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Cizakca, Murat

INCEIF, Kuala Lumpur

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THE CASE AGAINST THE ISLAMIC GOLD DINAR¹

BY

PROF. DR. MURAT CIZAKCA

INCEIF

KUALA LUMPUR

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THE CASE AGAINST THE ISLAMIC GOLD DINAR

Recently, there has been an increasing amount of publications, conferences, even a campaign, about the re-introduction of the Islamic gold dinar. The proponents of this idea, known as the *denarists*, particularly active in Malaysia, advocate that this country as well as the whole Islamic world “urgently” return to the Islamic gold dinar.² They argue that if this return is achieved, nearly all the ills of modern economies such as rampant inflation, credit crunches, stagnation, unemployment etc., which they associate with the present paper money system, would be solved. Some scholars also argue that since the Prophet (SAW) used coins, it would be only appropriate for Islamic countries to transform their currencies into gold dinars.

Let us start with this argument first. First of all, we need to understand what the overall purpose of the Prophet was when he condoned the use of coinage. Verses from the Qur’an as well as a number of *ahadith* make it perfectly clear that, there was a divine plan to make Mecca the global hub of world commerce.³ For this, the first task was to catapult the Islamic community from the age of barter to the age of monetized trade. The Prophet did this with two *ahadith*.⁴ While barter was thus declared as a form of *riba*, trade with money was approved and encouraged. The Prophet used Byzantine and Persian coins. Authentic Islamic coins were introduced later.

Since paper money had not yet been invented during the Prophet’s time, he couldn’t have used such currency even if he had wanted to. Therefore we need

² Ahamed Kameel Mydin Meera, *The Islamic Gold Dinar*, pp. 88-89.

³ Consider for instance: Qur’an: 2: 198, as well as Dawud: Book 10, *Kitab al-Manasik wa'l-Hajj*, hadith 1730.

⁴ Malik, Book 31 (Business Transactions), *hadith* 31.12.21; Muslim, Book 10 (Book of Transactions), *Hadith* 3861.

to ask, would he have wanted to use paper money, if he had any choice? Let us imagine for one minute that the Prophet had the choice between coinage containing gold or silver and paper currency. Which one would he have chosen and on what basis would he have made his decision? It is my contention that he would have thought of the Qur'an and would have based his decision upon the inspiration he obtained from the Word of God. The Qur'an does not ordain Muslims to use this or that currency but does provide a powerful clue: the prohibition of the rate of interest. Obviously, it is based upon this clue that he would have tried to reach a decision. We now know, with hindsight that while paper money fulfils the ultimate Islamic goal of zero percent rate of interest, coinage does not.

Now, fast forward 14 centuries: as it is well known, the Japanese interbank interest rate reached zero rate of interest already in 1999. Japan was followed by several other western nations during the latest crisis. On July 30, 2010 the London interbank offered rate on three month dollars was fixed at 0.46563 percent.⁵ Although, this was obviously unintentional, indeed, none of these countries reduced their rate of interest to zero percent for religious or ideological reasons, they nevertheless demonstrated that it is possible to bring into being an economy with zero rate of interest using paper money. The question boils down now whether this could have been achieved with coinage. I doubt it; because, every coin has two different values, face value and intrinsic value. Face value, which we may call "fiat value", refers to what is written on it and is determined by the power of the state which declares it legal tender, while the intrinsic value refers to the cost of producing the coin plus, more importantly, by the value of the metal contained in it. The intrinsic value of the coin is thus primarily determined by the global commodity market, where

⁵ Uwe Vollmer and Ralf Bebenroth, "Policy Reactions".

equilibrium prices of gold or silver come into being.⁶ Under normal circumstances, face value should be greater than or at least equal to the intrinsic value. But this is not always so as will be explained below.

Let us make two assumptions now. First, let us assume that a government with Islamic inclinations decides to reach zero rate of interest. This follows directly from the interest prohibition in Islam. Since most economists agree that interest rate is actually the price of money, interest prohibition means that this price should be zero.

Assume further that gold coinage constitutes the currency of the country and the Central Bank is ordered to take all necessary measures to reduce the prevailing interest rate to zero percent, regardless of any macro-economic consequences. My hypothesis is that whereas the Japanese Central Bank reached this level without any such intention with paper money, the Central Bank of an Islamic country using coinage as its currency, cannot do so with all its good intentions. Indeed, the Central Bank can adjust all the macro-economic variables under its control to reach its target of zero rate of interest but would find it extremely difficult, even impossible, to do so. This is because of the intrinsic value of the coinage, which is determined not by the Central bank but by the global demand and supply for the metal that is contained in the coin.

