “legal tender”.¹² By the time of the advent of Prophet Muhammad (peace be upon him), gold coins of the Roman Byzantine empire were already in circulation and were fully accepted by the Arabian community. The gold coins of the Muslim world were called ‘dinar’, a word derived from the Latin *denarius*.¹³ While the Prophet (peace be upon him) brought many changes to the social institutions of the time, the dinar was, however, fully accepted as money. The first Islamic dinar¹⁴ was not minted until about fifty years after the demise of the Prophet (peace be upon him), by the caliph Abd al-Malik ibn Marwan in 75 Hijrah (696 CE). The caliphs were very concerned over the quality of the gold dinar and imposed severe punishments for crimes like coin clipping, etc. As the Islamic world expanded, these precautions along with the high moral standards of the Muslims of the past, made the dinar the dominant and desired international currency, even replacing the bezant gold coin throughout Europe. The dinar remained the currency of the Muslim world for centuries until the fall of the Ottoman caliphate in the early 20th century. The dinar is held as the *Shari’ah* currency by some Muslim scholars and is seen as being capable of promoting socio-economic justice. This book looks at gold

¹² Since paper money and other fiat money has no intrinsic value, governments had to make their people accept them as money through legal means. This is what legal tender is all about.

¹³ The word *dinar* refers not to the shape of the coin or what is inscribed on it. Rather it refers to a standard weight of gold, i.e. 4.25 grams of a gold alloy that contains 91.6 per cent gold (also known as 916 gold or 22 Karat), just as the British sovereign that weighs 8 grams (also of 916 gold).

¹⁴ The Islamic dinar simply had the Roman pagan inscriptions removed and replaced with Qur’anic verses instead.

as a possible solution to the problems inherent in a fiat monetary system. Is gold capable of making a true difference? We argue that gold can, in one way or another, provide solutions to each of the problems identified earlier.

A major advantage of gold over fiat money is that it has intrinsic value and that it can neither be created nor destroyed. Its issuance or production is also not a monopoly of any single party. Gold is scattered throughout the earth and can be mined by anybody unlike fiat money, the issuance of which is under the prerogative of some issuing bodies like the central banks and the commercial banks. The following section reasons why gold can be a solution to the problems.

Superiority of Gold over Fiat Money

We argued earlier that fiat money is easily created by the banking sector and that the growth in money supply is necessary for the sustainability of the system. Part One highlighted the many problems encountered in the interest-based fiat monetary system. Those problems may be matched with the characteristics of fiat money as summarized in Table 2.

The gold dinar is not likely to be the cause of the above problems simply because it cannot be created the way fiat money is being created through multiple deposit expansion. Gold is, in contrast, physical and real. Therefore, it can neither be created at the will of anyone nor be counterfeited. This characteristic alone can obviate most of the problems associated with fiat money — hyperinflation, asset price bubbles, debt bubbles, amplification of business cycles, etc.

Table 2: Characteristics of Fiat Money and Problems Caused

<p style="text-align: center;">Fiat Money is Created Out of Nothing</p> <ol style="list-style-type: none"> 1. Amplifies business cycles. 2. Causes inflation and asset price bubbles. 3. Debt bubbles and financial collapses of firms and governments. 4. Trade-off between inflation and unemployment. 5. Agriculture sector disadvantaged due to price controls in this sector. 6. Along with interest rates, it places the burden of a continuous growth requirement, promotes competition and accumulates wealth in the hands of a minority by taxing the majority. 7. Widening inequality in distribution of income that creates poverty with a host of social problems like housing, long working hours, multiple jobs, female and child labour, crime, etc.
<p style="text-align: center;">The Existence of Many Different Fiat Currencies</p> <ol style="list-style-type: none"> 1. The many fiat national currencies currently existing provide a fertile ground for currency speculation, manipulation and arbitrage. 2. Makes it possible for huge amounts of short-term funds to move in and out of nations within seconds. This fact is very destabilizing, sometimes behaving as a shadow government that apparently disciplines 'misbehaving' governments! 3. Through the seigniorage of fiat money some nations gain substantially when other nations use their currency for international trade and dealings or in domestic transactions. 4. Provides an easy tool for domestic and international financial institutions to gain control over the money, wealth, the political structure (i.e. sovereignty) of nations, etc.
<p style="text-align: center;">Gets Destroyed in Certain Circumstances</p> <ol style="list-style-type: none"> 1. Causes a shrink in money supply and aggregate demand, and thereby recession. 2. Business failures and unemployment during financial collapses. 3. Bank failures and crises. 4. Leaves governments in debt 5. Possible political turmoil.

If gold were used as a common currency instead of the different national currencies, then there would be no exchange rates in the first place.¹⁵ Therefore, speculation, manipulation and arbitrage would no longer be possible.¹⁶ The possibility of the kind of currency attacks that the East Asian countries experienced in 1997-98 would be very much diminished. The additional benefits of using gold in international trade are discussed in the next chapter.

Also if gold were to become a common currency, no individual country would enjoy substantial seigniorage. The “theft of nations” that we discussed earlier would be very much minimized, if not eliminated. Accordingly, gold protects the sovereignty of nations and thereby, in turn, also protects their culture, religion, education, legal structure, etc.

During a recession, fiat money gets destroyed through the reverse process of money creation. Money that is initially created in the form of accounting entries, later gets destroyed in the same way. This destruction of money brings about a shrink in the money supply and a lower circulation of money in the economy which, in turn, causes lower demand and business transactions, lower business profits, bankruptcies, retrenchments, unemployment, etc. With gold as money, however, this destruction is not possible due to the physical nature of gold. Therefore, gold as money can be expected to provide the much desired stability missing in the current fiat money system. Unlike fiat money, gold would not be introduced into the economy in the form of debt. Therefore, it would neither create capital structure

¹⁵ Of course, convincing all nations to adopt a single currency is easier said than done, more so if gold is to be the money itself.

¹⁶ Appendix D provides an example of how speculative and arbitrage profits in the currency markets are made.

problems nor require constant growth in money and the economy for the mere sustainability of the system.

Gold, therefore, seems to be a superior and desirable money compared to fiat money. It promises a just and stable monetary system while protecting the wealth, sovereignty, culture and religion of the people. A real money like gold is, therefore, also urgent in the current era of globalization and neo-liberalization. While countries are likely to gain from the implementation of gold money, the only parties that might lose out are those in control of the financial institutions, particularly the international ones, and the countries that enjoy immense seigniorage through their currencies.

Some Common Objections to the Gold Dinar

Even though we postulate that gold has numerous advantages, there are some who nevertheless do have reservations regarding the gold system. Some even say that this is like taking people back through the centuries to the olden days to a system that is no longer applicable to the modern day scenario. Some common objections given are as follows:

A. Gold Standard and Bretton Woods Both Failed!

But both failed because some countries printed money considerably in excess of what their gold reserves could support. This meant that a significant portion of their fiat currencies were not backed by gold. The failure to match these brought about their collapse.

B. Price of Gold Fluctuates

Yes, the price of gold fluctuates for many reasons. But, this should not be of much concern if people start to think of gold as the price itself. The value of gold is still much more stable than that of any other currency including the dollar.

C. Gold Producing Countries at an Advantage

This is a very common objection or query. Yes, gold producing countries would be at an advantage¹⁷ but the gold needs to be mined first with some heavy investments. Additionally, this is the same as if God were to give one a fertile land that produces lush vegetation and fruits. The produce of the land could then be exchanged for gold. Similarly, knowledge, skills and technological know-how are just as valuable.

D. Gold is not Practical. It is Heavy and Entails Security Issues

With information technology these problems can be minimized. Most transactions can be done electronically and the gold can be kept safe with a custodian. Accounting entries for the ownership of gold are all that is required. Gold can be transferred only when necessary.

E. Gold Stock is Insufficient and Inelastic to Meet Growing International Trade

As we argued earlier, in most cases gold would only play the role as a unit of account. Therefore, gold is needed only for settling the balances of multilateral trade among a matrix of countries. This fact is further elaborated in the next chapter.

F. Fiat Money is Cheaper to Produce

But it is the fiat nature of money that causes the many problems that were discussed earlier.

G. New Discoveries of Gold May Cause High Inflation

Actually, it is fiat money that can be easily created or counterfeited and hence is more likely to cause inflation. Gold production is not easy and entails heavy investment. Hence there are automatic

¹⁷ On the contrary, in the current system where the dollar is the dominant international currency, only the US benefits because it enjoys a monopoly over its issuance. However, no country has a monopoly over the production of gold.

checks on overproduction since miners know that overproduction would only entail inflation, i.e. why waste investment and effort that would only translate into inflation?

H. Gold Price is Too Volatile for it to be a Monetary Standard

When the ringgit exchange rate relative to the dollar fluctuates, for example, it could be due to factors affecting the ringgit or even factors affecting the dollar or both. The volatility is not necessarily due to factors affecting the ringgit alone. Similarly, when the gold price fluctuates, it may not necessarily be due to changes in the demand and supply of gold, but it could be due to changes in fiat money itself. If the gold price goes up, it could also mean that the value of fiat money is falling. For example, if a government prints too much of its currency, then the gold price in that currency would rise. Nevertheless, historically, gold has proven to be more stable than most currencies including the dollar, in terms of keeping its value.¹⁸

I. Gold is Incompatible with the Current International Monetary Order

History has shown that gold is a globally acceptable currency and hence more compatible with the international monetary order than any fiat currency.

¹⁸ For example, Roy W. Jastram, *The Golden Constant*, New York, John Wiley & Sons, 1977, showed that price levels based on gold were extremely stable over long periods of time. Using wholesale price index data, Professor Jastram concluded that this was not because gold moved towards commodity prices, but because commodity prices eventually returned to gold.

J. Now is an Inopportune Time Since Developing Nations will lose their Gold Stock

Looking at the current global scenario, now is the time to implement the gold system. The idea behind the gold payment system is to use it as a monetary unit of account as much as possible, i.e. use gold to settle net trade balances only. This is further elaborated in the next chapter. As such, the gold dinar would at least protect the future wealth of nations being unfairly plundered.

The Prophet Muhammad (peace be upon him) is reported to have said that: “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”.¹⁹

We believe that that time is very close, in the very near future. In our opinion, the use of gold in settling international trade balances is a great step forward. For Muslims, it would be a significant step that complements the establishment of the Islamic Banking system itself. The gold dinar promises a just and stable global monetary system while providing a stable international unit of account, which has been profoundly missing since the demise of Bretton Woods in 1971. It promises to check excessive currency speculation, manipulation and arbitrage while reducing transaction costs. Most importantly, it promises to protect countries from the threat of losing their national wealth and sovereignty to foreign financial powers through the interest-based fiat money system. In the current system, the Islamic bank is also caught up in the law-of-one-price that causes it to refer to the market interest rate — the very thing it was supposed to avoid — in designing and pricing its financial products. Tan Sri Nor Mohamed Yakcop, the special economic

¹⁹ *Musnad* of Imam Ahmad ibn Hanbal.

adviser to the Prime Minister of Malaysia, rightly called the gold dinar the next component in the international Islamic financial system. The gold dinar seems truly to be the missing link that is necessary to perfect Islamic money, banking and finance.

Practicalities

A gold payment system needs to be implemented in a gradual manner. One cannot and should not attempt to overturn the present system overnight. Therefore, a practical way to introduce a gold payment system is to begin with a dual system, i.e. the gold dinar co-existing with the national currencies. This is desirable considering the fact that not every individual may favour a gold payment system.²⁰ The best area to start is probably to implement the gold dinar for settling bilateral and multilateral trade arrangements. This would have the least implications for the existing national currencies. Concurrently, a small but parallel gold dinar economy should be established. This refers to a set of businesses that accept gold for payments in the domestic economy. This gold economy would form the nucleus for the implementation of a gold payment system domestically. This is further discussed in the next section.

²⁰ Disagreement on this matter is, therefore, a blessing. Those who disagree need to be convinced by a working and successful implementation. Their gradual acceptance would also provide the gradual growth necessary for a smoother transition.

Colonialism and Financial Liberalization

What were the features of colonialism? Basically, the colonialists were the true rulers of the countries they colonized. They set the laws, rules, regulations and policies. They basically decided on the use of national resources, the education policies, social structure and even culture. Colonialism is nothing new. Many developing nations including Malaysia have gone through it before. These nations didn't like to be colonized and hence fought to regain their sovereignty and independence. But when the colonialists left, they left behind an education system that effectively separated religion from science (i.e. secular) and a financial system that is basically a fiat money interest-based one.

In Malaysia, long before the era of colonialism, the historical rulers of the northern states of the peninsula paid *uffi* (flower ornaments made of gold) to the Kings of Siam as “protection money”. The Kings of Siam did not interfere with the local rulings and policies though. They merely took the gold “gifts”.

What we intend to highlight here is that the financial liberalization that is being championed by the West in the name of globalization in effect can be a tool to re-colonize the developing nations. To see this, one needs to understand how the fiat money interest-based system works. If globalization succeeds in bringing in foreign banks to operate in the land, then it is merely a matter of time before the national wealth and sovereignty will fall into the hands of foreign financial institutions. With sovereignty lost, developing nations will be back to the olden days of colonialism, but this time the colonialists will be much more powerful. Every citizen will be basically transformed into a “slave”. The interest rate will determine the “*uffi*” rate. This is necessarily a huge *uffi* because even a small interest rate of 5 per cent represents a large amount of the real economy!²¹ Not only will the developing nations be paying the *uffi*, but vital decisions will be made by the colonialists including the law of the nation, the education system and even the culture. Colonialists of the past were able to obtain such power only after some serious confrontations like battles, wars, etc. However, today the financial system provides an easy and convenient tool.

The impending financial liberalization will effectively transfer such colonial power to the financial institutions “peacefully”. The people will be basically transformed into “slaves” who have to give to the colonialists a portion of their produce and take orders from them with respect to laws, education, etc. Financial liberalization within the fiat money framework is, therefore, a tool for global colonization. Nothing of the past can match it.

If this colonialism is something good, e.g. if it provides the people with better standards of living in terms of wealth, education, health, etc. with the

²¹ Because money is predominantly introduced into the economy as loans.

freedom to practice religion, etc., it may be accepted by the people. However, what we see is that it is likely to impose Western secular culture on the people. The religion and culture of the people are likely to suffer under this. A spiritual vacuum may ensue with religious rulings like the *Shari'ah* reduced to mere history.²² Basically, life will be transformed into a life of materialism with periodic “*ufti*” being paid to the colonial masters.

If, in the past, such powers were basically acquired through battles and wars, by analogy, financial liberalization is war.²³ The gold dinar breaks the very foundation of the tool for colonization, i.e. the fiat money. It significantly reduces the reliance on foreign reserve currencies for trade. Gold places strong resistance against economic colonization. The developing world may thus unite on the gold dinar and reap all the benefits of a common global currency that has intrinsic value on its own. Gold money and trade settlement mechanisms using gold are means by which this new economic colonialism can be prevented.

Implementing the Gold Dinar

The earlier sections discussed the advantages of the gold dinar over the fiat money system. One particular issue of importance is the matter of sovereignty. The sovereignty of developing nations is at stake in this era of globalization and neo-liberalization as it has never been before. Therefore, it is imperative for nations that want to protect their national wealth and sovereignty to plan-out a defence strategy in the current global economic and financial chaos. Implementing the gold dinar is surely one strategy in this respect.

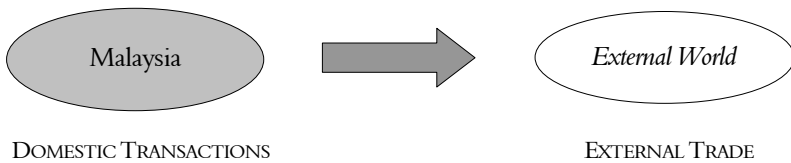
The gold dinar may be implemented in two areas: (1) for settling external trade balances and (2) for use in internal domestic transactions

²² They may even forbid the *hijab* for Muslim women while the *azan* is considered as “noise pollution”.

²³ Malaysia, for example, could have lost this war in 1997 if it had only accepted the IMF loan offer. It is, therefore, a Blessing of God that Malaysia refused and decided on her own course of recovery. Some neighboring countries that understand this war had already accepted defeat by declaring that they would go along with the “new world order”. Will the foreign financial giants try again on Malaysia? Yes, likely so. The 2007 financial liberalization looming over Malaysia is surely a threat in this sense.

(See Diagram 7). Since the gold dinar touches the very structure of the current financial system, it would certainly be prudent to implement the gold dinar in a more gradual and carefully structured manner. Rushing

Diagram 7: The Gold Dinar System may be Implemented in Two Areas: For Domestic Transactions & External Trade



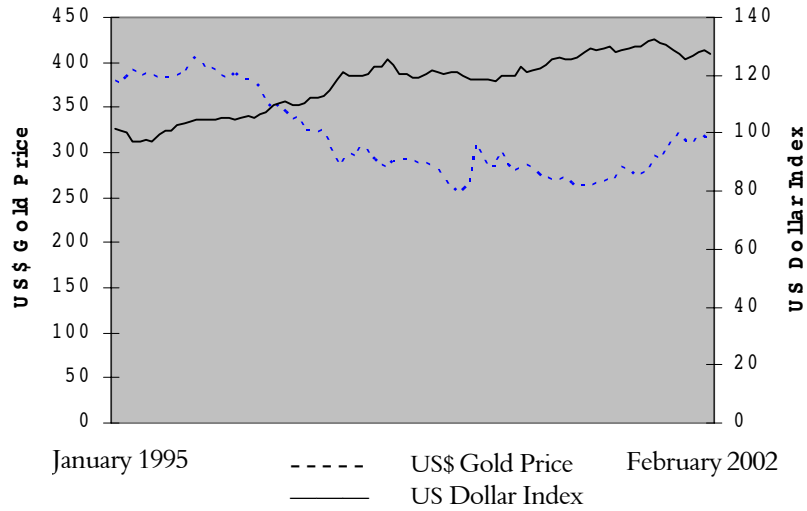
The gold dinar may be implemented in two areas: (1) In external trade for settling trade balances between countries and (2) For use in domestic transactions, i.e. for payment purposes.

