

## Part II

# **Seigniorage of Fiat Money and the *Maqāsid al-Sharī'ah*: The Compatibility of the Gold Dinar with the *Maqāsid***

*by*

*Ahamed Kameel Mydin Meera & Moussa Larbani*

Department of Business Administration  
Faculty of Economics and Management Sciences  
International Islamic University Malaysia  
Jalan Gombak  
53100 KUALA LUMPUR  
Selangor, Malaysia

akameel@iiu.edu.my  
moussa @iiu.edu.my

## Part II

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#### Abstract

Part I of the paper argued that fiat money is counterproductive to the attainment of the *maqāsid al-Sharī'ah*. In the present interest-based fiat monetary system one of the *maqāsid*, namely, the protection of wealth (*māl*) cannot be realized, which in turn causes the other *maqāsid* to be affected too. In this Part II paper we argue for commodity monies, like the gold *dinār* and silver *dirham*, as being compatible with the *maqāsid*. Basically the paper concludes that the Islamic economic system is fundamentally a 'barter' system, i.e. an exchange economy where goods and services are exchanged value for value; but avoids the problems associated with barter by taking some of the commodities exchanged in the economy, that have the characteristics of money, as money; and gold is here argued as the best *Sharī'ah* money.

#### 1. Introduction

The Part I paper<sup>1</sup> highlighted the many problems faced in present day economies particularly by developing nations due to the very definition or the nature of money itself — i.e. fiat money that has no intrinsic value of its own, but nonetheless deemed 'legal tender'. Since fiat money of today comprises of primarily accounting entries<sup>2</sup>, it is created easily and in certain circumstances is also destroyed easily<sup>3</sup>. This unreal or virtual feature of fiat money has numerous implications for the economy particularly in the context of stability and justice. This system, nevertheless, benefits the minority in whose hands the control of the financial institutions rests, i.e. those who have the power to create fiat money and distribute the purchasing power thereon created (by means of loans

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<sup>1</sup> Meera and Larbani (2004), 'Seigniorage of Fiat Money and the *Maqāsid al-Sharī'ah*: The Unattainableness of the *Maqāsid*'.

<sup>2</sup> Demand deposits created through fractional reserve banking.

<sup>3</sup> When borrowers pay back loans or default on loans, for example.

or otherwise). Part I paper argued that the system, therefore, gradually accumulates wealth and sovereignty into the hands of this minority. Interest charges also pose structural problems in the sense that they necessitate more and more fiat money to be created simply to sustain the system, apart from causing wealth to accumulate and circulate among the rich in the society. Some of the socio-economic problems caused or worsened by the interest-based fiat money system were also mentioned in the Part I paper. We concluded that under interest-based fiat money system, the *maqāsid al-Sharī'ah* indeed cannot be realized. The paper traced the source of the problem to the seigniorage of fiat money, which was argued to be a profound *riba*, embedded both in the creation of fiat money and the interest charges thereupon demanded.

If fiat money, which Muslims have taken for granted all along, is not *Sharī'ah* compatible, then the question arises: What then is money in *Sharī'ah*? What are the characteristics of money in Islam – that can assist in the realization of the *maqāsid*? Before we delve into the question *what may constitute money in Sharī'ah*, let us glance over the normal functions of money.

## **2. Production, Trade and Money: The Catalysts for Economic Growth and Well-being**

Production and trade, no doubt had improved the economic wellbeing of mankind. With trade one is able to enjoy more goods and services, through specialization, which otherwise may not be able for one to produce oneself. However, a barter economy poses a number of problems; double coincidence of wants is one of them<sup>4</sup>. Introducing money into the system, nevertheless, not only solves the problems inherent in barter trade, but also promotes specialization, encourages trade and improves the overall well-being of people. Money is, on the other hand, generally anything that is accepted as payment for goods and services or debt. Normally, people only refer to currency (paper notes and coins) as money but, technically, it is anything that is accepted as a medium for payment.

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<sup>4</sup> That is, the need for one party to find a counter party who would be willing to accept what one has to offer and in return has what one wants, in agreed proportions.

