Islamic Dinar Reloaded

By Mobasher Zein Kazmi

The writer is an Islamic finance researcher who completed his MBA (Investment Management) from Concordia University and is a CFA Level 3 candidate. He was recently awarded the Islamic Finance Qualification (IFQ) designation.

An Islamic Reserve Currency

The rise of modern Islamic banking and finance in the 21st century has been one of the greatest success stories in recent economic history. The industry remains poised in a high-growth stage as banking practices are evolving into a core group of standardized financial products compliant with the letter and spirit of Sharia law. The initial challenge of reorienting conventional banking structures towards interest-free financial systems has endured as Islamic banks are hard-pressed in pricing financial products using benchmark interest rates to remain competitive. Critics of Islamic banking charge that the Islamic financial system has not reached the pristine level of best practices as ordained by Sharia through the negation of uncertainty in financial contracts; current financial practices remain tainted with the brush of riba am naseeyah (usury). It is in this context that the introduction of an Islamic reserve currency becomes paramount in removing the element of doubt in Islamic financial contracts while providing a strong moral foundation for Islamic financial systems to thrive across the global economic landscape.

The introduction of an Islamic reserve currency will bring some measure of stability to the existing disorder in international financial markets whose origins can be traced to the actions of a coterie of Wall Street bankers and their reckless use of financial instruments in pursuit of bottom-line profitability. Federal Reserve notes are undeniably in a permanent state of decline as the economy of the United States is saddled with record budget and trade deficits; external financial inflows will prove inadequate in sustaining future US government spending programs particularly the badly needed stimulus required to jumpstart its moribund economy. In this uncertain environment the need for a genuine alternative reserve currency becomes ever more critical if only as a vehicle of wealth preservation for sovereign nations.

The Islamic Development Bank is the ideal financial institution which can assume the responsibility of providing such a reserve currency to member and non-member states alike authenticating its halal credentials while working towards cementing the ascendancy of Islamic financial systems. The trade off in utilizing fiat currency as a principal medium of exchange remains a costly option as its store of value consistently erodes after each business cycle. Instead, the new reserve currency will improve upon the old Bretton Woods System of fixed parities and will be backed by a free-float gold peg ensuring the reserve currency retains intrinsic value. The current global financial crisis has clear implications for the Muslim world and a desire for macro-economic stability mandates a monetary policy that will protect regional economies in the medium to long-term from the inevitable currency crisis.

Islamic Origins

The introduction of an Islamic currency can be traced to the reign of the second Caliph Omar bin Khattab (644-655 AD) who established the following currency standard which was upheld by succeeding Islamic governments namely:

* The Islamic Dinar whose weight of gold was fixed at 4.3 grams
* Islamic Dirham whose weight of silver was fixed at 3 grams.[i]

Commodity backed Islamic currencies were in use up until the collapse of the Ottoman Empire and onset of World War 1 in 1914 when the Ottoman Empire chose to abandon the gold standard.[ii] Clearly, a very strong tradition of metal based currency exists in the Islamic world and can gain rapid acceptance provided the sponsor is an established and recognized institution willing to act as a force stabilizer of the Islamic financial system. The Kelantan state of Malaysia is only a recent example of attempts by local authorities to bring greater confidence in the monetary system and is understandable given the savage speculative attacks the Malaysian Ringgit has suffered in the recent past. Former Malaysian Prime Minister Mahathir Mohammed himself has been a champion of Islamic monetary reform and is at the forefront in calling for a new reserve system used to facilitate international trade. [iii]

Historical Perspective

Looked at through the ages, gold has played a pivotal role in the execution of economic transactions as the principal medium of exchange; be it in the era of Pax Romana or the medieval Ming Dynasty of China. However, the late 19th and early 20th century witnessed an extensive use of gold reserves within the prevailing international monetary system especially for the use of settling international trade accounts. This fell into complete disfavor by 1933 when the gold standard was abandoned by the United States under the aegis of President Roosevelt.[iv] Its critics argued that gold was no longer seen as desirable, citing its perceived inability to cope with the demands of global trade and investment. In this backdrop the Bretton Woods system was born where fixed exchange rates would be managed by the newly created International Monetary Fund placing the US Dollar as the world's reserve currency; it remained fully convertible to gold until 1971 underscoring the value of utilizing gold in stabilizing exchange rates.

Aside: Bretton Woods Reloaded

In order to discuss the Islamic Dinar (and the broader topic of an Islamic economy) we are required to take equal attention to the fiat currency system of today as well as previous monetary systems. This calls for an analysis of not just the Bretton Woods but what came before as well as what came after (and the reasons surrounding these choices). Effectively the current debate surrounding monetary policy is rather similar to the one that has surrounded Islamic finance instruments, namely we have a distinction between asset-backed and asset-based products. The gold standard (i.e. pre-Bretton Woods) represented the notion of an asset-backed currency, whereas the exchange rate systems that followed (the fixed system of Bretton Woods and the and floating rate system of today) represent an asset-based regime (the fiat or faith-based regime banks on the credit worthiness of the issuer country).