The former may not have much implication for the national currency since here gold only replaces international reserve currencies like the US dollar. The latter, however, will have implications for the national currency since in this case gold would be its complement.

into its implementation in both the areas may even prove disastrous. A gradual shift without unduly rocking the present set-up is important. The Prime Minister of Malaysia, Dr Mahathir Mohamad proposed that the gold dinar be initially used for settling bilateral trade balances alone. This is the area that warrants immediate attention anyway, since most currency trading for real transactions take place in this sector. Implementing the gold dinar here would also curb the huge currency speculation that takes place globally. Later, the bilateral structure may be expanded into a multilateral set-up. In this way, problems could be ironed out while they are still small. In an incremental manner, more and more countries could then be added into the gold dinar structure. If the system is implemented on a large scale immediately, the danger is

that it may place an undue demand pressure on the existing international gold market and thereby cause a substantial increase in gold price. Furthermore, considering the present global economic and financial conditions this is not advisable for it could even cause a collapse of the dollar. The price of gold and the dollar index have a marked negative correlation as shown in Diagram 8 below. Nevertheless, a collapse of the dollar is not good not only for the United States but also for the rest of the world since many nations are currently holding on to the dollar as the reserve currency and have investments in the United States and in dollar denominated financial assets.

Diagram 8: Negative Correlation between Gold Price vs US dollar Index



The plot uses monthly data of gold price (US\$/ounce) and the US dollar Index for the period January 1995 to February 2002. The negative correlation between the two series is quite obvious even to the naked eye. The Pearson's correlation value is a negative 0.88. This high negative correlation between the gold price and the US dollar suggests that if the gold price were to increase suddenly due to the implementation of the gold dinar on a large scale, it may prove detrimental for the US dollar.

Chapter 6

The Gold Dinar in International Trade

Gold is going to be part of the structure of the international monetary system for the 21st century. — Robert A. Mundell, Nobel Laureate

Implementing the Gold Dinar in Bilateral Payment Arrangements (BPAs) and Multilateral Payment Arrangements (MPAs)¹

MANY PEOPLE ARE convinced that the gold dinar system is desirable. However, the question now is how to implement it in the present fiat money system. As mentioned earlier, it is always wise to implement any new system gradually so as not to rock the present set-up drastically. Abrupt changes may cause more harm than good. With small changes, one may be able to monitor the impact of the changes and take necessary action where needed. Problems could be ironed out while they are still small, before embarking on further developments. Implementing the gold dinar in international trade, as proposed by Dr Mahathir Mohamad, is probably the best initial step that can be taken. In the Malaysian case, the gold dinar is not intended to replace the

¹ This section makes use of materials presented by Tan Sri Nor Mohamed Yakcop, the special economic adviser to the Prime Minister of Malaysia, in a keynote address delivered at the *2002 International Conference on Stable and Just Global Monetary System*, held in Kuala Lumpur on August 19-20, 2002.

ringgit, which will continue to play its role in domestic transactions. Basically, the model is as follows.

In the bilateral and multilateral trade settlement systems, the gold dinar need not exist in its physical form. However, the external trade will be denominated in dinar, i.e. a standard unit of weight of gold. The historical dinar was equivalent to 4.25 grams of gold. For convenience though, we may denominate one ounce of gold as the standard international trade dinar simply because currently the international gold price is quoted in dollar per ounce.² For example, if one trade dinar is equivalent to one ounce of gold, and the price of one ounce of gold is at US\$300, then the value of one gold dinar will be US\$300 or equivalent in other currencies, on the basis of the then prevailing real-time exchange rates.

The central banks of participating countries would play pivotal roles in the implementation of the gold dinar in the bilateral and multilateral trade settlement mechanisms. All external trade transactions pass through the central banks that keep the trade accounts. Exporters will be paid in their own national currencies by their respective central banks on the due date of exports, based on the gold dinar exchange rate prevailing at the time of the transaction. Similarly, the importers will pay to the central bank in their respective national currencies. These are intermediary steps towards a total gold system. In the ultimate system exporters and importers should be paid in gold itself. Only then can the exchange rate risk be totally eliminated. Another important point to note is that, when exporters are paid in high-powered national currencies, this would spin off a

² This follows the suggestion given by Tan Sri Nor Mohamed Yakcop. Some people might object to this, insisting that the Islamic dinar must be 4.25 grams of gold. Denominating it in ounces would not change the essence of things though.

chain of credit creation. Therefore, countries with current account surpluses (i.e. trade surpluses) would tend to experience credit expansion and asset price bubbles.³ Such a set-up may even prove detrimental in a gold dinar system particularly when currently the gold price is expected to continue to rise.

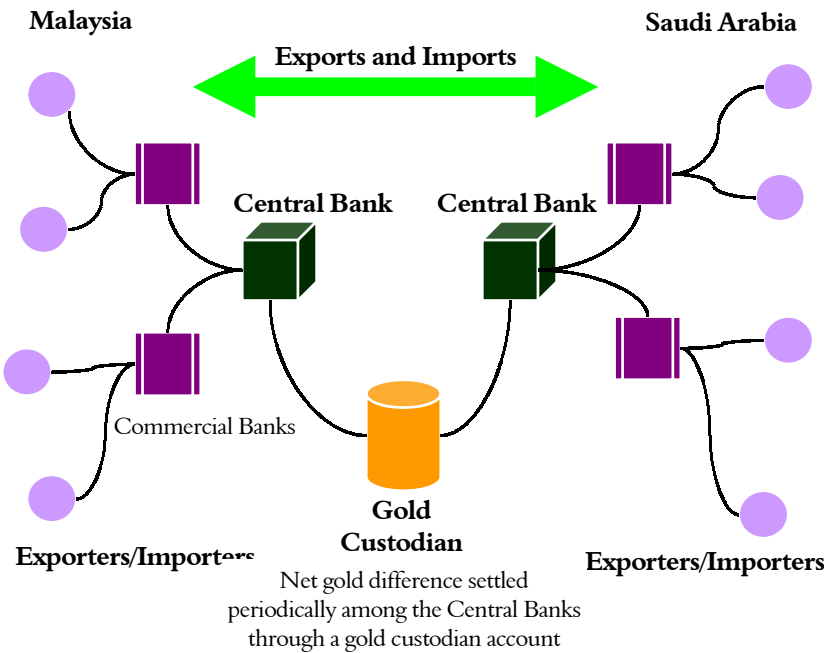
On the ground, commercial banks that support gold accounts would be viable partners in the implementation of the gold dinar. Individual businessmen, corporations and traders would deal with commercial banks that support such gold accounts. These commercial banks would, in turn, deal with the central bank for their respective gold accounts. The structure may sound like the gold standard of the past, but it is not. Here, gold itself is used for pricing and not any instrument backed by gold. Also with today's information technology, physical movement of gold is not necessary. The historical gold standard failed because instruments backed by gold are vulnerable to easy abuse, i.e. some countries created more instruments (i.e. paper money) than the amount of gold they actually had. Hence it is the fiat portion that brought about the collapse of the system. We cannot afford to repeat this failure in the gold dinar system. There must be real-time audit to make sure that the amount of gold being transacted (electronically or otherwise) matches the actual amount of gold held.

Bilateral Payment Arrangement (BPA)

The BPA gold dinar model is shown in Diagram 9. When Malaysia trades with Saudi Arabia, for example, the gold accounting is kept through the medium of the central banks and only the net difference between the two is settled periodically by way of transfer of an

³ As experienced by Japan, East Asian countries and now China.

Diagram 9: Gold in Bilateral Trade Model



Exporters and importers (circles) would deal with commercial banks (squares) that support gold accounts. All external trade transactions pass through the central banks (cubes) that keep the trade accounts. The net difference between the two is settled periodically by way of transfer of an equivalent amount of gold. A physical transfer of gold from one country to another is not necessary though, but only a transfer of beneficial ownership in a gold custodian's account (cylinder). Any gold that needs to be settled can always be brought forward and used for future transactions and settlements.

If exporters are paid in their own national currencies by their respective central banks on the due date of exports, based on the gold exchange rate prevailing at the time of the transaction, the central banks must be wary of the credit creation this would bring about domestically, more so in the current scenario that is bullish on gold.

equivalent amount of gold. Hence every transaction in essence involves gold “movement”. A physical transfer of gold from one country to another is not necessary though, but only a transfer of beneficial ownership in a gold custodian’s account.

The custodian role can be played by the Islamic Development Bank (IDB), the Bank of England or preferably by some other non-interest-based non-money-creating institution. The role of the gold custodian should decrease the probability of default by any of the parties involved, increase efficiency and thereby bring confidence into the system. However, any gold that needs to be settled can always be brought forward and used for future transactions and settlements. Where it is not possible to transfer the gold, payment can be made by way of an equivalent amount in other acceptable currencies using real-time gold price as the exchange rate.

As an example,⁴ consider that Malaysia and Saudi Arabia sign a bilateral payments arrangement where trade balances are to be settled every three months. Say, in a particular three-month cycle, Malaysia exports 2 million gold dinar worth of goods and services to Saudi Arabia while importing 1.8 million gold dinar (See Table 3). Hence Malaysia has a surplus trade of 0.2 million gold dinar with Saudi Arabia and Saudi Arabia needs to settle only this difference of 0.2 million gold dinar. The actual payment can be by way of the Saudi Central Bank transferring 0.2 million ounce of gold in its custodian’s account, say, in the Bank of England in London, to Bank Negara Malaysia’s account with the same custodian. The important point to note here is that,

⁴ This example is from Tan Sri Nor Mohamed Yakcop, “Trade and the Gold Dinar: The Next Component in the International Islamic Financial System”, a keynote address presented at the *2002 International Conference on Stable and Just Global Monetary System*, Kuala Lumpur, August 19-20, 2002.

under this mechanism, a relatively small amount of gold (0.2 million gold dinar) is able to support a much larger trade value (3.8 million gold dinar). In other words, we optimize the use of foreign exchange. Even countries with little or no foreign exchange reserves can participate significantly in international trade under this mechanism.

Table 3: Gold in Bilateral Payment Arrangement (BPA)

Export to	Gold Dinar (million)		
	Malaysia	Saudi Arabia	Total Export
Malaysia	X	2.0	2.0
Saudi Arabia	1.8	X	1.8
Total Import	1.8	2.0	3.8

	Gold Dinar (million)		
	Export	Import	Net payment
Malaysia	2.0	1.8	+0.2
Saudi Arabia	1.8	2.0	-0.2

However, the amount of 0.2 million gold dinar could be used for settling future trade imbalances between the countries and hence a physical gold transfer between the countries is not necessary. This simple structure considerably reduces, if not eliminates, exchange rate risk. At this juncture, one may ask the question, how does this structure differ from a simple barter trade between the countries? The advantage here is that gold acts as a unit of account and thereby eliminates problems associated with barter.

Multilateral Payment Arrangement (MPA)

The MPA structure is similar to the BPA, but it involves more than two countries and, therefore, makes the whole system more efficient. Let's illustrate this using three countries, namely Malaysia, Saudi Arabia and Egypt. Let us assume that the volume of trade between Malaysia and Saudi Arabia was the same as in the BPA example, and we add the additional trade of these two countries with Egypt, as shown in Table 4 below:

Table 4: Gold in Multilateral Payment Arrangement (MPA)

Export to	Gold Dinar (million)			Total Export
	Malaysia	Saudi Arabia	Egypt	
Malaysia	X	2.0	1.5	3.5
Saudi Arabia	1.8	X	2.0	3.8
Egypt	1.7	1.7	X	3.4
Total Import	3.5	3.7	3.5	10.7

	Gold Dinar (million)		
	Export	Import	Net payment
Malaysia	3.5	3.5	Nil
Saudi Arabia	3.8	3.7	+0.1
Egypt	3.4	3.5	-0.1

Now a total trade of 10.7 million gold dinar takes place among the three countries but with a net payment of only 0.1 million gold dinar. The only payment required is for Egypt to pay Saudi 0.1 million gold dinar.

This mechanism can be refined further, whereby the credit or debit outstanding at the end of each quarter is forwarded to the subsequent quarters and the final settlement is made only at the end of the year. The advantage of this is that a net import position for a country during a particular quarter may be offset by a net export position in the subsequent quarter, so that, for the year as a whole, the payment flows are further minimized.

The above example answers the often asked question: Are the existing gold reserves enough to support the growing volume of international trade? The answer is that in most cases gold would only play the role of a unit of account. Only the net balances remaining in the matrix of trade need to be settled in gold. David Ricardo, the famous 19th century economist, wrote in his *Principles of Political Economy and Taxation* (London, 1817), that when money is working at the peak of efficiency, the central bank need not hold any gold. We may not expect such peak efficiency, but some gold should be there to settle balances. Nevertheless, central banks need not hoard large amounts of gold like in Fort Knox. The efficiency could be further improved if trade experts sit together and analyze the export potentials and import needs of every participating country and thereby come up with a more efficient trade matrix.⁵ The international financial institutions may not favour such multilateral payment arrangements because they significantly reduce the participating countries' dependence on international fiat reserve currencies.⁶

⁵ Ahamed Kameel Mydin Meera and Moussa Larbani, "The Gold Dinar in Multilateral Trades: A Mathematical Model for Determining an Efficient Trade Matrix" provides a non-linear mathematical programming method to determine an efficient trade matrix that minimizes the amount of gold needed for settling the multilateral trade balances.

⁶ Hence do not be surprised if these financial institutions object to MPA's on top of a possible objection to the use of gold for trade settlements.

In summary, therefore, for the implementation of the gold dinar system, central banks need not stock up gold reserves as suggested by some international agencies. It would be better to start small with whatever gold reserves are already in the possession, of a small group of participating countries. Countries with little gold reserves could trade with gold producing countries like South Africa, Mali, Russia,, etc. in order to increase their gold reserves. In this way, problems can be tackled while they are still small without placing undue demand pressure on the existing gold market. If all developing countries rush into implementing the gold dinar, this may only increase the international gold price substantially. However, observing the present global financial scenario, in our opinion, it is better for countries and individuals to have a good portion of gold reserves and savings.

The Bilateral and Multilateral Payment Arrangements may not affect the national currencies much since the gold dinar only replaces the international reserve currencies like the US dollar for settling international trade.

Advantages of the Gold Dinar System in Multilateral Trade

The bilateral and multilateral payment systems using the gold dinar have numerous advantages that are summarized below:

1. Substantially reduces, if not eliminates, foreign exchange risk. Accordingly, the gold dinar also removes the need for currency derivative markets for hedging against exchange rate risk.⁷ Exchange rates are so volatile that many international investments, trade and projects are shelved simply due to the unwillingness of parties to assume the exchange rate risk.

⁷ Appendix F compares currency risk hedging using forwards, futures, options and the gold dinar.

Traditionally, the currency forward, futures and options contracts have been used for managing currency risk. However, in most developing nations including Malaysia, futures and options on currencies are not available. Even in countries where currency derivative markets exist, however, for example the Philadelphia Stock Exchange in the United States, not all derivatives on all currencies are traded.

Derivatives are available only on select major world currencies like the yen, pound sterling, Australian dollar, etc. against the US dollar mostly. For most other currencies of the world there are no formal tools for hedging foreign exchange risk — a risk that has become immensely significant in today's global business environment. With the gold dinar, nevertheless, all countries including those without derivative markets can enjoy this benefit. After all, developing a derivative market is not only costly but time consuming. It also introduces inefficiency into the market since additional transaction costs need to be incurred.

2. Unlike the forward, futures and options markets, the gold dinar does not depend on speculators for increased liquidity. By being a global currency it is capable of providing the needed liquidity without bestowing any “unfair” seigniorage on any particular currency.
3. Also, unlike imperfections of hedging that are likely to occur with forward, futures and options contracts due to the standardized nature of these contracts, the gold dinar does not introduce such imperfections.
4. A hedger also pays neither the initial margin nor daily variation margins as is the case with currency futures. Such margins are potential cash flow burdens on hedgers.
5. The gold dinar would also reduce speculation, manipulation and arbitrage between national currencies. For example, if three countries agree to use the gold payment system, then it tantamount to the three currencies becoming a single currency. Accordingly, speculation and arbitrage among these three currencies will be reduced, if not eliminated. This “unification” of the three currencies through gold provides

diversification benefits. This is like obtaining diversification through a portfolio of stocks. Individual currencies face risks that are unique to the issuer country. Political turmoil, for example, can cause a national currency to depreciate, but in a unified currency such unique risks would be diversified away. Since gold is treasured globally, it is a suitable global currency that enjoys global diversification. This means that no single country's unique risk may be significantly embedded in gold. A basket of currencies is generally less volatile than the individual currencies — an advantage the euro can be expected to enjoy. However, the gold dinar is even better than the euro because it has intrinsic value unlike the latter and is also likely to hold its value better (as it has always done).