In ancient times, people had 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 better for a considerable span of time in human history. After Bretton Woods ended in 1971, paper money and electronic money have become the dominant forms of money globally.

The primary function of money in the economy is, of course, as a *medium of exchange*, i.e. used for paying for goods and services. This simple function is, nevertheless, responsible for promoting specialization and accelerating trade among people; and thereby, elevating the standards of living for the people. The function of money as a medium of exchange, therefore, brings about a high degree of economic efficiency. In a barter economy efficiency is much suppressed and, therefore, the standards of living would be necessarily low.

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

For an item to function effectively as money, the following five characteristics are normally mentioned as should be present:

1. Standardizable such that its value can be ascertained easily.
2. Accepted widely. This function requires money to be something that has its own worth or intrinsic value. The rarer the item the better (so that a small quantity can fetch high value). Since fiat money has no intrinsic value of its own, it is made ‘acceptable’ by means of law, and hence the term ‘legal tender’.
3. Divisible, so that it can be used for the exchange of a range of values.
4. Mobile, i.e. easy to carry around.
5. Stable/Durable, so that it does not deteriorate, perish, deplete or erode easily due to its own chemical structure, weather, pest, fire or other reasons.

A good monetary system should encourage the circulation of money rather than the hoardings of it. In normal circumstances, a high velocity of money circulation would encourage increased economic activity and productivity. Hoarding, on the contrary would slacken economic activity which show up in the form of poor demand, low business activities and profits, business failures, unemployment, etc.

The second function of money is as a *unit of account*. This refers to its use as a measure of value in the economy, e.g. \$50 being the price of a shirt or \$2 being the price of kilogram of sugar and so on. This function eliminates the need to quote the barter exchange prices between every pair of goods and services that exist in the economy.<sup>5</sup>

The third function of money is as a *store of value*. This refers to the purchasing power of money over time. If money is a good store of value, then its purchasing power should be preserved from the time money is received until it is spent. If \$1,000 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<sup>6</sup>. In contemporary financial systems, money is not a good store of value since its value generally depreciates over time, i.e. its purchasing power erodes due to inflation.

The Part I paper postulated that the following characteristics of the present monetary system, i.e. fiat money, fractional reserve banking and interest charges as being at the root of the instability and unjustness of the system<sup>7</sup>. We argued that these characteristics, indeed, negate the attainment of the *maqāsid al-Sharī'ah*. The opposites of those three characteristics are of course: real money, 100 per cent reserves and negative interest rates (e.g. *zakāt* or demurrage charge)<sup>8</sup>. A negative interest rate encourages money to be spent and kept in circulation rather than being hoarded. If the

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<sup>5</sup> In a barter economy with one hundred goods for example, 4,950 pairs of prices need to be quoted, i.e.  $C_2^{100}$ . With money, however, the 100 items will have their respective price each, and therefore, only 100 prices need to be there.

<sup>6</sup> Of course, relative to that basket of goods.

<sup>7</sup> See Meera (2002) for further elaboration.

<sup>8</sup> Many past Muslim scholars and contemporary works like Choudhury (1997 & 2002) and Meera (2002) assert the importance of real money and 100 percent reserve requirement in order to truly match the monetary sector with the real sector. Lietaer (2001) and Meera (2004), for example, show the importance of replacing positive interest rates with negative interest rate. Lietaer (2001) and Greco (2001), for example, show how alternative real money systems have been used by communities around the world to foster sustainable development.

earlier characteristics were shown to prevent the attainment of the *maqāsid al-Sharī'ah*, could the opposites of those be then compatible with *Sharī'ah* money?

We argue in the next section why real money and negative interest rates are indeed characteristics of Islamic monetary system.