Specifically, the gold standard as practiced in the 19th and 20th century was based on the concept of having currencies being backed by a unit of fixed weight in gold. In fact there have been different versions of this system (namely the gold specie standard, the gold exchange standard, and the gold bullion standard). The latter would have a relatively short lifespan, in-between the end of WWI and the outset of the Great Depression. Nonetheless, the gold standard reflected a need to manage exchange rate risks and it was seen as an automatic regulator of trade imbalances, although the effectiveness of this system increasingly came into question. In particular with regards to short term shocks and its inability of monetary policy to alleviate these pressures in a timely fashion.

Overall, the gold standard proponents cite various benefits including: long term price stability (i.e. inflation and specifically hyperinflation are hampered); limiting governments from engaging in excessive seignorage (supressing their ability to inflate prices through extensive issuance of their paper currency); and the subsequent control of a government's deficit (as countries can't inflate away the value of their foreign debt). On the other hand, disadvantages to the gold standard are equally numerous, mainly relating to the linkage between a gold standard and deflation; the total amount of gold available (suggested to be insufficient to back all current money in circulation); removing a key tool of monetary policy to be used to alleviate a recession; eventual dependence on gold production (i.e. inflationary pressures could ensue when gold production increases or decreases) and in that sense short-term price fluctuations due to the volatility of gold price in the open markets.

The introduction of Bretton Woods aimed to replace the gold standard in favour of a specified fixed exchange rate, US dollars to Gold ($35 per ounce of gold), therefore each signatory country would be obligated to maintain the exchange rate of its currency within a fixed value. Nevertheless, there were stark differences as to how this system could be implemented. Most notably, John Maynard Keynes proposed the creation of a global currency - the Bancor - which would be backed by barter and its value denominated in weight of gold. In other words this system called for replacing the direct barter of "goods for goods" (i.e. currency for currency) with a "goods for bancor for goods". Keynes argued that this would lead to an equilibrium in international trade flows, in other words he viewed imbalances as being caused when goods are not exchanged for other goods but for money instead (i.e. any promissory note - form cash to bills of exchange). The Bancor would have addressed these issues, although as we know the US dollar was eventually chosen as the reserve currency. This was due in part to geopolitical pressures emanating from the cold war (and the fact that the USSR had access to significant gold deposits) as well as the economic prominence that the US had built in the post-war era (and the perceived strength of the US dollar).

The current monetary system is primed for an overhaul and the advent of a so-called Bretton Woods II regime. All in all, many factors are coming into play: the concept of Gold as a store of value has been extended to other commodities (not just hard commodities); the prominence of a single economic power is much less apparent (as well as a clear shift from US current account surpluses to significant deficits); there is less political polarization (i.e. the end of the Cold War) and instead a global segmentation into economic blocs (with the emergence of the BRIC, Asian and MiddleEastern economies, as well as the relatively-recent creation of the European currency); and ultimately the economic liberalization/globalization of the world economy. While many lessons have been learned from both fixed-rate and floating-rate monetary regimes, we can expect that the effectiveness of the current system will continue to be challenged - in much the same way as Bretton-Woods challenged the gold standard.

The Islamic Dinar

The Islamic Dinar is presently the Islamic Development Bank's unit of account and forms the basis for its authorized capital stock of 30 billion and subscribed capital stock of 16 billion.[v] One Islamic Dinar is equivalent to one special drawing right (SDR) of the International Monetary Fund.[vi] This special drawing right based on IMF guidelines is further weighted in the following manner to derive its value:

				YTD 2010	YTD 2010
Symbol	Currency	Share	Value	Exchange Rate	USD Equivalent
$	US Dollar	44%	$ 0.63	1.00	0.63
€	Euro	34%	€ 0.41	1.32	0.45
¥	Japanese Yen	11%	¥ 18.40	0.01	0.20
£	British Pound	11%	£ 0.09	1.53	0.14
				SDR1=USD	1.42

Note: Exchange rates based on average yearly rates.

If instead the Islamic Dinar was pegged and fully convertible to gold based on the established Islamic precept of 4.3 grams per dinar then its hypothetical make-up would be quite different:

	Price of 1 SDR in USD	Price of 1 Islamic Dinar
2006	1.47	83.49
2007	1.53	96.14
2008	1.58	120.50
2009	1.54	134.50
YTD 2010	1.42	161.13

Note: Exchange rates based on average yearly rates.

Gold prices have clearly shown an upward trend and remain grossly undervalued when inflation is factored in and prices are evaluated in real terms. The long-term preservation of value particularly of a reserve currency such as the Islamic Dinar can only be maintained if a gold standard is adopted. The fact that the Bretton Woods system collapsed can be traced towards the US government's spending programs (Lyndon Johnson's "Great Society") and the Vietnam War. In fact one can draw a reasonable correlation between the abandonment of sound monetary policy and the rise of wars where governments recklessly print fiat currencies to pay for bloated defence budgets with costs being passed on to the citizenry in the form of higher taxes and price inflation. Frankly, this is destructive and quite toxic for growth to the most productive sectors of the economy.

References

[i] History of Islamic Dinar and Dirham, September 6, 2010
[ii] Turkey Travel Guide, September 7, 2010
[iii] DAWN, Malaysian State Launches Islamic Currency, September 7, 2010
[iv] Lords of Finance, Liaquat Ahmed, 2009, pp. 461
[v] Islamic Development Bank, September 8, 2010
[vi] Islamic Development Bank, September 8, 2010

Your feedback and comments are very important to us, please feel free to contact the author via email.