6. The gold dinar is likely to reduce transaction costs too, since only accounting records need to be kept. Transactions can be executed by means of electronic mediums at minimal cost. In a comprehensive dinar system, one no longer needs to incur currency exchange transaction costs (i.e. the different buying and selling rates for currencies)⁸ or even face exchange rate risk. This would surely encourage trade.
7. With increased trade, a smaller amount of gold is needed to support the gold payment system since gold would, in most cases, play the role of a unit of account. Therefore, even countries without foreign reserves can still trade.
8. With less reliance on international reserves for trade, there would be less reliance on foreign debt too.
9. With increased trade, one could expect improved unity and cooperation in education, science, technology, research, defence, etc.
10. Since in the initial model the gold dinar simply replaces foreign reserve currencies, therefore, it has few implications on the national currency.
11. Gold has held its value stable throughout history, and is also free from obsolescence.

⁸ Also known as the bid and ask quotes.

12. With the gold dinar there will be neither creation nor destruction of money; a characteristic of fiat money that amplifies business cycles, unemployment, etc. This also greatly reduces the possibility of future attacks on currencies.
13. There are numerous other socio-economic advantages but most important of all it promises to protect the sovereignty, wealth and culture of developing nations from the predatory forces under the pretext of globalization and liberalization, that can only result in economic and cultural colonization.
14. It basically places an “iron-grill” so that the resources and future economic production of developing nations are not easily plundered by foreign forces through the easy means of seigniorage and interest charges.

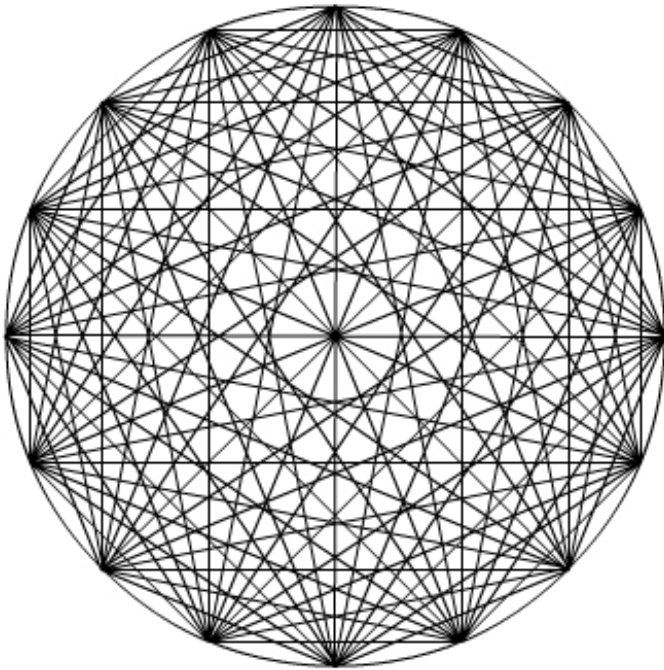
It is interesting to note that some early scholars of the past seem to have had great insight into this. Consider, for example, Al-Ghazali, Ibn Khaldun and al-Maqrizi who asserted that God had created gold (and silver) to serve as a measure of all commodities.

There are some important things to be wary of when implementing gold in international trade and transactions:

1. Never reschedule or revalue old trade balances and loans in terms of gold. This is very important. The gold payment system must be made applicable only for new wealth creation, i.e. new production, new trade, etc. It should not be applicable for past economic activities and transactions, i.e. past trade balances, past loans, etc. This is because, for example, past total loans are huge simply as a result of the over-creation of fiat money. These enormous loan balances cannot and should not be transformed into gold equivalent, for this would be tantamount to realizing the seigniorage of past fiat loans.
2. If exporters and importers are dealt with in national currencies while the central banks settle among themselves in gold, then the central banks must be wary of the spiral of credit creation and asset price bubbles this arrangement can bring about.

THE GEOMETRICAL PATTERN shown below is a symbolic representation of a multilateral trade arrangement between 16 countries. Each line represents a bilateral payment arrangement (BPA) between two countries. Collectively they form a multilateral framework.

From an engineering perspective such a structure must be necessarily **strong** and **stable**. The symmetry of the structure symbolizes **fairness** and **justice**.



A Short Quiz: Can the reader figure out how many bilateral arrangements there are among the 16 countries? Put in another way, how many lines are there in the above diagram?

(Answer on next page.)

Answer: 120. It takes two points to make a straight line. Therefore the question is basically how many combinations of two are possible from the sixteen

points. ${}_{16}C_2 = \frac{16!}{2!14!} = 120$

Chapter 7

The Gold Dinar in Domestic Transactions

You have a choice between the natural stability of gold and the honesty and intelligence of the members of government. And with all due respect for those gentlemen, I advise you, as long as the capitalist system lasts, vote for gold.

— George Bernard Shaw (1856-1950)

THE PRECEDING SECTION discussed the use of the gold dinar in settling bilateral and multilateral trade balances among participating countries. However, the gold dinar model would not be complete until it is also used for domestic transactions within the country. It is true, however, that the use of the gold dinar in domestic transactions is likely to affect the national currency. Nevertheless, considering the present global economic scenario and the socio-economic benefits that can be derived from the gold dinar, perhaps countries should plan towards its gradual domestic implementation. Initially, the gold dinar may co-exist together with the conventional national currencies. It need not replace existing national currencies but rather it should give everyone a choice for their preferred money — gold dinar and/or national currency. This is also in line with the true definition of money: *Money is an agreement (and not a legal tender) among people to use something as a medium of exchange.* The gold dinar is dear to many Muslims who regard it as the *Shari'ah* money. If this choice is not

given, then the gold dinar will have little chance of successfully circulating in the economy. This is according to Gresham's Law that states that bad money drives out good money from circulation. The domestic implementation of the gold dinar is important if we are to solve the internal problems created by fiat money. The amplification of business cycles, unemployment problems, inflation, widening inequality of income distribution, poverty, gradual transfer of political power to the financial institutions, etc. are rooted in the process of monetary expansion and destruction of fiat money.

Most money that exists in an economy is created by the commercial banks through multiple deposit creation. In almost all countries, only a small portion of their monetary aggregates is state money or money issued by the governments in the form of paper currencies and coinage (Please see Appendix E). The rest is predominantly bank money that simply comprise accounting entries. In many cases, even governments borrow money from the banks at interest whereas the issuance of money should in the first place rest within the domain of the governments.¹ Within the domestic economy, fiat money brings about a number of serious consequences. Its only benefit is probably its ease of use. But what is the point of having something that is easy and convenient which, however, is highly detrimental to the people, the nation and the world?

Instability of Fiat Money

Because fiat money is created out of nothing, there is a tendency to overcreate it. In most countries, the monetary aggregates (i.e. money

¹ As we argued earlier, this is likely to bring about a gradual shift of power away from the governments to the financial institutions, unless the financial institutions are government owned.

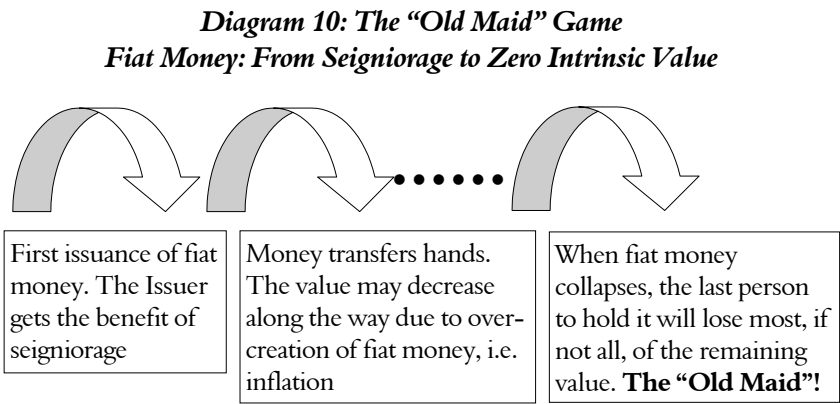
supply) have increased at high rates relative to the growth in the real economies. In many cases, the growth rates in broad money (M2) are more than double the growth rates in the real GDPs — a recipe for inflationary pressures and economic problems. Appendix E provides the growth rates for these two variables between 1986 and 1996 for sixty-two developing nations. Take a look and decide which countries in your opinion are likely to get into economic and financial crises.

Such overcreation of fiat money can jeopardize the credibility of the issuing nation. Many fiat monies have collapsed to their zero-intrinsic value in the past. As the truth unfolds, all fiat currencies ultimately seem to return to their zero intrinsic value. Obsolescence of fiat money is nothing new. Many paper currencies and coins of the past have become obsolete and therefore valueless.² Gold, on the other hand, has maintained a fairly stable value throughout history. No gold coin has ever become totally valueless. We could probably learn from the behaviour of our great-grandmothers who always had some gold ornaments as reliable and stable savings for the future. Due to political turmoil, wars, etc., many people in the past have been displaced to new lands. In such circumstances, it is assets like gold that one can safely rely upon for relocating or re-establishing oneself in a new country. National fiat currencies simply cannot be relied upon during such turbulent times. Fiat currencies have been known to devalue to very low levels. For example, when the Russian rouble collapsed in 1991-92 the savings of the people were practically wiped out.³ It is important to

² Except those that are collected for their numismatic value.

³ The trust in and the value of a fiat currency are very much dependent on the credibility of the issuer. When credibility is lost, the currency could significantly lose its value or even become obsolete, as happened to many currencies of the past. The Iraqi dinar in the aftermath of the American invasion is an example. Significant portions of the savings of the people are likely to be lost. If only the savings were in real money like the gold dinar!

note that currency transactions are zero-sum games. This means the loss to one is a gain to another. If that is the case, as in the Russian example, then who actually gained if the people lost their savings? It is clear, though, that the last person to hold a currency that has lost its value would lose all the purchasing power of the money at that point in time. The winners and losers in this fiat-money “game” are shown below in Diagram 10. In the fiat money system, basically, the issuer of the fiat money gets all the benefit of seigniorage upfront when it is introduced into the economy for the first time. Due to inflation, the subsequent holders bear the gradual loss of its value. The last person to hold it when the fiat money collapses loses most, if not all, of its value. This is like the “Old Maid” game — the person who holds the *old maid* card last loses the game! The same is also true in the case of international reserve currencies like the dollar.



Implementing the Gold Dinar in Domestic Transactions

It is always wise to institute changes in well-seasoned systems gradually. Abrupt changes may “rock the boat” and thereby cause more

harm than good, even if intentions are noble. As a strategy, therefore, it may be best to introduce the gold dinar in international trades first where the implications on national currencies are minimal.

Introducing the gold dinar for domestic transactions needs to be done carefully since this has strong implications for the national currency, the banking and finance system, etc.

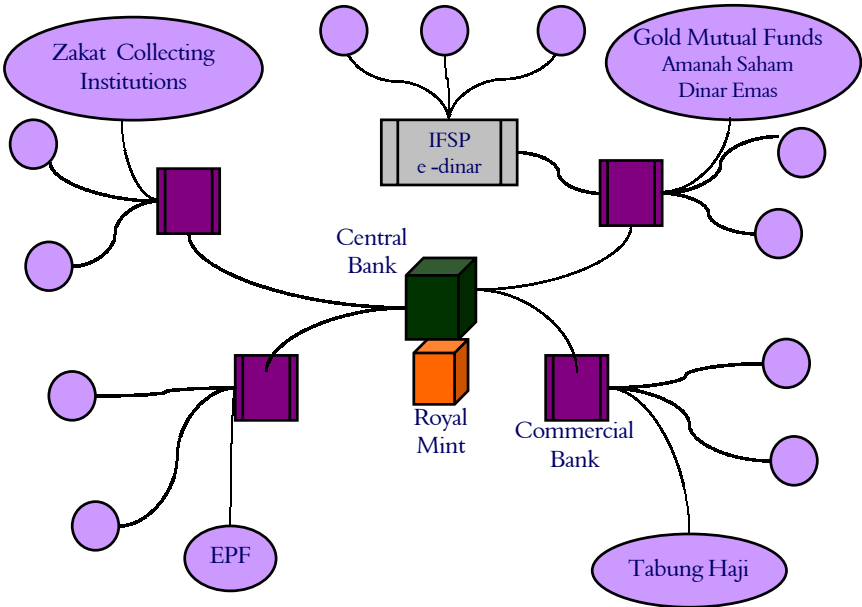
A practical way to introduce the gold dinar for domestic use is probably through electronic means, i.e. an electronic payment system similar to the debit card system but which uses gold for money. This is illustrated in Diagram 11.

Here individuals and firms may transact using electronic money but every transaction would involve gold “movement” between accounts with a custodian. Again, even though this seems like a gold backed instrument, it actually uses gold itself for payment.⁴ The custodian role can be played by an Internet financial services provider (IFSP), a commercial bank or, even better, the Central Bank⁵ itself. The Central Bank/Mint would probably be the best since this would boost confidence and ensure that the system is less susceptible to abuse. It is extremely important to make sure that the amount of gold dinar circulating matches the actual amount of gold deposited with the custodian(s). Otherwise, this would mimic the historical development of banking where the goldsmiths entrusted with gold for safekeeping printed more certificates of ownership than the amount of gold they actually had in their possession.

⁴ This is not a system where one redeems a financial instrument for gold. Nonetheless, a transparent constant monitoring and real-time auditing may be necessary to ascertain that the total gold in circulation matches the actual amount of gold held within the system.

⁵ Or the mint like the Royal Mint in the Malaysian case. The mint is suitable since generally it is a high security place that has vaults for the safekeeping of gold.

Diagram 11: Model for the Gold Dinar in Domestic Transactions



Individuals, firms, businesses and institutions (circles and ellipses) would deal with the commercial banks (squares) that support gold accounts. The gold holdings of these economic units would be held by a custodian, say, the Central Bank, the Mint (cubes) or an Internet financial services provider (IFSP). As the economic units transact among themselves, the ownership of gold changes and is kept track of, but nevertheless, a physical transfer of gold is not necessary.

Advantages of the Gold Dinar in Domestic Transactions

The use of the gold dinar in domestic transactions may be expected to bring about numerous advantages, among which are:⁶

⁶ Ahamed Kameel Mydin Meera, *The Islamic Gold Dinar*, Pelanduk 2002 may shed further light on why the following are benefits of the gold dinar system.

1. Socio-economic benefits. Since with gold there would be neither creation nor destruction of money, business cycle effects can be expected to be very much reduced. Along with this, problems like inflation and unemployment can be minimized too. During a recession money gets destroyed and that translates into business slowdowns, unemployment, etc. During such times it is the lack of money in circulation that is truly the cause of unemployment, etc.
2. Unlike the effects of money creation in the present system, a more equitable distribution of income and wealth can be expected from the gold dinar.
3. Since money creation is not possible with the gold dinar, financial distress, bankruptcies and unfair confiscation of real wealth would be minimized too.
4. Agriculture would be given its due importance. Money creation in the present fiat money system causes the prices of many agricultural products, particularly those of necessities, to be controlled. This, in turn, makes agriculture not an attractive sector compared to other sectors.
5. With the gold dinar, better and more affordable housing can be expected. In the present fiat money system, the property sector is one of the sectors that absorbs money supply thus making the price of homes increase substantially, thereby placing a burden on the low income group. The size of homes gradually becomes smaller while the mortgage duration tends to lengthen.
6. The basic necessities of people can be expected to be fulfilled faster in a gold dinar system and, therefore, it would release a lot of time for the people. The current system tends to make people busy with work, some working day and night shifts — just to fulfil their basic needs.
7. The gold dinar is a just system that protects a nation's sovereignty that could easily be lost if, for example, huge foreign banks are allowed to come in. With sovereignty protected, the wealth, religion, law, education and culture of people would be protected too.

8. With the gold dinar, counterfeiting would not be possible. In the present fiat money system, with modern printing technologies counterfeiting of money could be very easy.
9. Transactions in the gold dinar are instantaneous with actual gold movement within a gold custodian accounts. Therefore, intermediate credit creation like that with credit cards does not take place.
10. Gold is a global currency. It does not become obsolete like many currencies of the past. Also, currency transaction costs (i.e. the different buying and selling rates for currencies) would be eliminated.
11. The gold dinar would dichotomize Islamic and conventional banking effectively. In today's dual banking system, any price difference between Islamic financing and the conventional would be easily arbitrated away, thereby bringing the two markets to converge, i.e. the law of one price. For this reason, when pricing Islamic financial instruments, the Islamic banks have to refer to the market interest rate — the very thing they were supposed to avoid in the first place. The gold dinar, nevertheless, puts a barrier for the law of one price to work and hence their convergence.
12. Protection from money meltdowns. The current global financial scenario is such that a global financial collapse seems unavoidable and may occur at any time. Fiat money could lose its value drastically as happened even to the so-called superpowers, like the Russian rouble in 1991-92.

Steps in Implementing Gold Dinar in Domestic Transactions

As countries implement the gold dinar in international trade, the public may be prepared to gradually use gold in domestic transactions. Observing the current unstable global financial scenario, it may be wise for everyone to have some real assets as savings. Gold is likely to be a better choice here since historically it has held its value stable. Gold is a good store of value.

Accordingly, before gold comes to be used for payment purposes, the public can be encouraged to save in gold. Gold savings are also likely to give protection against any money meltdowns as that being predicted by some experts on money. It may even be advisable for governments to implement national gold (and other precious metals like silver) saving schemes for the people.⁷ Basically, these are unit trusts that invest in gold and other precious metals like silver. Since gold is bullish in the present unstable global financial scenario, even a good portion of national employee savings could be invested in gold. In Malaysia, a portion of the Employees Provident Fund (EPF) and liquid funds with the Lembaga Tabung Haji could be invested in gold. The people are unlikely to lose in this.