**Table 1**  
**Characteristics of Fiat Money and Problems Caused<sup>9</sup>**

<p><b>Creation of Fiat Money Out of Thin Air</b></p> <ol style="list-style-type: none"> <li>1. Causes inflation and asset price bubbles.</li> <li>2. Debt bubbles and financial collapses of firms and governments.</li> <li>3. Amplifies business cycles.</li> <li>4. Trade-off between inflation and unemployment.</li> <li>5. Agriculture sector disadvantaged due to price controls in this sector.</li> <li>6. Along with interest rates, it places the burden of a continuous growth requirement, intensifies competition and accumulates wealth in the hands of a minority by taxing the majority.</li> <li>7. Widening gap in the distribution of income - creates poverty and social problems like housing, long working hours, multiple jobs, female and child labour, corruption, crime, etc.</li> </ol>
<p><b>Destruction of Fiat Money in Certain Circumstances</b></p> <ol style="list-style-type: none"> <li>1. Causes a shrink in money supply and aggregate demand, and thereby triggers economic problems like recession with business failures, unemployment etc.</li> <li>2. Bank failures and financial crises.</li> <li>3. Leaves governments in debt.</li> <li>4. Possible political turmoil.</li> </ol>
<p><b>The Existence of Many Fiat National Currencies</b></p> <ol style="list-style-type: none"> <li>1. The many fiat national currencies currently existing, provide a fertile ground for currency speculation, manipulation and arbitrage.</li> <li>2. Makes possible for huge amounts of short-term funds (particularly electronic money) to move in and out of nations within seconds. This fact is very destabilizing.</li> <li>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.</li> <li>4. Provides an easy tool for domestic and international financial institutions to gain control over money, wealth, the political structure (i.e. sovereignty) of nations, etc.</li> </ol>

### **3. Real Commodity Monies: The Viability of Gold as Money**

The opposite of fiat money is, of course, real money, i.e. money that has intrinsic value. This necessarily has to be commodity based, i.e. money which itself is a commodity valued by people or money that is backed by such commodities. Indeed, historically mankind has used a number of commodities as money – cowry shells, salt, leather, gold and silver to

<sup>9</sup> Source: Meera (2002) and Meera (2004a).

name a few. But in later periods, gold and silver dominated money. The gold dinar and silver dirhams were the dominant money during the early days of Islam and for the most part of the Muslim history. Commodity money, unlike its fiat counterpart, cannot be created out of nothing. We argued in Part I paper that fiat money is easily created by the banking sector and that the growth in money supply is necessary simply for the sustainability of the system. It also highlighted the many problems inherent in the interest-based fiat monetary system. The problems may be matched with the characteristics of fiat money as summarized in Table 1.

A commodity money is not likely to cause the above problems simply because it cannot be created the way fiat money is easily created. A commodity is, in contrast, physical and real. It can neither be created at the will of anyone nor be counterfeited<sup>10</sup>. This characteristic alone can obviate most of the problems associated with fiat money — hyperinflation, asset price bubbles, debt bubbles, amplification of business cycles, etc.

If a commodity like gold were used as a common currency instead of the different national currencies, then there would be no exchange rates in the first place. Therefore, speculation, manipulation and arbitrage would no longer be possible. The possibility of the kind of currency attacks that the East Asian countries experienced in 1997-98 would be very much diminished.

Also if gold were to become a common currency, no individual country can enjoy substantial seigniorage, like the seigniorage of international currencies. Accordingly, gold protects the sovereignty of nations<sup>11</sup> and thereby, in turn, also protects their culture, religion, education, legal structure, etc<sup>12</sup>.

A number of ‘real money’ solutions are currently being discussed, examples of which include: (1) gold and silver money, (2) a basket of commodities as money,<sup>13</sup> (3)

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<sup>10</sup> Some may argue that sudden discoveries of gold can be inflationary. Please see section 4 for a counter argument.

<sup>11</sup> Particularly the vulnerable developing nations.

<sup>12</sup> As argued in Part I paper.

<sup>13</sup> See Lietaer and Nerb (2002).



complementary currencies<sup>14</sup> and (4) Real Money Units (RMU).<sup>15</sup> In our opinion, any real money would, in one way or another, provide some solutions to the above problems. Indeed, the historical Islamic economic system was fundamentally a barter economy, i.e. one that exchanged real goods and services. Nevertheless, some commodities in the economy, with the right characteristics, played the role of ‘money’; and thereby prevented the problems generally associated with barter.