Gradually, these savings in precious metals can be transformed into a payment system — using both minted coins and electronic money. The gold dinar for domestic transactions is, therefore, compatible with modern financial architecture with automated teller machines (ATMs) and Islamic debit cards, charge cards, credit cards, etc. Internet financial service providers (IFSP) could also operate within this system. The electronic dinar or e-dinar, gold dinar cards, etc. could be easily implemented. With the card system, the financial architecture can also be made to replicate the gold dinar in multilateral trade and thereby make the whole system more efficient with a smaller amount of physical gold (See Diagram 12). For example, let's assume that the physical gold of individuals is kept with the central bank/mint and the accountings are kept by the commercial banks. Individuals make payments using cards, but postings or settlements are done only once a month (just as in the present credit card system when individuals are

⁷ In Malaysia, an investment trust like *Amanah Saham Dinar Emas* could be launched to encourage the public to invest in gold.

**Diagram 12: Gold Dinar in Domestic Transactions
using electronic medium, e.g. the e-dinar card**

		Businesses and Corporations						Institutions						Individuals						Total Payments
		1	2	3	.	.	n	1	2	3	.	.	m	1	2	3	.	.	p	
	1	■																		
	2		■																	
Businesses	3			■																
&	.				■															
Corporations	.					■														
	.						■													
	n							■												
	1								■											
	2									■										
	3										■									
Institutions	.											■								
	.												■							
	.													■						
	m														■					
	1															■				
	2																■			
	3																	■		
Individuals	.																		■	
	.																			■
	.																			
	p																			■
Total Receipts																				

Using electronic card system, the gold dinar in multilateral trade concept can be replicated for the domestic implementation of the gold dinar. Economic units, i.e. individuals, institutions, businesses and corporations, use the electronic payment system for their gold dinar transactions. Just like the present card system, these comprise only accounting entries, without involving any actual transfer of money. The economic units would be provided with their respective summary of transactions on a monthly basis, who are then required to settle only the net differences among themselves. In this way, significant transactions cancel among themselves and thereby require smaller amounts of physical gold for settlement compared with the volume of transactions.

Mechanisms similar to current accounts, debit cards, charge cards etc. can be used, but the important thing is that all transactions must use gold as unit of account for pricing and all settlements must involve real physical gold units.

provided with their statements once a month). In this way, significant transactions⁸ are likely to contra themselves and thereby require smaller amounts of physical gold for settlement compared with the volume of transactions. However, minted coins should also be allowed to circulate in order to boost confidence in the system.

In the meantime, individuals and businesses should be encouraged to accept and use the gold dinar for transactions. This establishes a parallel gold dinar economy that creates new wealth using the new money. Goods and services would be priced in the gold dinar too. Retail outlets like supermarkets should particularly be targeted to encourage the use of the gold dinar. In Malaysia, institutions like the Lembaga Tabung Haji could price *hajj* and *umrah* trips, etc. in gold dinars.⁹ The existence of a dinar economy would also facilitate *zakat* payments to be made in dinars. In fact, instituting *zakat* in the gold dinar model is highly desirable since this would act as a demurrage charge and thereby encourage the circulation of the gold dinar.¹⁰

It should be highlighted here that the gold dinar is not a Muslim monopoly system. Even though the gold dinar is associated with the Muslims, it was actually “borrowed” from the Roman Byzantine Empire. The word *dinar* is derived from the Latin word *denarius*. The Roman gold coin and the Persian silver coin (called *dirham*) were accepted by the Prophet Muhammad (peace be upon him) as the

⁸ Particularly those made by corporations.

⁹ *Hajj* institutions in Indonesia have resorted to pricing in gold dinars after the rupiah’s depreciation during the 1997 East Asian crisis. The people lost substantially and were unable to perform their *hajj* even after they had enough savings due the rupiah’s terrible depreciation.

¹⁰ In a dual system where national currencies and gold dinars coexist, the physical gold dinar might not circulate well. This is due to Gresham’s Law that says bad money drives out good money from circulation.

monetary units for Muslims.¹¹ The Holy Prophet (peace be upon him) brought changes to many economic, social and business institutions¹² but accepted the gold dinar as money. The gold dinar must, therefore, necessarily be something just and desirable. Hence, the acceptability of the gold dinar by non-Muslims should not be a problem at all. In fact, electronic gold payment systems are already functional in some parts of the world. Examples include e-gold, goldeconomy, goldmoney, e-dinar,¹³ etc. Even some retail outlets like supermarkets have begun to accept gold as money.¹⁴ This is certainly a good development. Just like the gold dinar in the international trade model, the gold dinar in domestic transactions can coexist with national currencies. Therefore, if the need arises, the gold dinar can be exchanged into national currencies based on the real-time gold price and vice versa. Since gold has an established international market, linking the gold dinar to other global gold payment systems like those mentioned above, should not be difficult. The e-dinar, e-gold, goldmoney, etc. can be easily linked for international transactions.

Silver as Money

We have discussed at length in favour of gold as money. However, historically for centuries it was gold and silver that together played the role of money. This is called bimetallism. In fact historically, man used silver as money long before he used gold for that purpose. Dirhams were the silver coins of the Islamic world. The existence of silver

¹¹ The words *dinar* and *dirham* are mentioned in the Holy Qur'an in the verses Al-'Imran (3):75 and Yusuf (12):20 respectively.

¹² And hence the birth of Islamic transaction law or *Fiqh Muamalat*.

¹³ The following are their respective weblinks: www.e-gold.com, www.goldEconomy.com, www.goldmoney.com, www.e-dinar.com

¹⁴ The current size is, nevertheless, small.

together with gold as money is desirable since both can provide a stable unit of account to price each other. Moreover, silver can be used for the smaller denominations of money. Accordingly, silver can reduce much of the burden on gold to play the role of money alone. In the history of Islam, the copper *fulus* was also used for even smaller denominations.

INTERMEDIARY STEPS TOWARD A DOMESTIC GOLD DINAR ECONOMY

Nationalization of Commercial Banks

In most countries, commercial banks are generally not totally government owned. In many cases they are privately owned.¹⁵ This means the minority owners of banks would benefit immensely from the interest that would be charged on money created by the banks. Currently, money created by the banking sector simply through the accounting process comprises huge proportions of national monies, in many cases greater than 70 per cent. In other words, less than 30 per cent of money supply is state money, i.e. paper notes and coins (See Appendix E). Therefore, as mentioned elsewhere earlier, most money is debt money that demands interest on it. Hence even an interest rate as low as 5 per cent means that the banking sector would “gobble” up a significant amount of national output and wealth basically from nothing! We have mentioned numerous times the many problems caused by fiat money, fractional reserve banking and interest rates. In plain language, this is basically robbing nations of their wealth and

¹⁵ As a matter of fact, even some central banks are privately owned.

sovereignty. Therefore, it is crucial to address this problem of private banking as it is today.

In the process of transition towards implementing the gold dinar in domestic transactions, it may be desirable to nationalize banks first. Unfortunately, the term ‘nationalization’ has negative connotations and thus strong opposition could be expected.¹⁶ Nonetheless, some important advantages of nationalizing banks are:

1. Money creation and the allotment of purchasing power rest with the government alone. The assumption here is that governments are likely to look after the welfare of the people better than private bankers who are likely to look after their private interests first.
2. Any additional money created by a nationalized bank is basically state money or public money. The new money may be introduced into the economy through the government’s fiscal expenditure. The seigniorage from the introduction of new money may be used for public benefits, e.g. building schools, universities, hospitals, roads and other infrastructures, better salary for the public servants, etc. Therefore, in the transition period, taxation and borrowing need not be the only means of public finance.

Hence with total money supply in the hands of the government, it would be easier to move towards a 100 per cent reserve requirement that is consistent with a real money system. A gold money system is incompatible with fractional reserve banking where the money supply can be more volatile than the quantity of gold reserves as changes in the reserve ratio take place. This would surely contribute to monetary instability.¹⁷

¹⁶ Particularly in the current era of globalization and neo-liberalization.

¹⁷ See Tarek el-Diwany, “History of Banking: An Analysis”, in the *Proceedings of the 2002 International Conference on Stable and Just Global Monetary System*, International Islamic University, p.15.

3. With the gold dinar as money, multiple deposit creation would not be possible and, therefore, money may no longer enter into the economy as debt (as is the case in the current fiat money system). As discussed in Part One, the introduction of money as debt has serious repercussions on the economy.
4. With nationalization of banks, the policy of a zero interest rate or even a negative interest rate can be easily administered. Negative interest rates or demurrage charges are important for a sustainable development.¹⁸ *Zakat* as a demurrage can also be instituted. These are additional revenues for the government. A zero or negative interest rate is also a prelude to the gold dinar economy.

Under previous gold standards, the existence of interest forced the aggregate loan stock (and money supply) to increase at a rate that could not be supported by growth in the gold stock.¹⁹

Nationalization of banks was also an option that was considered in solving the current Japanese banking crisis, which has been there for quite some time now.

Orderly Implementation within a Timeframe

An orderly implementation of the gold dinar, without creating any chaos, should cover a reasonable time span. A complete gold payment system (for international and domestic transactions) may take about 10 to 15 years for implementation. Below is a time-line we foresee.²⁰

¹⁸ See Bernard Lietaer, *The Future of Money*, Century, p.248.

¹⁹ Tarek el-Diwany, "History of Banking: An Analysis", in the *Proceedings of the 2002 International Conference on Stable and Just Global Monetary System*, International Islamic University, p.11.

²⁰ Of course, subject to political wills and so on.

0-5 years

- Continuous public and government education on the need for a new global monetary system and the feasibility of real monetary systems like the gold dinar, commodity monies, complementary currencies, etc. Establishing a gold dinar secretariat may help in achieving the above objectives — with fliers, pamphlets, web-pages, etc.
- Start the gold dinar in multilateral trade on a small scale among a small number of countries. Countries may trade with gold producing countries in order to increase their respective gold holding.
- Establish the nucleus for a parallel gold dinar economy, i.e. the implementation of the gold payment system in domestic transactions. Encourage gold savings (EPF, Tabung Haji, Amanah Saham Dinar Emas, etc.), mint physical gold dinars, identify businesses that would accept the gold dinar (Retail outlets for consumer goods, Tabung Haji, Zakat Collection Centres, etc.), create a small circle of gold dinar electronic payment system (e-dinar and gold dinar cards).

6-15 years

- Enlarge further the gold payment system by transferring gold savings into the system.
- Nationalize banks and government takes total control of money creation. Gradually convert all monetary aggregates into M0.
- Further accumulate gold stock and use it to back the M0.
- Expand further the gold dinar in multilateral trade by bringing in more countries.

Chapter 8

Conclusion

An invasion of armies can be resisted, but not an idea whose time has come.

— Victor Hugo, ‘Histoire d’un Crime’, 1852

THIS BOOK BASICALLY highlighted the instability and unjustness embedded in the present global fiat monetary system and suggested a solution or a way out for nations that desire one. It reasoned with the reader that there are huge stakes in the current monetary system — i.e. national wealth and sovereignty — as faced by all nations particularly the developing ones.

The book also highlighted the fact that the current fiat money is created out of nothing and is mostly introduced into the economy in the form of debt, providing a tremendous advantage to those who create it.¹ Moreover, interest charges on fiat money make the entire system not only unjust but unsustainable too. The easy creation of fiat money has brought about too much liquidity globally while interest charges force the additional creation of money that demands a constant growth in the

¹ If lending money, for a time period, with a fixed return is considered *riba* (usurious), then the creation of fiat money must constitute a greater *riba* since it is created at a point in time, out of nothing, but ‘enthroned’ with purchasing power.

real economy, just to maintain living standards. This is the reason why in almost all countries, including the developed nations, money and debt grow together. Growth in debt, in turn, has implications for financial management that makes the whole system unsustainable. All this has currently brought the global financial system to the verge of collapse that has serious repercussions for the real economy. Major world economies, i.e. the United States, Europe and Japan, are in financial and economic distress simultaneously, as never before.

The book also reasoned with the reader about how developing nations tend to lose substantially in the present global fiat money system, that some kind of “theft of nations” is taking place. At the international level, nations lose enormously when they use alien fiat currencies as international reserve currencies. They are also likely to become victims of currency rigging, manipulation, speculation, etc. Some have already been enslaved through the international debt system and are subjected to unfair agreements and regulations. In their zeal to protect their strategic position, the international financial institutions like the IMF, the World Bank and the like may attempt to establish themselves as the global central bank (GCB).² Just as the Bank for International Settlements (BIS) was created in the wake of the 1931-32 German debt crisis and the IMF and World Bank were created after World War II, it is not surprising that a GCB is being promoted in the current global financial chaos.³

Nonetheless, the book argues that countries need not feel hopeless. It suggests a promising solution, i.e. returning to the use of real monies, focusing on gold. Any real money for that matter — like other precious

² A GCB would effectively become the Supreme World Ruler.

³ Please see Robert L. Bartley, “World Money at the Palazzo Mundell — Does the global economy need a global currency?”, *Wall Street Journal*, June 30, 2003.

metals and complementary currencies like the LETS schemes, etc. — are likely to provide some solution. Nations may gradually implement a gold payment system, starting with international trade — i.e. for settling bilateral and multilateral trade arrangements. The book highlighted the benefits of multilateral payment arrangements where the amount of gold needed for settling trade balances can be minimized. Such arrangements not only bring about stability by eliminating foreign exchange risk and reducing the chances of currency rigging, speculation and so on, but also enable countries without international reserve currencies to trade globally. For the interested reader, Appendix F compares gold with currency forwards, futures and options as a tool for hedging foreign exchange risk.

Finally, some steps for the implementation of the gold payment system in domestic transactions are also discussed. The use of real monies for international and domestic transactions is likely to bring about numerous desirable effects on the economy particularly in the form of stability and protection from international financial “predators”. Real monies promise a stable, balanced, harmonious and just economic growth for nations to relish.

Our personal prediction for the future is that a global central bank (GCB) with a single world currency — a unification of the dollar, euro and yen — is likely to come true. The IMF, the World Bank, the Bank of International Settlement and similar institutions are probable candidates for the GCB. Since central banks of countries are “diplomatically” linked to these international financial institutions, the former are also likely to go along with the latter and succumb to the idea of a single world currency and a world central bank. If this

happens, the GCB would marginalize the local central banks and reduce their role to mere enforcers of the GCB's policies.⁴

The Islamic banking system as today, enjoys the seigniorage of creating money out of thin air, just like the conventional bank, but lends it out using Islamic principles.⁵ The Islamic Development Bank (IDB) on the contrary, works similar to the IMF. The IMF lends out to countries Special Drawing Rights (SDR)⁶ which are basically overdraft facilities (which are again money created out of nothing). The IMF brought forth the SDR as a substitute for gold. The former competes with the latter as a reserve asset. Nonetheless, the Islamic Development Bank's "SDR" is ironically called the "Islamic Dinar"! A monetary system based on gold would not allow such easy money creation. With such a background, can we expect the banks, i.e. the commercial banks, central banks, Islamic banks, the IMF and the IDB, to support the gold dinar concept? The chances are small, but we are hopeful, for the sake of future global financial and economic stability, justice and peace.

My greater hope lies, nevertheless, with the private sector. Private sector units of account based on gold are already functional on the internet — e-gold, goldmoney, e-dinar are some examples. While the size is still small, it will grow as people begin to understand the benefits. Other parties that could be expected to support the gold

⁴ So much for the argument that the fiat monetary system allows policy independence and flexibility.

⁵ In fact, the Islamic banking system in Malaysia has been known to lobby for the minimizing or even the abolition the statutory reserve requirement, which can effectively enable the bank to create an unlimited amount of money, irrespective and unrelated to the amount of deposits it has (only to be checked by other conditions like the capital adequacy ratio). While this may seem good for the Islamic banks, it is a likely disaster for the economy.

⁶ One SDR was initially equivalent to one US dollar, but now redefined as a basket of currencies consisting of the dollar, euro, yen and pound sterling.

payment system are the religious groups once they understand the wisdom behind it and patriotic politicians who do not wish to see their subjects enslaved by foreign forces.⁷ In this regard, the Prime Minister of Malaysia, Dr Mahathir Mohamad, should be commended for mooted the gold dinar concept and providing a political will for it. Also to be commended is the Royal Mint of Malaysia that minted and launched the first Malaysian gold dinar coin⁸ on July 28, 2003 — the significance of which only time will tell.

⁷ Through the pretext of globalization, for example.

⁸ A picture of which adorns the cover of this book.

Appendix A

The Equation of Exchange¹

THE EQUATION OF exchange is usually expressed as below:

$$M \times V = P \times Y$$

Where M is the money supply; V is the velocity or the number of times per year the average dollar is spent on goods and services; P is the aggregate or average price level; and Y is the real output of goods and services produced in the economy.²

The money supply M consists of currency in circulation plus demand deposits in banks. In monetary aggregates this is usually referred to as M1. We take this definition for money here since payments for most transactions are done with either of these two. The velocity is the number of times the average dollar is spent on goods and

¹ For the benefit of the reader, this section is reproduced from Ahamed Kameel Mydin Meera, *The Islamic Gold Dinar*, Pelanduk, 2002.

² MV is the monetarist counterpart of $C + I + G + X$ in the Keynesian framework, that we normally see in Macroeconomics textbooks. MV is the total amount spent on final goods and services in one year, thus is equal to nominal GDP. Nominal GDP, in turn, equals PY which is the price level times physical output of goods and services.

services within a year. Assume that Mr A used a RM50 note to buy a book, and then the bookseller used the note to buy a pair of shoes. The same RM50 note changed hands twice, being used to pay for two items in the economy within the year. Therefore, its velocity is two. The P is the aggregate price level, which is like the average price of all things in the economy. It is not measured by the consumer price index (CPI), which tracks the price of only a basket of selected goods. The Y is the real output of goods and services produced in the year — the actual quantity of tables, cars, etc.

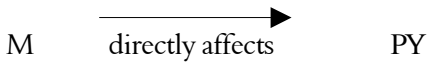
The above equation therefore simply equates the flow of money to the opposite flow of goods and services. M times V is the total amount of money in the economy while P times Y , i.e. price times quantity is the total dollar value of the output of goods and services in the economy. Therefore, the equation of exchange is actually an identity — something that is true by logic. The equation suggests, for example, that if we increase the quantity of money without a corresponding increase in goods and services, only price levels will go up, i.e. inflationary (assuming velocity is constant). An example would be during the Japanese occupation of Malaya, when the Japanese introduced an abundance of paper money sometimes called by the locals ‘banana leaf money’.³ This sudden increase in money supply only brought about inflation. This suggests that a nation cannot be made wealthy by simply printing money and putting it into the hands of its people.

The velocity of money supply is generally constant in the short run.⁴ It may change, for example, if there is a change in the mode of

³ The money had a picture of a banana tree featured on it.

⁴ This is a monetarist view. The Keynesians may argue that the V is not stable. If V is in fact stable, then a direct, predictable relationship must exist between the money

payments as when credit cards are introduced into the system for the first time. After a change, it would remain fairly constant until some other shocks come about. As suggested by the equation of exchange, if for any reason the velocity increases abruptly, the effect would be inflationary too. An example would be during the fall of the Soviet Union, people lost confidence in the Russian rouble and thus tried to get rid of it by spending it away. This increased the velocity significantly and hence brought about hyperinflation. If we take velocity as constant, this transforms the equation of exchange into the quantity theory of money that states that the nominal income ($P \times Y$) is solely determined by the quantity of money, i.e.



Therefore, a direct relationship between money supply and nominal GDP would be observed if velocity is constant.

supply and nominal GDP. In fact, this is the case for Malaysia. The correlation coefficient between Money Supply, M1 and nominal GDP is almost unity, suggesting a stable and predictable relationship.

Appendix B

Riba in the Holy Scriptures

Riba in the Qur'an

Al-Baqarah (2)

275. Those who devour usury will not stand except as stands one whom the Evil one by his touch hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: They will abide therein (for ever).
276. Allah will deprive usury of all blessing, but will give increase for deeds of charity: For He loveth not creatures ungrateful and wicked.
277. Those who believe, and do deeds of righteousness, and establish regular prayers and regular charity, will have their reward with their Lord: on them shall be no fear, nor shall they grieve.
278. O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers.
279. If ye do it not, take notice of war from Allah and His Messenger. But if ye repent, ye shall have your capital sums: Deal not unjustly, and ye shall not be dealt with unjustly.

Ali Imran (3)

128. Not for thee, (but for Allah), is the decision: Whether He turn in mercy to them, or punish them; for they are indeed wrong-doers.
129. To Allah belongeth all that is in the heavens and on earth. He forgiveth whom He pleaseth and punisheth whom He pleaseth; but Allah is Oft-Forgiving, Most Merciful.
130. O ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper.
131. Fear the Fire, which is prepared for those who reject Faith:
132. And obey Allah and the Messenger; that ye may obtain mercy.

An-Nisa (4)

158. Nay, Allah raised him up unto Himself; and Allah is Exalted in Power, Wise;
159. And there is none of the People of the Book but must believe in him before his death; and on the Day of Judgment he will be a witness against them;
160. For the iniquity of the Jews We made unlawful for them certain (foods) good and wholesome which had been lawful for them; — in that they hindered many from Allah's Way;
161. That they took usury, though they were forbidden; and that they devoured men's substance wrongfully; — we have prepared for those among them who reject faith a grievous punishment.

Ar-Rum (30)

39. That which ye lay out for increase through the property of (other) people, will have no increase with Allah: but that which ye lay out for charity, seeking the Countenance of Allah, (will increase): it is these who will get a recompense multiplied.
40. It is Allah Who has created you: further, He has provided for your sustenance; then He will cause you to die; and again He will give you life. Are there any of your (false) "Partners" who can do any single one of these things? Glory to Him! and high is He above the partners they attribute (to him)!
41. Mischief has appeared on land and sea because of (the meed) that the hands of men have earned, that (Allah) may give them a taste

of some of their deeds: in order that they may turn back (from evil).

Riba in the Bible

(Quoted from the New International Version)

Exodus 22:25

[God says] “If you lend money to one of my people among you who is needy, do not be like a moneylender; charge him no interest.

Leviticus 25:35-37

[God said] ³⁵“If one of your countrymen becomes poor and is unable to support himself among you, help him as you would an alien or a temporary resident, so he can continue to live among you. ³⁶Do not take interest of any kind from him, but fear your God, so that your countryman may continue to live among you. ³⁷You must not lend him money at interest or sell him food at a profit.

Psalms 15

¹LORD, who may dwell in your sanctuary?
Who may live on your holy hill?
²He whose walk is blameless
and who does what is righteous,
who speaks the truth from his heart
³and has no slander on his tongue,
who does his neighbour no wrong
and casts no slur on his fellowman,
⁴who despises a vile man
but honours those who fear the LORD,
who keeps his oath
even when it hurts,
⁵who lends his money without usury
and does not accept a bribe against the innocent.
He who does these things
will never be shaken.

Ezekiel 18:5-9

[God says] ⁵“Suppose there is a righteous man who does what is just and right. ⁶He does not eat at the mountain shrines or look to the idols of the house of Israel. He does not defile his neighbour’s wife or lie with a woman during her period. ⁷He does not oppress anyone, but returns what he took in pledge for a loan. He does not commit robbery but gives his food to the hungry and provides clothing for the naked. ⁸He does not lend at usury or take excessive interest. He withholds his hand from doing wrong and judges fairly between man and man. ⁹He follows my decrees and faithfully keeps my laws. That man is righteous; he will surely live, declares the Sovereign LORD.”

Luke 6:32-36

³²“If you love those who love you, what credit is that to you? Even ‘sinners’ love those who love them. ³³And if you do good to those who are good to you, what credit is that to you? Even ‘sinners’ do that. ³⁴And if you lend to those from whom you expect repayment, what credit is that to you? Even ‘sinners’ lend to ‘sinners,’ expecting to be repaid in full. ³⁵But love your enemies, do good to them, and lend to them without expecting to get anything back. Then your reward will be great, and you will be sons of the Most High, because he is kind to the ungrateful and wicked. ³⁶Be merciful, just as your Father is merciful.

Riba in the Torah

(Quoted from the New International Version)

Exodus 22:25

[God says] “If you lend money to one of my people among you who is needy, do not be like a moneylender; charge him no interest.

Appendix C

The Money Creation Process Illustrated¹

LET US ASSUME that the central bank places a statutory reserve requirement (SRR) ratio of 10 per cent; and that the SRR is the only policy variable used for affecting the money creation process.² The reserve requirement is the proportion of deposits which the banking sector must keep as reserves to fulfil withdrawal needs. An original deposit of RM1,000 will enable the banking sector to increase deposits to a maximum amount of RM10,000 (i.e. RM1,000 divided by the reserve requirement of 0.10) through loan creation (i.e. money creation). Let us illustrate how this is done. Say that Mr X found RM1000, which he decided to deposit into a bank account. For simplicity, let us assume there is only one bank in the economy (alternatively you may think of all banks being consolidated or merged into a single entity). A T-account balance sheet entry of the bank would appear as below:

¹ This section is also reproduced from Ahamed Kameel Mydin Meera, *The Islamic Gold Dinar*, Pelanduk, 2002.

² Other variables include the capital adequacy ratio, which we ignore here for simplicity.

Balance Sheet			
Cash Reserve	1,000	Deposit	1,000

The cash account (reserve) is debited while Mr X's deposit account is credited with RM1,000. The cash reserve now is 100 per cent of the deposit. However, since the bank is required to keep only 10 per cent as reserves, the bank creates additional deposits until the reserve is 10 per cent of total deposits. How can additional deposits be created? By means of giving loans! The balance sheet position after money creation (assuming maximum money creation)³ would be as follows:

Balance Sheet			
Reserve	1,000	Deposits	1,000
Loans	9,000	Deposits (loans)	9,000

Notice that for the original RM1,000 deposit, an additional RM9,000 deposit is created by means of loans.⁴ After money creation, the original RM1,000 deposit is now equivalent to 10 per cent of the current total deposits of RM10,000, i.e. the required reserve ratio. This increase in money through multiple deposit creation is a one-time

³ Although real world multipliers may never create the maximum amount, in principle the fractional reserve system allows 'money to be created'.

⁴ Notice how banks create money out of thin air. Money is created when banks extend loans. Hence money in most part is only accounting entries in the books or computer records in the form of binary bit memory space.

increase in the ‘money base’. The formula for multiple deposit creation may be written as follows:

$$D = \frac{1}{r} \times R$$

Where D = change in total checkable deposits

r = required reserve ratio (e.g. 0.10 as in our example)

R = change in reserves (e.g. the new deposit of RM1,000 as in our example)

Interest Rates and the Growth in Money Supply

In addition to the above, the interest rates given and charged by banks also increase money supply in the long run.⁵ In the conventional economic thinking, interest rate is said to be the price of money capital, following the normal demand-supply theory. However, we should notice that interest rates themselves, *ceteris paribus*, would increase the money supply. This fact is very important. Therefore, we expound on this matter further.

Continuing with the earlier example, let us assume that interest rates are as follows — 5 per cent for the deposit rate and 10 per cent for the lending rate. We shall also assume that borrowed money does not earn interest. Now, in the next period the RM1,000 deposit money would earn RM50 interest and thus becomes RM1,050. The depositor would now be able to buy things in the economy for RM1,050. On the other hand, the loan balances would become RM9,900 (RM9,000 + 0.10 x RM9,000). The extra RM900 is simply the interest income to the

⁵ See Tarek El-Diwany, *The Problem With Interest*, TA-HA Publishers, United Kingdom, 1997.

bank. After paying depositors the interest of RM50, the bank makes a spread of RM850, which is 85 per cent of the original deposit. It is with this spread, the bank would pay the salaries of its employees, utility bills, etc., the remainder of which would comprise the bank's retained earnings. The current balance sheet position is as shown below:

Balance Sheet			
Cash	1,000	Deposit	10,050
Loans	9,900	Profit	850

Notice that the current reserve of 1,000 is now inadequate for a total deposit of RM10,050. This suggests that, in the long run, the central bank would be forced to continually increase fiat money and/or the banks would continuously extend loans so that the reserve requirement can be met and thereby sustain the system.⁶ The implication of this is that the existence of interest rates would themselves, *ceteris paribus*, force a continuous increase in both state money (fiat money) and bank money (loans).

Hence with the simple existence of interest rates alone, under normal circumstances, money supply in an economy will grow by default. However, it is possible for this money supply to shrink back if a depositor withdraws cash from the banking system (and keeps it from re-entering the financial system), or when a loan is repaid, or when a borrower defaults on loan repayment (which at serious levels may cause banking crises, as was the case with non-performing loans or NPLs during the 1997 Malaysian financial crisis).

⁶ In most countries the domestic debt levels have continuously grown.

In summary, a fiat money interest based financial system continuously creates money in the economic system, and by the reverse process, the money so created can also be destroyed in the event deposits are withdrawn, loans repaid or borrowers default on loan repayments.

Credit Cards and Growth in Money Supply

The credit card system also increases the money supply. This is because every credit card transaction is a credit transaction. The implication of this is easy to see using a T-account. Assuming Mr A purchases something from Mr B for RM1,000 using his credit card. The Bank that issued the credit card will record the transaction as follows: Mr A’s account is debited as a loan to reflect a credit transaction while Mr B’s account is credited. This simple accounting entry is, however, interpreted as follows: The Bank had paid Mr B on behalf of Mr A. Therefore, Mr A owes the Bank RM1,000!

Mr A	
Loan	1,000
Mr B	
	Deposit 1,000

Now since Mr B’s account is considered as a deposit, the Bank could also create money as discussed earlier through the fractional reserve requirement system. The bank can create multiple deposits by means of loans from this accounting “deposit”. If the reserve ratio is 10

per cent, then additional RM9,000 deposits can be created through loans.

Apart from this, the bank also has an additional way to create money. Let us assume that Mr A fails to pay the Bank when he receives his statement. Then the Bank will impose two charges on Mr A: (i) interest on the \$1,000 for not settling it! and (ii) a late payment fee! Note that Mr A has to pay these charges even though the bank did not pay anything to Mr B in the first place. It's all in accounting!

While it is possible to reduce (or control) money supply in the short run, for example, by increasing the reserve requirement ratio or through open market operations (i.e. the selling of government bonds or by increasing bank discount rates), we postulate that the net long-run effect will still be an increase in money supply. This is simply due to the existence of interest rates in the economy (note that government bonds too pay interest even though the money obtained through the sale of such bonds may be simply kept in the vaults).

Therefore, in an interest-based fiat monetary system, money supply simply grows in the long run, even though in the short run it may be altered through monetary policies.

Appendix D

Currency Speculation and Arbitrage¹

CURRENCY SPECULATORS AND arbitrageurs made huge profits during the 1997 East Asian Crisis. They took advantage of the flaws inherent in the global fiat monetary system. These speculators, that include international financial institutions and fund managers, are very knowledgeable about financial markets, economic cycles, etc. They use this knowledge to “attack” currencies, etc. to reap huge profits. The huge economic bubble that hovered over the East Asian countries, created by the fiat money credit bubble,² lured these speculators to attack the currencies of these countries by shorting them. Their action popped the bubble that brought about the 1997 East Asian crisis.

Collective action of speculators would amount to an attack on the currency. While the central bank may counter such attacks to keep exchange rates within reasonable levels, a continuous attack can be difficult for the central bank to match. While speculators can take on huge leveraged positions, the central bank would need large amounts of foreign reserves to counter this. Inability to match the speculators

¹ This section is also reproduced for the benefit of the reader from Ahamed Kameel Mydin Meera, *The Islamic Gold Dinar*, Pelanduk, 2002.

² But erroneously termed the ‘Asian Miracle’.

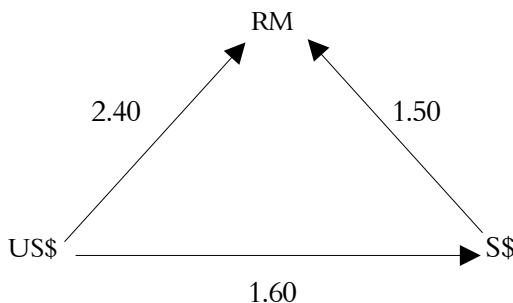
would cause the exchange rate to plunge as happened to the Asian currencies. The ringgit depreciated from an exchange rate of about RM2.47 to the dollar before the crisis to a rate of RM4.80 at some point in time during the crisis.

While one may argue that it is ethically not right for speculators to attack a currency, it is the current global monetary system that allowed them to do so.

When an exchange rate moves due to speculative attacks or otherwise, it breaks the equilibrium among currencies. This makes it possible for further profiteering called arbitrage profits. Arbitrage is like finding money on the ground. An example of currency speculation and arbitrage is given below.

Currency Speculation and Arbitrage: An Example

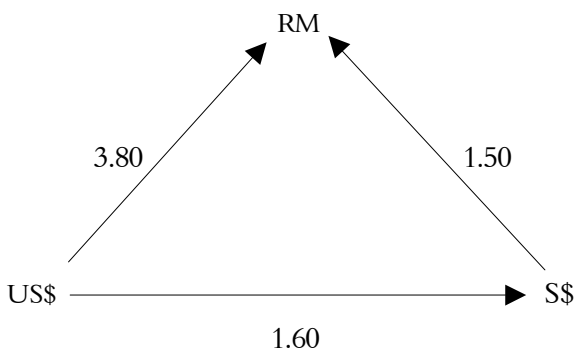
Consider the ringgit when it was attacked in August 1997. The shorting of the currency by speculators pushed the ringgit downward. Let us assume an initial exchange rate between three currencies, say, the ringgit, dollar and Singapore dollar as below:



The ringgit exchange rate is RM2.40 and RM1.50 to one dollar and Singapore dollar respectively. The Singapore dollar rate is S\$1.60 to the dollar.

Such exchange rates are in equilibrium since no one can make profit by just trading between the three currencies. If one were to start with a dollar, exchange it into Singapore dollar, then change the Singapore dollar into ringgit and then back into US dollar, one would end up with a dollar again.³

Now assume that the shorting of the ringgit by the speculators pushes the exchange rate to RM3.80 per US dollar as shown below:



By attacking the currency as such, the traders make two types of profits: (i) speculative and (ii) arbitrage profits.

Speculative Profit: Speculative profit comes from the speculating that a currency would appreciate or depreciate (either due to economic factors or the speculative attacks themselves or even both). If the speculation is

³ In this example we have ignored transaction costs. In practice, the buying and the selling rates for currencies would differ; the difference being the profit to the bank or money changer. Ignoring transaction costs, however, does not affect the illustration of this example.

correct, then the traders would make profits, however, if their speculation turns out to be wrong, they would then make losses. In our example, profit is made as follows. First, the trader sells short RM2.4 million ringgit at the initial exchange rate of 2.40 per dollar. This equals US\$1 million and would be credited to his account. Assume now that the attack caused the ringgit to depreciate to RM3.80 per dollar. Now at this new exchange rate the RM2.4 million is worth only US\$0.63 million.⁴ Therefore, the trader closes his position by buying back the RM2.4 million at this new rate and makes a handsome profit of US\$0.37 million (i.e. US\$370,000!). Even though the trader makes a hefty speculative profit of about US\$370,000, the profit does not end there. There is another profit to be made — the arbitrage profit.