*Abu Said al-Khudri reported Allah’s Messenger s.a.w. as saying: Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates and salt by salt, like for like, payment being made on the spot. If anyone gives more or asks more he has dealt in riba. The receiver and giver are equally guilty.*

(Sahih Muslim)

Also consider the following hadith<sup>16</sup>:

*Yahya related to me from Malik that Yahya ibn Sa’id said, “The Messenger of Alla, s.a.w., ordered the two Sa’ds to sell a vessel made of either gold or silver from the booty. They either sold each three units of weight for four units weight of coins or each four units of weight for three units weight of coins. The Messenger of Allah s.a.w. said to them, ‘You have taken usury’, so they returned it”*

The commodities mentioned in the above *ahādith* have the characteristics of money as discussed earlier, are to be exchanged weight for weight. Table 2 below summarizes the characteristics of these ‘money-commodities’ mentioned in the sayings of the Prophet s.a.w., as per our judgment.

As for the *Homogenous and Standardizable* characteristic, we give a grade of *good* for the food items, i.e. dates, wheat and barley because these items can easily be recognized and graded. But we grade *excellent* for salt, gold and silver due to their fineness (in texture). For *Acceptability*, we grade *excellent* for gold due to its

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<sup>14</sup> Examples include the Austrian Worgle, Thai Bia, German WARA, Swiss WIR, New Zealand ‘Green Dollar’ and Local Exchange Trading Systems (LETS). For a discussion on these, see Bernard Lietaer, *The Future of Money*, Century, 2001.

<sup>15</sup> See Bawany (2002).

<sup>16</sup> Aisha Bewley (trans.) (1989). *Al-Muwatta*. p.256.

international acceptability<sup>17</sup>. For silver we grade *very good* since it had historically played the role of money for a long period. Many gold proponents still talk about its possible comeback. For the food items, i.e. dates, wheat, barley and salt we provide a grade of *good* since they don't enjoy international acceptability. For example, dates may not be desired in some cultures.

As for *Mobility*, we give all the items a grade of *good* since they all can be moved location easily. As for *Stable and Durability*, gold and silver enjoy an *excellent* grade since both can last for very long periods unlike the food items that can perish due to bacterial activity, fungus, pest, fire etc.; and indeed these items are also destroyed in the process of consumption.

As for *Rarity*, of course, gold enjoys an *excellent* grade while we give a *good* grade to silver which is available in a slightly higher quantity. For the food items we give a *fair* grade since they are available in much larger quantities and can also be cultivated. Nevertheless, unlike fiat money, all the above commodities cannot be created out of nothing.

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<sup>17</sup> In fact, gold is the only commodity held by central banks as reserve asset.

**Table 2**  
**Commodities with Money Characteristics**

	<b>Homogenous/ Standardizable</b>	<b>Acceptability</b>	<b>Divisible</b>	<b>Mobile</b>	<b>Stable/ Durable</b>	<b>Rare</b>
Date	Good	Good	Good	Good	Good*	Fair
Wheat	Good	Good	Good	Good	Good*	Fair
Barley	Good	Good	Good	Good	Good*	Fair
Salt	Excellent	Good	Excellent	Good	Good*	Fair
Gold	Excellent	Excellent	Excellent	Good	Excellent	Excellent
Silver	Excellent	Very Good	Excellent	Good	Excellent	Good

\*These items are perishable through bacterial activity, fungal, pest, water, fire etc. and are also destroyed in the process of consumption.