Arbitrage Profit: Arbitrage profit is made from the mispricing or disequilibrium among the exchange rates. In our example, this disequilibrium happened when the ringgit exchange rate moved. Arbitrage profits are realized at a point in time unlike speculative profits that require a span of time. In the above example the arbitrage profit is made as below:

- Step 1: Borrow US\$1 million⁵ and exchange it into RM3.8 million (at the new prevailing exchange rate of RM3.80 per US dollar).
- Step 2: Exchange the RM3.8 million into S\$2.533 million (at the exchange rate of RM1.50 per Singapore dollar)
- Step 3: Exchange the S\$2.533 million into US\$1.5833 million (at the exchange rate of S\$1.60 per US dollar)

⁴ In practice the speculators and arbitrageurs would not wait till the exchange rate moves this much in order to profit. Profits are realized when the exchange rate moves enough to cover transaction costs.

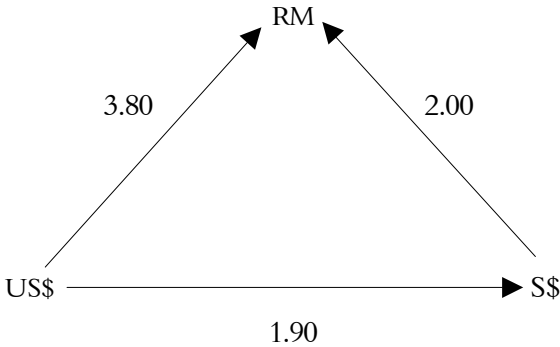
⁵ Since arbitrage is done at a point in time, one may borrow this US\$1 million probably for just a few minutes within which the entire transaction could be completed, particularly if transactions are done on-line using computers.

Step 4: Return back the loan of US\$1 million, and keep the remaining US\$583,333 as arbitrage profit.⁶

Hence the total speculative and arbitrage profits equal $370,000 + 583,333 = \text{US}\$953,333$. Note that for a transaction of US\$1 million each in the speculative and arbitrage activities, the profit is almost a whopping US\$1 million too! Currency traders, however, do not just trade in millions but rather in billions! Hence imagine the amount of profits they would be making!!

As arbitrageurs make profit through their actions, the exchange rates between currencies would move until the arbitrage opportunity is eliminated. In our example since a profit is made by first exchanging US\$ into ringgit, there would be a tendency for the ringgit to appreciate over the US dollar (or to “fight back” the attack). Similarly, the action of exchanging ringgit into Singapore dollar would make the Singapore dollar appreciate over the ringgit. The last transaction of changing the Singapore dollar back into the US dollar would cause the US dollar to appreciate over the Singapore dollar. Therefore, even though the speculators attacked only the ringgit, the Singapore dollar would appreciate over the ringgit and the US dollar would appreciate over the Singapore dollar until the arbitrage opportunity is eliminated. A final exchange rate as below would have eliminated such an arbitrage opportunity and would now form the new equilibrium exchange rate between the three currencies:

⁶ Note that, in the example, the arbitrage transactions must be done clockwise starting from any of the currencies. This example starts from US\$. If we had started using RM1million, the profit would have been RM583,333 instead. Transactions done anti-clockwise would result in losses. Therefore, upfront one needs to determine the direction for making arbitrage profits — clockwise or anti-clockwise.



An arbitrage profit, as shown above, can be made with any three currencies and need not be using only the ringgit, the US dollar and the Singapore dollar. Therefore, movements of all cross-currency rates could be expected. Nonetheless, only three currencies are needed for making an arbitrage profit. It takes only three currencies to break equilibrium and make arbitrage possible. For this reason such an arbitrage is also called a triangular arbitrage.⁷

Speculative and arbitrage profits using national currencies are made possible by the mere existence of numerous fiat currencies that are volatile in nature. The global fiat monetary system provides a fertile ground for speculation, manipulation and arbitrage in the foreign exchange market.⁸

⁷ If profit is made using four or more currencies, then all transactions except three are either redundant or they reduce the profit made. Mathematically, if all the cross exchange rates were placed in a matrix, equilibrium would imply the determinant of the matrix to equal zero. If the determinant does not equal zero, then it implies arbitrage opportunity exists somewhere between the currencies.

⁸ Back in the 1970s, the daily global volume of foreign exchange transactions was around \$10-\$20 billion. By 2000, the average transaction was around \$2 trillion! See Bernard Lietaer, *The Future of Money*, Century, 2001, p.312.

**Country Monetary Aggregate Proportions and Growth Rates
for the Period 1986-1996**

Country	State Money (M0) as a Proportion of Broad Money (M2) in 1996	Average Annual Growth Rate 1986-1996		
		Real GDP	Narrow Money (M1)	Broad Money (M2)
1 Argentina	0.23	2.49	179.09	181.80
2 Bahrain	0.14	6.15	4.72	5.65
3 Bangladesh	0.23	4.23	10.98	13.92
4 Belize	0.20	8.34	8.73	11.39
5 Bolivia	0.24	3.86	23.54	35.58
6 Botswana	0.14	7.82	14.60	18.06
7 Brazil	0.23	2.57	591.80	677.76
8 Burkina Faso	0.52	2.66	10.35	10.12
9 Burundi	0.43	-0.47	8.53	11.81
10 Cameroon	0.31	-2.36	-3.57	-3.53
11 Chile	0.88	7.89	25.06	24.68
12 China, P.R.: Mainland	0.35	9.99	23.03	28.19
13 Costa Rica	0.47	3.98	15.37	24.22
14 Ecuador	0.21	2.62	40.81	53.45
15 Egypt	0.30	4.20	10.79	17.13
16 El Salvador	0.36	4.11	13.90	19.31
17 Ethiopia	0.42	3.90	10.98	13.59
18 Fiji	0.17	2.78	10.24	9.98
19 Ghana	0.50	4.64	36.25	38.56
20 Guatemala	0.27	3.88	18.55	20.11
21 Honduras	0.32	3.63	21.24	22.07
22 India	0.31	5.94	16.20	16.74
23 Indonesia	0.13	10.76	16.08	25.97
24 Iran, I.R. of	0.44	3.65	23.61	25.48
25 Jamaica	0.35	2.66	31.68	30.50
26 Jordan	0.46	2.36	5.50	8.61
27 Kenya	0.33	3.30	16.25	21.70
28 Kuwait	0.06	2.95	1.94	3.67
29 Lesotho	0.25	28.04	15.13	14.17
30 Madagascar	0.57	1.22	22.30	23.55

Country	State Money (M0) as a Proportion of Broad Money (M2) in 1996	Average Annual Growth Rate 1986-1996		
		Real GDP	Narrow Money (M1)	Broad Money (M2)
31 Malawi	0.56	2.94	28.65	28.04
32 Malaysia	0.30	8.50	17.71	15.74
33 Maldives	0.63	8.45	18.82	20.26
34 Malta	0.26	5.83	4.24	10.50
35 Mauritius	0.20	5.84	14.99	18.67
36 Mexico	0.15	2.50	42.94	41.90
37 Mozambique	0.37	4.29	42.99	49.40
38 Myanmar	0.66	2.52	26.24	26.56
39 Nepal	0.36	4.52	17.73	19.75
40 Niger	0.51	1.60	0.89	0.32
41 Nigeria	0.52	4.23	33.87	31.64
42 Oman	0.20	4.43	4.87	6.46
43 Pakistan	0.33	5.26	13.78	15.92
44 Paraguay	0.38	3.69	26.88	32.71
45 Peru	0.40	1.15	240.04	271.95
46 Philippines	0.22	3.68	18.37	21.93
47 Poland	0.25	1.10	68.76	74.15
48 Rwanda	0.49	-2.39	10.19	9.96
49 Saudi Arabia	0.21	2.92	4.43	4.90
50 Sierra Leone	0.51	-2.90	39.91	43.75
51 South Africa	0.09	1.56	20.33	15.15
52 Sri Lanka	0.34	4.31	14.02	16.99
53 Syrian Arab Republic	0.56	5.62	14.84	16.74
54 Thailand	0.12	9.43	15.26	18.69
55 Trinidad and Tobago	0.22	0.27	5.84	6.82
56 Tunisia	0.26	4.34	6.88	10.30
57 Turkey	0.18	4.38	67.55	80.88
58 Uganda	0.50	7.04	54.20	57.42
59 Uruguay	0.31	3.59	59.82	62.51
60 Venezuela, Rep. Bol.	0.42	2.60	40.81	39.85
61 Zambia	0.25	1.25	61.09	67.28
62 Zimbabwe	0.28	3.13	28.54	25.54
Average	0.34	4.25	36.92	41.40

Source: Computed using data from IMF Financial Statistics Yearbook 2000. The growth rates are geometric means for the decade 1986-1996, avoiding the 1997 East Asian economic crisis period.

Hedging Foreign Exchange Risk with Forwards, Futures, Options and the Gold Dinar: A Comparison Note

THE 1997 EAST ASIAN economic crisis made apparent how vulnerable currencies can be. The speculative attacks on the ringgit for example, almost devastated the economy if not for the quick and bold counter actions taken by the Malaysian government, particularly in checking the offshore ringgit transactions. It also made apparent the need for firms to manage foreign exchange risk. Many individuals, firms and businesses found themselves helpless in the wake of drastic exchange rate movements. Malaysia being among the most open countries in the world, in terms of international trade, was exposed to significant foreign exchange risk.¹ Foreign exchange risk refers to the uncertainties faced due to fluctuating exchange rates. For example, a Malaysian trader who exports palm oil to India for future payments to be received in rupees, faces the risk of rupees depreciating against the ringgit at the time the payment is made. This is because if the rupee depreciates, a smaller amount of ringgit will be received when the rupees are

¹ *The Economist* magazine's *Pocket World in Figures* (2002 edition) ranks Malaysia the second most trade dependent country in the world. Trade as a percentage of GDP is 92 per cent for Malaysia, even higher than that of Singapore which ranks third with a percentage of 78.8 per cent. See p.32.

exchanged into ringgit. Therefore, what originally seemed a profitable venture could turn out to be a loss due to exchange rate fluctuations. Such risks are common in international trade and finance. A significant number of international investments, trades and dealings are shelved due to the unwillingness of parties concerned to bear foreign exchange risk. Hence it is important for businesses to manage this foreign exchange risk so that they may concentrate on what they are good at and eliminate or minimize a risk that is not their trade. Unfortunately, however, in the case of most developing nations including Malaysia, tools available for managing foreign exchange risk are minimal. Traditionally, the forward rates, currency futures and options have been used for this purpose. The futures and options markets are also known as derivative markets. However, in many nations, including Malaysia, futures and options on currencies are not available. The Malaysian Derivatives Exchange (MDEX), for example, makes available a number of derivative instruments — Kuala Lumpur Composite Index Futures, Index Options, Crude Palm Oil Futures and KLIBOR (interest rate) Futures — but not ringgit futures or options. Even in countries where currency derivative markets exist, however, for example the Philadelphia Stock Exchange in the United States, not all derivatives on all currencies are traded. Derivatives are available only on select major world currencies. While the existence of these markets assists in risk management, speculation and arbitrage also thrive in them. This section compares and contrasts the use of derivatives — forwards, futures and options — and the gold dinar for hedging foreign exchange risk. It also argues why a gold dinar system is likely to introduce efficiency into the market while reducing the cost of hedging against foreign exchange risk, compared with the derivatives.

Hedging with Forwards

Hedging refers to managing risk to an extent that it is bearable. In international trade and dealings foreign exchange plays an important role. Fluctuations in foreign exchange rates can have significant implications on business decisions and outcomes. Many international trade and business dealings are shelved or become unworthy due to significant exchange rate risk embedded in them. Historically, the foremost instrument used for managing exchange rate risk is the forward rate. Forward rates are custom agreements between two parties to fix the exchange rate for a future transaction. This simple arrangement easily eliminates exchange rate risk, however, it has some shortcomings, particularly the difficulty in getting a counter party who would agree to fix the future rate for the amount and at the time period in question. In Malaysia many businesses are not even aware that some banks do provide forward rate arrangements as a service to their customers. By entering into a forward rate agreement with a bank, the businessman simply transfers the risk to the bank, which will now have to bear this risk. Of course, the bank, in turn, may have to make some other arrangement to manage this risk. Forward contracts are somewhat less familiar, probably because no formal trading facility, building or even regulating body exists.

An Example of Hedging Using Forward Agreement

Assume that a Malaysian construction company, ABC Corporation just won a bid to build a stretch of road in India. Now is July and the contract signed for 10,000,000 rupees, would be paid for in September. This amount is consistent with ABC's minimum revenue of RM1,000,000 at the exchange rate of RM0.10 per rupee. Nonetheless, fluctuating exchange rates could end with a possible depreciation of

rupees and thus render the project unworthy. ABC, therefore, enters into a forward contract with the First Bank of India to fix the exchange rate at RM0.10 per rupee. The forward contract is a legal agreement and, therefore, constitutes obligations on both sides. The First Bank may have to find a counter party for this transaction — either a party that wants to hedge against an appreciation of 10,000,000 rupees expiring at the same time or a party that wishes to speculate on an upward trend in rupees. If the bank itself plays the counter party, then the risk would be borne by the bank. The existence of speculators increases the probability of finding a counter party. By entering into a forward contract ABC is guaranteed of an exchange rate of RM0.10 per rupee in the future, irrespective of what happens to the spot rupee exchange rate. If the rupee were to actually depreciate, ABC would then be protected. However, if it were to appreciate, then ABC would have to forego this favourable movement and hence bear some implied losses. Even though a favourable movement could be lost, ABC still proceeds with the hedging since it knows that a “guaranteed” exchange rate of RM0.10 per rupee is consistent with a profitable venture.

Hedging with Futures

The futures market came into existence as an answer for the shortcomings inherent in the forward market. The futures market solves some of the shortcomings of the forward market, particularly the need and the difficulty in finding a counter party. A currency futures contract is an agreement between two parties to buy or sell a particular currency at a future date, at a particular exchange rate that is fixed or agreed upon upfront. This sounds a lot like the forward contract. In fact, the futures contract is similar to the forward contract but is much more liquid. It is liquid because it is traded in an organized exchange —

i.e. the futures market. Futures contracts are standardized contracts and thus are bought and sold just like shares in a stock market. The futures contract is also a legal contract just like the forward, however, the obligation can be ‘removed’ prior to the expiry of the contract by making an opposite transaction, i.e. if one had purchased a futures contract then one may exit by selling the same contract. When hedging with futures, if the risk is an appreciation in value, then one needs to buy futures, whereas if the risk is a depreciation then one needs to sell futures. Consider our earlier example, instead of using forwards, ABC could have thus sold rupee futures to hedge against a rupee depreciation. Let’s assume accordingly that ABC sold rupee futures at the rate RM0.10 per rupee. Hence the size of the contract is RM1,000,000. Now assume that the rupee depreciates to RM0.07 per rupee — the very thing ABC was afraid of (See Table 4). ABC would then close the futures contract by buying back the contract at this new rate. Note that in essence ABC bought the contract for RM0.07 and sold it for RM0.10. This gives a futures profit of RM300,000 $[(RM0.10 - RM0.07) \times 10,000,000]$. However, in the spot market ABC gets only RM700,000 when it exchanges the 10,000,000 rupees at RM0.07. The total cash flow, however, is maintained at RM1,000,000 (RM700,000 from spot and RM300,000 profit from futures). With perfect hedging the cash flow would always be RM1 million no matter what happens to the exchange rate in the spot market. One advantage of using futures for hedging is that ABC can release itself from the futures obligation by buying back the contract anytime before the expiry of the contract. To enter into a futures contract a trader, however, needs to pay a deposit (called an initial margin) first. Then his position will be tracked on a daily basis so much so that whenever his account makes a loss for the

day, the trader will receive a margin call (also known as variation margin), requiring him to pay up the losses.

Table 4: Outcome of Hedging using Currency Futures

Cash Market	Futures Market
July	July
ABC Corp. expects to have 10,000,000 rupees in September.	ABC sells 5 September rupee futures contracts at RM0.10 (Assuming each rupee futures contract size is 2,000,000 rupees)
Currently, the rupee exchange rate is RM0.10 per rupee.	Total underlying value of the futures: $5 \times 2 \text{ mil.} \times 0.10 = \text{RM}1,000,000$
September	September
Exchanges the 10,000,000 rupees in the spot market for RM0.07.	ABC buys 5 September rupee futures contracts at RM0.07
Value in ringgit: $10,000,000 @ \text{RM}0.07 = \text{RM}700,000$	Total underlying value of the futures: $5 \times 2 \text{ mil.} \times 0.07 = \text{RM}700,000$
Plus futures profit: $\text{RM}700,000 + \text{RM}300,000 = \text{RM}1,000,000$	Futures profit: $1,000,000 - 700,000 = \text{RM}300,000$

Standardized Features of the Futures Contract and Liquidity

Unlike the forward contract, the futures contract has a number of features that have been standardized. These standard features increase the liquidity in the market, i.e. increase the number of transactions that match in terms of size and expiration. In the practical world, traders are faced with diverse conditions that need diverse actions (like the need to hedge different amounts of currency at different points of time in the future) such that matching transactions can be difficult. By standardizing the contract sizes (i.e. the amount) and the expiry dates, these different needs can be matched to some degree, even though not perfectly perhaps. Some of the standardized features include the expiry

date, contract month, contract size, position limits (i.e. the number of contracts a party can buy or sell) and price limit (i.e. the maximum daily price movements allowed). Nevertheless, these standardized features introduce some hedging imperfections. In our earlier example, assuming the size of each rupee futures contract to be 2,000,000, then 5 contracts need to be sold for a contract size of 10,000,000 rupees.