From the above comparison of the characteristics, gold and silver dominate the other items in terms of durability, homogeneity, divisibility, rarity and global acceptance. Hence these two metals are also capable of playing the role of international money. Indeed, the most well-known commodity monies in the history of mankind are gold and silver. Gold as *Sharī'ah* money is not something being asserted only in present times. Many great Islamic scholars of the past have stressed the importance of using gold as money. Examples include al-Ghazzālī, ibn Taymiyyah, Qudama ibn Jaafar, ibn Khaldūn and al-Maqrīzī<sup>18</sup>. Also al-Asfahānī in his book *al-Dharī'ah Ilá Makārim al-Sharī'ah* indicated that only gold and silver could be used as money<sup>19</sup>. Indeed, al-Maqrīzī held that the change of the monetary standard from gold and silver to copper *fulūs* during the reign of Muhammad al-Kāmil ibn al-‘Ādil (615 – 35 H/1218 – 38 AD) in Egypt and Syria, were among the reasons for the ordeals that Egypt faced at that time, which included inflation and scarcity of necessities of life that brought about the disappearance of joy of life and ruination of wealth that reduced the people to privation, poverty and

<sup>18</sup> See Sanusi (2002).

<sup>19</sup> Mustafa Omar Mohammed (1998), p61.

humiliation<sup>20</sup>. The Holy Qur’ān and the Sunnah of the Prophet s.a.w. also seem to suggest gold as money. Consider the following verse for example.

*And there are those who hoard gold and silver and spend it not in the Way of Allah, announce unto them a most grievous chastisement.*

*(Qur’an, At-Taubah, 9:34)*

It is clear that in the above verse Allah SWT is referring to gold and silver as money to be spent in His path. As for *Shari’ah* rulings, consider the following ahadith:

*The Holy Prophet (peace be upon him) said: The system of weights and measures is the system of the people of Medina.*

*(Sahih Bukhari)*

*Yahya related to me from Malik from Humayd ibn Qays al-Makki that Mujahid said, “I was with ‘Abdullah ibn ‘Umar when an artisan came to him and said, ‘Abu ‘Abd ar-Rahman, I fashion gold and then sell what I have made for more than its weight. I take an amount equivalent to the work of my hand.’ ‘Abdullah forbade him to do that, so the artisan repeated the question to him, and ‘Abdullah continued to forbid him until he came to the door of the mosque or to an animal that he intended to mount. Then ‘Abdullah ibn ‘Umar said, ‘A dinar for dinar, and a dirham for dirham. There is no increase between them. This is the command of our Prophet to us and our advice to you.’”<sup>21</sup>*

It is interesting to note from the above hadith that even gold ornaments are to be exchanged weight for weight, which means that an artisan or jeweller is not allowed to add workmanship charges. The above tradition strengthens our contention that gold is to play the role of money and, therefore, discourages the fashioning of it into ornaments that would technically end up being ‘hoarded’ and not circulated in the economy. Also, the gold dinar and the silver dirham were, in fact, the units of measurement of the Medina

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<sup>20</sup> Ibid. pp.61-63.

<sup>21</sup> Aisha Bewley (trans.) (1989). *Al-Muwatta*. p.256.

System<sup>22</sup>. Also, in *Sharī'ah*, gold and silver are covered under *al-Sarf*, i.e. rulings that govern the exchange of money<sup>23</sup>. Therefore, the Holy Qur'ān, the traditions of the Prophet (s.a.w.), the history of Islam and the writings of Muslim scholars of the past, all do indeed point towards gold and silver as money in Islam. But somehow in the passage of time, Muslims seem to have lost the wisdom behind this, adopted fiat money and have subjected themselves to subjugation, poverty and humiliation as observed by al-Maqrīzī in Egypt with *fulūs* as money<sup>24</sup>.

### **3.1 Superiority of Gold over Other Forms of Money**

Gold has intrinsic value just like any other commodity, but it distinguishes itself in that people of every race, creed and nationality desire it for its own sake as proven by the obsession humanity had for this metal throughout history. The following verse of Qur'an attests this:

*Fair in the eyes of men is the love of things they covet: women and sons, heaped-up hoards of gold and silver ...*  
(Qur'an, Ali Imran, 3:14)

We summarize in Table 3 below, the characteristics that make gold as an ideal money:

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<sup>22</sup> See Farishta Zayas (2003), pp. 69-72.

<sup>23</sup> Tariqullah Khan (2004).

<sup>24</sup> History repeating itself but on a much larger scale involving global Muslim world.

**Table 3: Characteristics of Gold as Ideal Money<sup>25</sup>**

	<b>Characteristic</b>	<b>Remarks</b>
1	Rare and Compact	Gold is rare; found and extracted only in minute quantities from earth. Being compact, a small amount of gold has big value. Therefore, one needs only small amounts for big purchases.
2	Stable and durable for very long periods.	The chemical property of gold is that it is an element that rarely reacts with any other element or compound. It is so inactive that it is even extracted from the earth as gold itself (unlike iron, for example, that is obtained as iron oxide, which is then processed to extract the iron). Gold does not oxidize easily and, therefore, does not get rusty. Even gold treasures buried in the salty seawater for many centuries remain in their pure form. Gold is also not destroyed by extreme heat and pressure.
3	Homogenous and divisible into minute quantity	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. <sup>26</sup>
4	Storable	Gold is an ideal store of value, i.e. something that can be saved for future use, even very far into the future. It is not uncommon for fiat money to become obsolete with the passage of time, but gold coins, on the contrary, had always maintained their intrinsic value.
5	Mobile	Gold can be moved between places easily and, therefore, can be used as money in different nations and places <sup>27</sup> .
6	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. When people use food items as money, for example, then when one consumes the food, money gets destroyed. But, gold as a metal cannot be created or destroyed and will be always there to play the role of money.

<sup>25</sup> Source: Meera (2004).

<sup>26</sup> The different colour of gold sometimes observed is basically due to the other alloy metals added in order to strengthen it.

<sup>27</sup> A reason why gold price rises in times of uncertainties, war etc.

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<sup>28</sup>, i.e. no unfair seigniorage. 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.

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<sup>29</sup>. With commodity money, particularly gold, however, such destruction is unlikely due to its physical nature. Therefore, gold as money can be expected to provide the much desired stability missing in the current fiat money system. Unlike fiat money, gold needs not be introduced into the economy in the form of debt. It can, therefore, neither create capital structure problems nor require constant growth in money and economy for the mere sustainability of the system.

It is not surprising, therefore, that with the above characteristics (Table 3) 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’.<sup>30</sup> 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’, deriving from the

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<sup>28</sup> Debasement etc. are of course attempts to benefit from seigniorage.

<sup>29</sup> Realizing that it is the lack of money in circulation that is behind many socio-economic problems, particularly unemployment, some societies world-wide have resorted to their own community currencies to solve their problems. Lietaer (2001) and Greco (2001) discuss some of these successful community currencies.

<sup>30</sup> Since paper money and other fiat money have no intrinsic value, governments had to make their people accept them as money through legal means. This is what ‘legal tender’ is all about. The ‘legal tender’ status is precisely where a serious fault lies in the current monetary system. It denies the right of a community to decide on its medium of exchange.

Latin *denarius*.<sup>31</sup> While the Prophet (peace be upon him) brought many changes to the social institutions of the time, the Roman denarius was, however, fully accepted as money in the new Islamic community. In that, is profound *Hikmah*. Indeed, the first Islamic *dinar*<sup>32</sup> was not minted until about fifty years after the demise of the Prophet (peace be upon him), by the caliph Abd al-Malik ibn Marwān 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 Roman gold coin throughout Europe<sup>33</sup>. The dinar remained the currency of the Muslim world for centuries until the fall of the Ottoman caliphate in the early 20th century<sup>34</sup>.

A commodity money like gold, therefore, is superior and desirable money compared to fiat money. It promises a just and stable monetary system while protecting the wealth (*al-māl*), sovereignty, culture and religion of the people. It also does not impose a ‘hidden tax’ on the people, which particularly affects the poor and the wage earners, as discussed in the Part I paper. All in all, commodity monies are, therefore, compatible with the *maqāsid al-Sharī’ah*.