However, if the size of each contract is 3,000,000 for instance, then only 3 contracts can be sold, leaving 1,000,000 rupees unhedged. Therefore, with standardization, some part of the spot position can go unhedged.

Some advantages and disadvantages of hedging using futures are summarized below:

Advantages of the futures contract

- **Liquid and central market.** Since futures contracts are traded on a central market, this increases liquidity. There are many market participants and hence one may easily buy or sell futures contracts. The problem of double coincidence of wants that could exist in the forward market is greatly reduced. A trader who has taken a position in the futures market can easily make an opposite transaction and thereby close his or her position. However, such easy exit is not a feature of the forward market.
- **Leverage.** Leverage is brought about by the futures market's margin system, where a trader takes on a larger position with only a small initial deposit. If the futures contract with a value of RM1,000,000 requires an initial margin of only RM100,000, then a one per cent change in the futures price (i.e. RM10,000) would bring about a 10 per cent change relative to the trader's initial outlay. This amplification of profits (or losses) is called leverage. Leverage allows the trader to hedge much bigger amounts with smaller outlays.
- **Positions can be easily closed out.** As mentioned earlier, positions taken in the futures market can be easily closed out by

making opposite transactions. If a trader had sold 5 rupee futures contracts expiring in December, then the trader could close that position by buying 5 December rupee futures. In hedging, such closing-out of positions is done close to the expected physical spot transactions. Profits or losses from futures would offset the opposite losses or profits from the spot transaction. Nevertheless, such offsetting may not be perfect due to the imperfections brought about by the standardized features of the futures contract.

- **Convergence.** As the futures contract approaches expiration, its price and the spot price would tend to converge. On the day of expiration both prices should be equal. Convergence is brought about by the activities of arbitrageurs who would move in to profit if price disparities were to exist between the futures and the spot, i.e. buying in the cheaper market and selling in the higher priced one.

Disadvantages of the futures contract

- **Legal obligation.** The futures contract, just like the forward contract, is a legal obligation. Being a legal obligation it can sometimes pose problems. For example, if futures are used for hedging a project that is still in the bidding process, the futures position can turn into a speculative position in the event the bidding turns out unsuccessful.
- **Standardized features.** Since the futures contract has some of its features standardized like the contract size, expiry date, etc., perfect hedging may be impossible. Since over-hedging is also not advisable, some part of the spot transactions will, therefore, have to go unhedged.
- **Initial and daily variation margins.** This is a unique feature of the futures contract. A trader who wishes to take a position in the futures market must first pay an initial margin or deposit. This deposit will be returned when the trader closes his or her position. Also, the futures contract is marked to market, i.e. its position is tracked on a daily basis and the trader would be required to pay up variation margins in the event of daily losses. The initial and daily variation margins can pose a significant cash flow burden on traders or hedgers.

- **Forego favourable movements.** In hedging using futures, any losses or profits in the spot transaction would be offset by profits or losses from the futures transaction. Consider our earlier example where ABC sold rupee futures to protect against a rupee depreciation. However, if the rupee were to appreciate, then ABC would have to forego such favourable movements.

The above shortcomings of the futures contract, particularly it being a legal obligation, with margin requirements and the need to forego favourable movements, prompted the development and establishment of the options markets that deal in more flexible instruments, i.e. the options contracts.

Hedging using Options

A currency option may be defined as a contract between two parties — a buyer and a seller — whereby the buyer of the option has the right but not the obligation, to buy or sell a specified currency at a specified exchange rate, at or before a specified date, from the seller of the option. While the buyer of an option enjoys a right but not an obligation, the seller of the option, nevertheless, has an obligation in the event the buyer exercises the given right. There are two types of options:

- **Call option** — gives the buyer the right to buy a specified currency at a specified exchange rate, at or before a specified date.
- **Put option** — gives the buyer the right to sell a specified currency at a specified exchange rate, at or before a specified date.

The seller of the option, of course, needs to be compensated for giving the right. The compensation is called the price or the premium of the option. The seller thus has an obligation in the event the right is exercised by the buyer.

For example, assume that a trader buys a September RM0.10 rupee call option for RM0.01. This means that the trader has the right to buy rupees for RM0.10 per rupee at anytime until the contract expires in September. The trader pays a premium of RM0.01 for this right. The RM0.10 is called the strike price or the exercise price. If the rupee appreciates over RM0.10 anytime before expiry, the trader may exercise his right and buy it for only RM0.10 per rupee. If, however, the rupee were to depreciate below RM0.10, the trader may just let the contract expire without taking any action since he is not obligated to buy it at RM0.10. In this case, if he needs physical rupee, he may just buy it in the spot market at the new lower rate.

In hedging using options, calls are used if the risk is an upward trend in price, while puts are used if the risk is a downward trend. In our ABC example, since the risk is a depreciation of rupees, ABC would need to buy put options on rupees. If rupees were to depreciate at the time ABC receives its rupee revenue, then ABC would exercise its right and thereby effectively obtain a higher exchange rate. If, however, rupees were to appreciate instead, ABC would then just let the contract expire and exchange its rupees in the spot market at the higher exchange rate. Therefore, the options market allows traders to enjoy unlimited favourable movements while limiting losses. This feature is unique to options, unlike the forward or futures contracts where the trader has to forego favourable movements and there are also no limits to losses.

Options are particularly suited as a hedging tool for contingent cash flows, as is the case in bidding processes. When a firm bids for a project overseas, which involves foreign exchange risk, the options market allows it to quote its bid price and at the same time protect itself from the exchange rate fluctuations in the event the bid is won.

In the case of hedging with forwards or futures, the firm would be automatically placed in a speculative position in the event of an unsuccessful bid, without any limit to its downside losses.

An Example of Hedging with Put Options

Consider our ABC Corp. example. Instead of already having won the contract in question, let's, however, assume that it is in the process of bidding for it — as is the common case in real life. ABC wants a minimum acceptable revenue of RM1,000,000 after hedging costs, but ABC need to quote a bid price now. In this instance, ABC would face the exchange rate risk only upon winning the bid. Options fare better as a hedging tool here compared with forwards or futures due to the uncertainty in getting the contract. Assume that it is now July and the results of the bidding will be known only in September, and that the following September options quotes are available today:

RM0.10 call @ RM0.002

RM0.10 put @ RM0.001

Assume that the size of each rupee contract is 2,000,000 rupees.

The following is how ABC could make its hedging strategy:

1. First, it needs to decide whether to buy puts or calls. Since ABC would receive rupees in the future if it won the contract, its risk is a depreciation of rupees. Therefore, it should buy puts.
2. What should the bid amount be? To answer this question we need to compute the effective exchange rate after incorporating the price of put, i.e. RM0.10 minus RM0.001 which equals RM0.099. Now the bid amount is computed as $\text{RM1,000,000} / \text{RM0.099}$, which equals 10,101,010 rupees.

3. How many put contracts should it buy? To answer this, just take the bid amount and divide by the contract size, i.e.
 $10,101,010 / 2,000,000$ equals 5.05. Since fractions of contracts are not allowed and we don't over-hedge, 5 contracts are sufficient, with some portion going unhedged. However, if we want to guarantee a minimum revenue of RM1,000,000, we cannot tolerate any imperfections in the hedging. Therefore, in this example we should go for 6 contracts.
4. What is the cost of hedging? The cost of hedging is computed as follows: 6 contracts x 2,000,000 per contract x RM0.001 equals RM12,000. This cost of hedging is the maximum loss possible with options.

In September, ABC would have known the outcome of the bid and by then the spot rupee rate might have appreciated or depreciated. Let's look at two scenarios where the rupee appreciates to RM0.20 in one and depreciates to RM0.05 per rupee in the other. Table 5 shows the four outcomes possible and their cash flow implications.

Table 5: Possible Cash Flow Outcomes for Hedging using Options

	Rupee Depreciates to RM0.05 per rupee	Rupee Appreciates to RM0.20 per rupee
Bid Won	<p>Exchange the 10,101,010 rupees @RM0.05 = RM505,050.50</p> <p>Plus profit from options: $6 \times 2,000,000 \times (RM0.10 - RM0.05) = RM600,000$</p> <p>Less cost of hedging = RM12,000</p> <p>Net Cash flow = RM1,093,050 (which is more than the minimum required revenue of RM1,000,000)</p>	<p>Exchange the 10,101,010 rupees @RM0.20 = RM2,020,202</p> <p>Put options not worth exercising, therefore, just let them expire.</p> <p>Less cost of hedging = RM12,000</p> <p>Net Cash flow = RM2,008,202 (In this case the option allows ABC to enjoy the favourable movement)</p>
Bid Lost	<p>In this case, the bid amount is not in consideration. However, ABC could still exercise its rights and realize a profit from the puts.</p> <p>Profit from options: $6 \times 2,000,000 \times RM0.05 = RM600,000$</p> <p>Less cost of hedging = RM12,000</p> <p>Net Cash flow = RM578,000</p>	<p>This is the worst case scenario that can happen. The bid is lost and also the put option ends up being not profitable. ABC loses the premium paid = RM12,000. This is the maximum loss possible.</p>

The above example illustrates how options can be used to guarantee a minimum cash flow on contingent claims. In the case the bid is won, a minimum cash flow of RM1,000,000 is guaranteed while allowing one to still enjoy a favourable movement if that does take place. If the bid is lost, the maximum loss possible is the premium paid.

An example for hedging with the call option is when a firm bids to buy a property (e.g. land) in another country. Say, a company bids to buy a piece of land in Indonesia to plant oil palm trees. Assume that the bidding is in Indonesian rupiahs. Here the risk would be an appreciation of the rupiah. Therefore, buying call options on the rupiah would be the suitable hedging strategy.

If one analyzes it carefully, the options market is simply an organized insurance market. One pays a premium to protect oneself from potential losses while allowing one to enjoy potential benefits. An analogy, for example, is when one buys car insurance, by paying the premium. If the car gets into an accident one gets compensated by the insurance company for the losses incurred. However, if no accident happens, one loses the premium paid. If no accident happens but the value of the car appreciates in the secondhand market, then one gets to enjoy the upward trend in price. An options market plays a similar role. In the case of options, however, the seller of an option plays the role akin to an insurance company.

Advantages and Disadvantages of Hedging using Options

The advantages of options over forwards and futures are basically the limited downside risk and the flexibility and variety of strategies made possible. Also in options there is neither the initial margin nor the daily variation margin since the position is not marked to market. This relieves traders from potential cash flow problems.

Options are, however, more expensive because they are much more flexible compared to forwards or futures. The option price is, therefore, probably its disadvantage.

The Gold Dinar

Some readers by now would have realized that the examples of rupee and rupiah futures and options are hypothetical. There are no such derivatives traded on any organized exchange. But that is precisely the point we intend to highlight. Currently, derivatives are mostly traded only in select major world currencies like the yen, pound sterling, Australian dollar, etc. against the US dollar. For most other currencies of the world including almost all of the developing nations there are no formal tools to hedge against foreign exchange risk. Malaysia, Thailand, Indonesia, the Philippines, India, etc. are no exception to this.

The use of the gold dinar to settle their bilateral and multilateral trade is expected to introduce some stability into the foreign exchange problem. In this mode, gold is used as a medium of exchange instead of the national currencies. The prices of exports and imports are quoted in weights of gold. If countries use the gold payment system, then the problem of foreign exchange risk can be significantly minimized or eliminated.

Hedging using the Gold Dinar

In the gold dinar mode, the central bank would play the important role of keeping national trade accounts and providing a safe place to keep the gold. The gold accounting is kept through the medium of the central banks and only the net difference between the countries is settled periodically, say, in a gold custodian's account. However, since international trade is an ongoing continuous process, any gold that

needs to be settled can always be brought forward and used for future transactions and settlements.

As an example, consider that Malaysia exports 10 million gold dinar worth of goods and services to Indonesia while importing 8 million worth of goods and services. Hence Malaysia has a surplus trade of 2 million gold dinar. Indonesia needs to settle only this difference of 2 million. However, this amount could be used for settling future trade imbalances between the countries and hence a physical gold movement between the countries is not necessary. This simple structure completely eliminates exchange rate risk if all pricings are done in gold dinar.² Even though the international gold price may fluctuate, the participants realize that they are dealing in something that has intrinsic value, that can be used for stable and continuous trade into the future. Therefore, even though with the existence of other national currencies, speculation and arbitrage on gold price could tempt a participating country to redeem or sell its gold, it should resist such temptation for the sake of the stability of future trade.

This simple gold payment system has numerous advantages:

1. Foreign exchange risk would be totally eliminated if a comprehensive gold dinar model is implemented. This means there is no need for forwards, futures or options on the currencies of the participating countries.
2. Reduced currency speculation and arbitrage between the currencies. For example, if three countries agree to use the gold payment system, then it is akin to the three currencies becoming a single currency. Speculation and arbitrage among these three currencies will be very much reduced. This unification of the three currencies through the gold dinar

² With the coexistence of national currencies though, some price risk may still exist. Nevertheless, gold has its own intrinsic value and thereby has held its value stable historically.

- provides benefits of diversification. It is like obtaining diversification through a portfolio of stocks. Individual currencies face risks that are unique to the issuing country, but in a unified currency such unique risks would be diversified away. In fact, since gold is treasured by all people, it is a suitable global currency that enjoys global diversification, i.e. no single country's unique risk may be significantly embedded in gold.
3. Low transaction costs since only accounting records need to be kept. Transactions can be executed by means of the electronic medium with minimal charges.
 4. Greatly reduces the possibility of future speculative attacks on national currencies.

The cost and benefits of using forwards, futures, options and the gold dinar for hedging foreign exchange risk are compared and summarized in Table 6.

In the final analysis, the gold dinar is akin to the forward contract, but with its problems of "barter", speculation and arbitrage removed; and is a superior tool for foreign exchange risk management compared to the futures and options contracts.

Table 6: Forwards, Futures, Options and Gold Dinar as Tools for Managing Foreign Exchange Risk: A Comparison

	Forwards	Futures	Options	Gold Dinar
Costs				
Initial Margin/Deposit	No	Yes	No	No
Variation Margin	No	Yes	No	No
Need for Speculators to assume the risks that hedgers seek to avoid	No, but speculators could be present.	Yes	Yes	No
Forego favourable movements	Yes	Yes	No	Yes
Speculation	Yes	Yes	Yes	No. Both parties have real spot transactions
Arbitrage	Yes	Yes	Yes	No, but can be possible with the co-existence of national currencies and lack of regulations.
“Barter” problems	Yes	No	No	No
Transaction Cost/Brokerage fee	Yes	Yes	Yes	Yes
Benefits				
Diversification benefits	No	No	No	Yes
Liquid market	No	Yes	Yes	No
Can hedge any currency	Yes. Counter party may be difficult to find	No	No	Yes
Legal obligation	Yes	Yes	No	Yes

Appendix G

Some Basic Facts about Gold

THE CHEMICAL SYMBOL of gold is AU from Aurum, the Latin word for gold. Chemically gold is an element, which means it cannot be broken down further. Interestingly, in the Periodic Table of Elements (below) gold occupies the same group, i.e. Group 11, as copper (Cu) and silver (Ag) that also played the role of money in the history of mankind.

Periodic Table of Elements																		
Periods	Groups																	
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
	IA	IIA	IIIA	IVA	VA	VIA	VIIA	VIII			IB	IIB	IIIB	IVB	VB	VIB	VIIIB	VIII
IA	IIA	IIIB	IVB	VB	VIB	VIIIB	VIII			IB	IIB	IIIA	IVA	VA	VIA	VIIA	VIIIA	
1	1 H																	2 He
2	3 Li	4 Be											5 B	6 C	7 N	8 O	9 F	10 Ne
3	11 Na	12 Mg											13 Al	14 Si	15 P	16 S	17 Cl	18 Ar
4	19 K	20 Ca	21 Sc	22 Ti	23 V	24 Cr	25 Mn	26 Fe	27 Co	28 Ni	29 Cu	30 Zn	31 Ga	32 Ge	33 As	34 Se	35 Br	36 Kr
5	37 Rb	38 Sr	39 Y	40 Zr	41 Nb	42 Mo	43 Tc	44 Ru	45 Rh	46 Pd	47 Ag	48 Cd	49 In	50 Sn	51 Sb	52 Te	53 I	54 Xe
6	55 Cs	56 Ba	57 La	1 72 Hf	73 Ta	74 W	75 Re	76 Os	77 Ir	78 Pt	79 Au	80 Hg	81 Tl	82 Pb	83 Bi	84 Po	85 At	86 Rn
7	87 Fr	88 Ra	89 Ac	2 104 Rf	105 Db	106 Sg	107 Bh	108 Hs	109 Mt	110 Uun	111 Uuu	112 Uub	114 Uuq		116 Uuh		118 Uuo	
6				1 58 Ce	59 Pr	60 Nd	61 Pm	62 Sm	63 Eu	64 Gd	65 Tb	66 Dy	67 Ho	68 Er	69 Tm	70 Yb	71 Lu	
7				2 90 Th	91 Pa	92 U	93 Np	94 Pu	95 Am	96 Cm	97 Bk	98 Cf	99 Es	100 Fm	101 Md	102 No	103 Lr	

- Pure gold is yellow in colour. Nevertheless, the colour changes depending on the added alloy metals, as illustrated below:

Colour	Gold and Alloy metals
Yellow Gold	Gold, Copper, Silver
White Gold	Gold, Nickel, Zinc, Silver, Platinum
Green Gold	Gold, Silver, Copper, Zinc
Red Gold	Gold, Copper

- Karat grade is used to express the purity of gold. It basically refers to the proportion of gold in an alloy. Pure gold (100 per cent) is 24 karat. The proportions in other karat are as in the table below.