### **Negative Interest Rates**

We mentioned elsewhere earlier that negative interest rates discourages hoarding and instead encourages the circulation of money that has benefits for the economy. Many Muslim scholars have written on the issue of interest and *riba*. El-Diwany (1997), for example, argues excellently the inherent problems brought about by interest charges. Therein he argues that creation of money out of thin air by the banking system and the subsequent lending of it at interest to be an important cause of economic injustice. Of

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<sup>31</sup> The word *dinar* 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). *Dinar* does not refer not to the shape of the coin or the inscriptions on it.

<sup>32</sup> The Islamic dinar simply had the Roman inscriptions replaced with Qur’anic and Arabic verses instead.

<sup>33</sup> See Bernstein (2000), p.??

<sup>34</sup> Which thereafter accelerated the degradation, backwardness and humiliation of Muslims to an unthinkable position relative to their glorious past in terms of knowledge, power and progress.



course, the money creation process is made possible by the fractional reserve banking system. Lietaer (2001) argues that positive interest rates as being counter to sustainable development and that negative interest rates (eg. demurrage charges) are instead compatible with or necessary for sustainable use of resources and hence development. To quote him<sup>35</sup>:

...interest rates create a built-in tendency to disregard the future  
...the higher the interest rate, the more that tendency prevails  
....which create a direct conflict between financial criteria and  
ecological sustainability under our present money system...

Lietaer argues that there is indeed a connection between currencies with demurrage charges and the remarkable prosperity during the First European Renaissance and the Pharaonic period in Egypt<sup>36</sup>.

In the Islamic monetary system the negative interest rate function is, indeed, played by zakāt which ‘taxes’ the Muslim who has had in his possession a minimum zakātable wealth for one full year. Therefore, unlike in the present monetary system, unutilized savings are not only not rewarded in Islam but instead are ‘taxed’ and distributed away to the sections of the economy that need them most, i.e. the poor, orphans, those in debt etc. This section of the economy indeed has a high propensity to consume and would keep the aggregate demand high and the economic engine working. Since gold is a physical item that can neither be created out of thin air nor destroyed, it is, therefore, compatible with a 100 percent reserve requirement. Hence, it’s obvious that the real money system of Islam with the institution of zakāt is diametrically opposite to the present monetary system of fiat money, fractional reserve banking and positive interest rates.

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<sup>35</sup> Lietaer (2001), p.243.

<sup>36</sup> Ibid, footnote 271.

#### 4. Some Common Queries and Objections to the Gold Dinar<sup>37</sup>

The talk about returning to gold, of course, is likely to rekindle our memory on past experiences with gold and raise some questions. For example, if gold standard failed, why return to it again?<sup>38</sup> With gold standard, why did the Great Depression of the 1930's take place? To answer questions like these, one needs to analyze why a system that lasted for centuries failed? Chances are that the failure is not due to the system itself but rather due to the distortion of the existing system. Indications show, for example, that the cause of the Great Depression was, indeed, fiscal in nature, i.e. due to high tax rates of the Smoot-Hawley Tariff Act of 1930<sup>39</sup>. Also governments printed more money than the gold reserves they had<sup>40</sup>.

The possible volatility of gold price is another common objection. Gold price may fluctuate for many reasons. It may not necessarily be due to changes in the demand and supply of gold alone, but also could be due to changes in fiat money itself. For example, if a government prints too much of its currency, then the gold price in that currency will rise simply indicating the falling value of that fiat currency. Nevertheless, historically, gold has proven to be more stable than most currencies including the dollar, in terms of keeping its value.<sup>41</sup>

Since the gold payment system is fundamentally a 'barter' system for every transaction involves mutual exchange of values, gold producing countries need not be necessarily placed at an advantageous position relative to non-gold producing countries<sup>42</sup>. Having gold deposits is, therefore, not necessarily better than a fertile land that produces

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<sup>37</sup> In the course of arguing in favor of gold, the authors and other proponents of gold get queries and objections that are somewhat similar as summarized in this section. See for example, Meera (2002), El-Diwani (2002), Meera (2004) and materials on the web, e.g. <http://polynomics.com>

<sup>38</sup> Backing fiat currencies by gold as proposed by gold proponents is simply like returning to the gold standard of the past. See Mundell (1997), for example.

<sup>39</sup> Wanniski (1978), p.136.

<sup>40</sup> The US, for example, printed much more dollar notes than her gold reserves would permit, to finance the Vietnam war. This ultimately brought about the collapse of the Bretton Woods in 1971.

<sup>41</sup> See for example, Jastram (1977).

<sup>42</sup> 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 single country has a monopoly over the production of gold.

lush vegetation and fruits for example. The produce of land could then be exchanged for gold. Similarly, knowledge, skills and technological know-how are just as valuable as gold.

Some also argue that the global supply of gold is not sufficient to support the ever growing international trade. Also, since in most cases gold would only play the role as a unit of account, the same gold can be used again and again in many transactions. This is basically the velocity of money circulation. The higher the velocity, the lesser the amount of money needed to support a given amount of exchange<sup>43</sup>. Meera and Larbani (2004) also showed that in international trade, a lot of transactions would cancel-out thereby requiring a much smaller amount of gold for settlement.

Some also query that 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<sup>44</sup>. Gold production, nonetheless entails technical know-how and heavy investment. Hence there are automatic checks on overproduction since miners know that overproduction would only invite inflation, i.e. why waste investment and effort that would only prove futile and translate into inflation?

Using gold for settling international trade balances would truly be a great step forward<sup>45</sup>. For Muslims, it would be a significant step that would complement the establishment of a true Islamic economics and financial system itself. The gold dinar promises a just and stable global monetary system while providing a stable international unit of account, which is lacking in the current global monetary system. 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 international financial powers through the interest-based fiat money system<sup>46</sup>. In the current system, the Islamic bank is also caught

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<sup>43</sup> This is easy to see from the equation of exchange  $MV = PY$ . For a given national output  $PY$ , the higher the velocity  $V$ , the smaller the money supply,  $M$ , is needed.

<sup>44</sup> For example, Mundell (1997) regards the Federal Reserve as the greatest engine of inflation ever created and Milton Friedman's opinion that inflation is predominantly a monetary phenomenon.

<sup>45</sup> Meera and Larbani (2004) discusses this in detail.

<sup>46</sup> See Part I paper.

up in the law-of-one-price that causes it to refer to the market interest rate in designing and pricing its financial products<sup>47</sup>.

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 be convinced by the gold argument.<sup>48</sup> The best area to start is probably to implement the gold dinar for settling bilateral and multilateral trade arrangements<sup>49</sup>, since this has 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<sup>50</sup>.

## 5. Conclusion

In this Part II paper we argued in favor of commodity monies, like the gold dinar for the elimination of the negative socioeconomic effects of fiat money. We argued that the gold dinar is compatible with the *maqāsid al-Sharī'ah* for it protects wealth (or *māl*), a *daruriyyah* component of the *maqāsid*, while fiat money prevents the attainment of the *maqāsid*. Further some common objections to the gold dinar were addressed. Finally, the initial steps for the implementation of the gold dinar were discussed. The paper asserts that commodity monies like the gold dinar, which is compatible with a 100 percent reserve requirement and the replacement of interest by *zakat* ( technically a negative of interest rate) are characteristics of an Islamic money system; indispensable for solving the

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<sup>47</sup> See Meera and Larbani (2004).

<sup>48</sup> 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.

<sup>49</sup> Meera and Larbani (2004) discusses a non-linear mathematical programming technique of determining an efficient trade matrix among nations that would require the minimum amount of gold for settlement.

<sup>50</sup> See Meera (2004) for further discussion on the implementation of the gold dinar.

problems inherent in the present interest-based fiat money system and for the attainment of a true Islamic economics and finance system.

Therefore, we conclude that the Islamic economic system being fundamentally a ‘barter’ system, i.e. an exchange economy where goods and services are exchanged value for value solves the problems associated with barter by taking some of the commodities exchanged in the economy, that have the characteristics of money, as money.

Commodity monies were argued as being compatible with the *maqāsid al-Sharī’ah* while fiat money as being counterproductive to the *maqāsid*. The best of these commodities are, indeed, gold and silver.

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