Karat	Parts Gold to Alloy	Percentage	Fineness
10K	10/24	41.66%	416
14K	14/24	58.33%	583
18K	18/24	75.00%	750
22K	22/24	91.66%	916
24K	24/24	100.00%	1000

Example: 22K means that 22 out of 24 portions are gold. This equals 91.66 per cent of gold, hence it is also known as 916 gold. Similarly 18K contains 75 per cent gold.

- As an element, gold cannot be further broken down by chemical means. Hence it is indestructible and permanent.
- Gold is also such an inactive metal that it is not affected by air and water, i.e. does not oxidize (tarnish, rust or corrode). Gold artefacts unearthed in the Egyptian pyramids still look new and bright.
- Gold is highly malleable (i.e. the ability to be pound into thin sheets) such that a single ounce of gold can be hammered into a 100 square-foot sheet.

- Gold can be hammered so thin that sunlight can shine through it. A pile an inch high can contain more than 200,000 sheets!
- Gold reflects infrared rays while allowing sunlight to pass through, hence its use in astronaut helmets and window glass.
- Gold is most ductile (ability to draw out into wire) that a single ounce of it can be drawn out into a 50-mile long wire!
- Gold is so rare that only about 90,000 tons of it have been taken from the earth in recorded history.
- South Africa is the largest gold producing country in the world. Other leading producers include Russia, Canada, and the United States.
- Gold is so heavy that one cubic foot of it weighs half a ton.
- All the gold in the world could be compressed into an 18-yard cube.
- Gold has been used by man for more than 6000 years.
- In 1933, President Franklin D. Roosevelt banned the private ownership of gold, which was then lifted on December 31, 1974.
- Gold reached an all-time high price of \$800 per ounce in 1980.
- Gold is said to be a cure for rheumatoid arthritis. It is chemically liquefied and injected into the muscles of arthritic patients. It is said that the treatment is successful in seven out of ten cases.

Reference: www.goldgold.com/goldfacts.htm

Appendix H

**Speech by The Prime Minister Of Malaysia
The Hon Dato' Seri Dr Mahathir Bin Mohamad
at the Gold Dinar in Multilateral Trade Seminar
IKIM Hall, Kuala Lumpur
On October 23, 2002**

I would like to thank the organisers for inviting me to speak at this seminar on the Gold Dinar in Multilateral Trade. I hope I can help to make clear the idea and the concept of the Gold Dinar.

For some time now the Muslims and their countries have become synonymous with backwardness, authoritarian and frequently unstable governments and lately with terrorists and terrorism. Yet Islamic states were not like that before, nor were Muslims involved in acts of terror. In fact Muslim countries were where the persecuted of Europe, in particular the Jews, sought refuge. The pogroms and the inquisition in Europe forced the Jews to migrate to the Muslim countries in North Africa. Yet before that when Muslims ruled Spain, the Jews, the Christians and the Muslims were able to live together in peace.

If today there is so much animosity between Jews and Muslims, it is not because of religious differences. The fact is that the Europeans who in the past never liked the Jews and massacred them every now and then, wanted to get rid of the Jews. Together with the Zionists they took Arab land in Palestine and gave it to the Jews for the setting up of the state of Israel. In the process the Palestinian Arabs were expelled from their homes and their land and ever since these people have been living in makeshift refugee camps in Lebanon and Jordan.

When the Arabs attacked Israel in a conventional war, they were not only defeated but more of their land was seized by Israel. The Israelis were able to win because they were strongly supported by Europe and then America. Every time the Arabs fought to get back their land, they actually lost more land.

The conflict is therefore about land, not about religion as it is made out to be. If the Palestinians indulge in acts of terror today, if other Muslims indulge in acts of terror, it is because conventional war has become impossible for them. We do not condone acts of terror by anyone. Suicide bombing against civilians must be considered as acts of terror. So are the killings of Palestinian children and civilians by the Israeli armed forces — all are acts of terror. And the Israeli army is no less a terrorist organisation now as is Hamas, as was the previous Jewish Irgun Zvai Leumi, the Stern Gang and others, all are terrorist organisations.

The events of September 11, 2001, have however focused the world's eyes on Muslim terrorists and this has led to a very distorted view of Islam and the Muslims. This view has affected Muslims in all areas. They are being discriminated against everywhere.

This unfortunate repercussion of September 11 has resulted in the whole world's economy being unable to grow. And now, as a direct consequence we are being threatened by a war against Iraq, a Muslim country and a major oil producer. Without doubt this will make the economies of the world even less able to grow, especially those of Muslim states.

The West and in particular the Americans are very angry. So are the Muslims. Angry people cannot act rationally. But if we want to solve the problem, we have to strive to be rational, to remain calm and not let emotions control us.

At the moment most Muslims are only bent on revenge. They are hitting back because of anger. They do not seem to care whether they achieve ultimate success or not. Every time they hit, the other side would hit back. And every time the other side hits back they would retaliate in kind.

The question is how long will we go on like this. The Palestinians have been fighting for the past 50 years. Their position has not improved. In fact, it has become worse. In fact, the position of the Muslims

worldwide has become worse. And if what is happening now is any indication, it would continue to be so for decades. The Muslims of this world, all 1.3 billion of them, will continue to be oppressed and humiliated.

There are, of course, some of us who believe that it is the fate of the Muslims to be oppressed in this world because in the akhirat we would be in heaven. If this is the fate of the Muslims, why did the Prophet strive to save the Muslims from the oppression of the Khuraish? Why did he and his followers migrate to Madinah; why did he unite the Ansars and the Muhajirin and gather them into a strong force in order to repel the enemy? Indeed, Al-Quran enjoins the Muslims to equip themselves for their defence, to educate themselves, to achieve success in life even as they must seek merit for the hereafter, so they may impress the Jahilliah and spread the teachings of Islam. In a matter of 100 years the Muslims had created a powerful Muslim world extending from Spain in the West to China in the East.

Did the Prophet preach to his followers that they should suffer in silence because for them there will be heaven in the next world? In fact, he prepared them to defend Islam with their wealth and their lives, to defeat the enemy. He did not advocate just seeking revenge upon the enemy in anger through attacks and killings.

It is clear that we Muslims are openly and blatantly ignoring the clear teachings of our religion in favour of quarrelling over contentious issues and interpretations while ignoring the oppression by the enemies of Islam, while failing to prepare for the defence and safety of the ummah and Islam.

One of the clearest teachings of Islam is that all Muslims are brothers and that no one should question the religion of anyone as long as he takes the oath that “there is no God but Allah and Muhammad is His Prophet.” The split amongst the Muslims into hundreds of different sects is due to the denial of the Islam of rival groups in order to justify the fight against them.

All who submit to “Allah and His Prophet” must be considered as Muslims and must be brothers of each other. Race and nations and borders should not stand in the way of Muslim unity nor should ideologies and political parties. There is only one Islam that was brought by the Prophet. The breakup of the Muslims into sects and groups all occurred after the death of the Prophet. It follows that the differences in the interpretations of Islam, differences which lead to the many splits and the formation of splinter groups, which are opposed to each other, is due to different interpretations of the teachings of Islam. But we all subscribe to the basics and it is a basic creed of Islam that all Muslims are brothers. If we can forget our differences in the interpretations of Islam, if we go back to the basics which we all accept then it is possible for us to unite. Certainly now, when the Muslim ummah everywhere is threatened and oppressed, when our holy places are being desecrated, when we are so weak and poor, particularly poor in knowledge and skills in this age of technology, certainly now we must forget our differences and unite.

However, our unity should not be for the purpose of futile attacks on the enemy. We should unite in order to build up our capacity and our strength. Simply by being united and strong, we would be freed from oppression. It will take time but Allah has enjoined upon us to be patient.

“Innallah hamaassabirin”. The Prophet was patient; He did not seek revenge for the humiliation and oppression he was subjected to. He retreated to a safer place in order to build up his strength. And he created sufficient wealth among his followers to support his struggle to return to Makkah.

We have to do the same. The Muhajirin and the Ansars among us must unite, must build up our capacities in terms of wealth and technology, in terms of stable Islamic communities, in terms of following all the undisputed injunctions of Islam.

Pure materialism is abhorred by Islam but there is no injunction against the legitimate acquisition of wealth. Tithes must be paid on our

wealth but we are also enjoined to be charitable. We know that the third Caliph, Saidina Othman, was wealthy. During the campaigns by the Prophet he donated camels and other supplies for the defence of the Muslims.

If the Muslims are going to protect themselves, they must have sufficient wealth. Allah has endowed Muslim countries with inexhaustible wealth. These need to be administered for the good of the ummah.

But wealth can also be acquired through commercial activities, through the production and distribution of goods and services and through trade.

Today trade between Muslim countries is small. It is not suggested that we reduce our trade with the non-Muslims. But we should endeavour to increase the trade between Muslim countries.

We can trade through the exchange of goods, through barter. But today we use money. Since we don't have a currency which is strong enough and stable enough in exchange rate terms, we have to use the American dollar. But the dollar is also not stable. Today the dollar has depreciated against many other currencies. This means that despite the increase in the price of oil for example, we are actually earning less due to the devaluation of the dollar. It is the same with the other currencies. It is the same with our own currencies. They all fluctuate in value. And they are all subject to speculation and manipulation as happened in Malaysia and other East Asian countries, in Russia and in Latin America.

The reason for this is that paper currency has no intrinsic value. You can print any figure you like on currency notes but in exchange rate terms the figure means nothing. The Malaysian ringgit is 3.8 to one U.S. Dollar. The Turkish Lira is 1.5 million to one U.S. Dollar. The Indonesian rupiah is 9,000 to one U.S. Dollar. The purchasing power within the country is different from the purchasing power outside the country. Sometimes countries have as many as four exchange rates —

one official, one for the domestic economy, one for export and one for import.

Clearly this situation in terms of international finance is chaotic and anarchic. But since the system benefits the powerful countries they are unwilling to correct it.

If we want to avoid being short-changed, we must have a currency that has intrinsic value. Gold does fluctuate in price but the fluctuation is minimal. It is not possible to devalue gold by one hundred per cent or one thousand per cent. Nor is it possible to revalue gold by the same percentage. The fluctuation in the value of gold can only be by a few percentages, up or down.

When the Allied nations met in Bretton Woods to determine the principle for the rate of exchange of international currencies in order to facilitate trade, they decided to use gold as a standard. The value of the U.S. Dollar was fixed at one dollar for 1/35 ounce of gold or 35 U.S. Dollars per ounce. All other currencies were valued in gold through the rates of exchange with the U.S. Dollar.

This worked quite well until some countries wanted to devalue their currencies in order to become competitive in the international market. Then other countries also decided to devalue in order to remain competitive. Finally, the U.S. Dollar was devalued against Gold.

At this stage the gold standard could not be sustained. The market claimed that it could determine the exchange rate through the demand and supply of currencies freely traded in the market. But profiteers moved in and they manipulated the value of the currencies so that there was chaos in terms of the exchange rates of currencies. Business became very difficult. Indeed, many good businesses went bankrupt when the domestic currency got devalued. The hedge Funds which claim to insure the value of the currencies made huge sums of money speculating and manipulating the values of the currencies.

This anarchy in the international financial regime will remain because it benefits the rich and the powerful. If we want to protect ourselves, we must evolve our own payment system, our own trading currency.

The Gold dinar can provide the currency for trade between nations. If we value all trade items against gold, then we will have no problem with the exchange rate. We know that in the last resort we can melt the gold and sell it in the market. You obviously cannot do that with paper currency, worst still with figures on a computer. They have no intrinsic market value as gold has.

But gold is bulky. We cannot be carrying gold all over the world in order to pay for goods we want to import. But we need not do that.

It is not intended to use the gold dinar as currency for everyday transactions in the domestic market. For this we can use national currencies. If there is inflation then the currency can buy less gold and other goods. And vice versa. So there is no necessity to carry bags of gold coins for transactions within the countries.

But even for international trade the transport of gold bullions or gold coins would be very minimal. Through bilateral payments arrangements the imports can be balanced by the exports and the differences settled in gold dinars. The Central Bank can provide a guarantee for the gold required for the payments of the balance. In the following weeks or months the deficits may be reduced or a surplus achieved. In that case the payments of the balance can be made through accounting arrangements between the Central Banks. It is only occasionally that a necessity might arise for the actual gold dinar to be used to pay for the purchase of imports.

We cannot really verify the amount of money a country has. A country's own currency cannot be regarded as its reserve. But gold dinars or gold bullion or gold ingots can serve as a country's reserve. Still in the end we have to trust each other. If we are good Muslims, then the cases of fraud by Central Banks would be minimal.

Assuming that Malaysia exports to a Dinar Area country a hundred million Dinars worth of motor vehicles and then imports 110 million dinars worth of oil, then the payment required by Malaysia would be just 10 million dinars. The ten million dinars is credited to Malaysia's trading partner. If in the following month the trading partner buys 110 million dinars worth of Malaysian cars and Malaysia buys 100 million dinars worth of oil, then no payment needs to be made by either party. The 10 million dinars that has to be paid by Malaysia's trading partner for the motor vehicle can be offset by the credit of 10 million dinars from the previous month's transactions.

Today with computers we can close account and pay more frequently. Through this method it is not necessary to purchase or earn hard currency.

Of course, there may be some countries which are so poor that they cannot have gold dinars. We can buy some raw materials to be paid in gold dinars. They can be helped to build up the reserves of gold dinars.

There will be problems. But if we begin with just a pair of countries we would be able to minimise problems and demonstrate whether it works or not. We will be able to identify the weaknesses and the faults and correct them.

Gold is a precious metal. There has never been a time when there was no demand for gold. It is also not so plentiful that its price will fall the way paper currency or even other precious metals can fall. Yet it is not so limited in quantity that anyone or any trader can corner it and manipulate the price.

In different countries the price of gold will differ in terms of the currency of that country. That is a function of the currency of the country. The value of one gold dinar is one gold dinar no matter what the exchange rate of a currency is against the gold dinar. If the value of goods or services is expressed in gold dinar, the value remains the same no matter which country is involved in the trade.

Thus an exporter can declare the agreed price in dinar to the importer in another country and to the Central Bank in his country. Depending on the agreement reached the Central Bank will pay the exporter the current local currency equivalent to the gold dinar price. At the importer's end, he would pay to his country's Central Bank the local currency equivalent of the agreed price in dinar. At the end of the week or month the Central Banks will total up the value in dinar of the exports and imports between the two trading countries. If they are not balanced then the country with a surplus will have a credit account against the country with a deficit. The difference can be paid in dinar or in goods or the country with the surplus can hold the dinar for future purchase from the country in deficit.

In multilateral trade, the process may be a little more complicated but it is entirely, manageable. A clearing house can be set up for a group of trading countries and the deficits and surpluses balanced. The process is not unlike the clearing of the cheques of numerous banks at a central clearing house.

Provided there are goods or services to be supplied by all participating countries, the amount of gold dinars that needs to be kept as reserve backing and for payment in the last resort is very small. Ideally, there would be no need to transport and pay in dinars. The imports and exports in most instances would cancel themselves. The profits come from disposing of the goods or services domestically when the local currency would be used.

There will be problems of course. But there are problems now. Countries with no "hard currency", i.e. U.S. dollars cannot pay for their imports anyway. In addition, the U.S. currency is not as stable as gold. Not only can it appreciate or depreciate widely, but a country's currency can be made to depreciate so much against the U.S. Dollar that its imports cannot be paid for, priced as they are in U.S. Dollar. The gold dinar cannot depreciate much against the U.S. Dollar.

Gold price can also be manipulated but not as easily as the U.S. Dollar or other currencies. No one can sell gold at below market price

because he just will not be able to deliver when called upon to do so. Short-selling will be very difficult if not impossible.

However, local currency prices of gold can still fluctuate if left to the market. It is up to the country concerned whether to control exchange rates or not. But speculation and manipulation will not be as easy as when the local currency is valued against the U.S. Dollar.

It must again be stressed that the Gold Dinar is exclusively for international trade. It is not to be used as local currency. In a sense it is like the U.S. Dollar now. Some countries, of course, use the U.S. Dollar locally for paying hotel bills by foreigners. But the dinar is heavy and cumbersome to carry. So it cannot be used as freely as the U.S. Dollar locally. This again lends credibility to the dinar and the local currency, which has to be used for local payment.

We should not be too ambitious as to launch the Gold Dinar for multi-lateral trade in one go. We should begin by pairing off the countries willing to use the Gold Dinar. A pair of good trading countries with a fairly well balanced trade should initiate the use of the Gold Dinar. Problems that arise can be resolved and the system improved. After the bugs have been got rid of then the trade using the dinar can be expanded gradually to involve more countries.

Traders in particular will be happy because their prices in Gold Dinar would not be affected by changes in the exchange rates of the importing countries or the exporting countries. In dinar, the prices will always remain the same.

It is not the intention to make the dinar a common currency for all countries. It is not really the Gold Standard with a fixed value against local currency. If countries print more local currency, there would still be inflation within the country. But trade would be stable and enhanced. Speculators and manipulators will not be able to undermine international trade.

Of course, the Gold Dinar can be a trading currency, for all countries, not necessarily Muslim countries. But Muslim countries are in the best position to demonstrate the viability of the system. They are in a position to manage their economies rationally and in the process show the world that they are capable of growing with stability and in peace. And this will do more towards countering oppression by their enemies than the futile violent retaliation.

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