The hypothesis that coins would always have a positive rate of interest is confirmed by monetary history. Genoa aside, where a one percent rate of interest had been observed during the seventeenth century thanks to very special institutional factors, in general, historical rates of interest never fell below three

⁶ Zubair Hasan, "Ensuring Exchange Rate Stability".

percent in economies using coinage. Indeed, a zero percent rate of interest has never been recorded throughout history in monetary systems using coinage.⁷

At this point we may ask, if there is any *fiqhi* objection to the use of paper money. Some of the most respected classical Muslim scholars, particularly Mohammad al-Shaybani, Ibn Kayyim and Ibn Taymiyah did not limit currency to gold and silver coinage only. Ahmad Ibn Hanbal ruled that there was no harm in adopting as currency *anything* that is generally accepted by the people. Thus, these scholars, among themselves, wide opened the way for Muslims of future centuries to utilize paper money. Leading contemporary scholars like Yusuf al-Qaradawi and Muhammad Taqi Usmani are also of the same opinion.⁸

There is a further complication: *ceteris paribus*, not only coins would always have a greater than zero price, i.e., a positive rate of interest, their circulation in the economy would also be affected in the long run by the price trends of precious metals in world markets. We will have more to say on this below.

The mechanics of an inflow or outflow of gold into a country should also be considered. An inflow, ignoring reasons, would lead to inflation and an outflow to depression.⁹ It is for this reason that in history most European nations were obsessed about ensuring that no gold would flow out of the country. Gold inflow, however, was encouraged as it expanded the economy. This Europe-

⁷ James Macdonald, *A Free Nation Deep in Debt*, pp.77, 97. See also, Manuel Sanchez Martinez, "Dette publique", p. 37.

⁸ Muhammad Aslam Haneef and Emad Rafiq Barakat, "Must Money be Limited to Only Gold and Silver?", *Journal of King Abdulaziz University: Islamic Economics*, 2006, vol. 19, no. 1, pp. 21-34. See also, Muhammad Umer Chapra, "Monetary Management in an Islamic Economy", *Islamic Economic Studies*, 1996, vol. 4, No. 1, p. 5.

⁹ Z. Hasan, "Ensuring Exchange Rate Stability", p. 14.

wide doctrine was called *mercantilism* and was the cause of many wars between mercantilist nations. This is another very dangerous implication of introducing the gold dinar.

Ahamed Kameel Mydin Meera, who is the main proponent of the gold dinar, has argued that money creation would not be possible in a fully gold backed system. With money creation thus prevented, inflation too would be avoided.¹⁰ The problem with this argument, like all the other arguments of the *denarists*, is that although they advocate a return to a system that existed in history they have not done their homework and studied how the system they are proposing has actually functioned in history. Let us now make up for this deficiency and observe if indeed in history currency systems based upon coinage have been able to keep money supply stable and therefore avoided inflation.

If we study historical data, the first thing we note is that inflation was well and alive in the past. Indeed, throughout Europe, there was massive inflation in the period 1440-1760, with the most rampant inflation being observed in the late sixteenth and early seventeenth centuries. Therefore, the claim made by another denarist, Umar Vadillo that “1400 years ago, a chicken cost one dirham. Today, it still costs one dirham”¹¹ invites incredulity. I do not know the details of Mr. Vadillo’s calculations, but since all serious works done by economic historians indicate otherwise, I have grave doubts. Indeed, during the period 1440-1600, sheep, candles, wine, beer, beef and wheat prices expressed in gold or silver coins exhibit a massive inflation all over Europe.¹² To give some examples; in Strasbourg, France, the average price index of rye went from 100

¹⁰ Ahamed K. M. Meera, *The Islamic Gold Dinar*, p. 79.

¹¹ James Hookway, “Malaysians Go for Gold”, p. 10.

¹² Fernand P. Braudel and F. S. Spooner, “Currencies, Precious Metals”, pp. 474-479.

in the fifteenth century to 350 in the seventeenth. Meat went from 100 to 250. In Saxony, Germany, the two percentages were respectively 350 and 250. In England, during the period 1450 to 1750 the general price index went from 100

Mr. Vadillo may, however, argue that the prices I have given above are European prices and therefore are not relevant for the Islamic world. In that case, we can look at prices in the Islamic world as well. Thanks to the more than four hundred million documents protected in the Turkish archives we are well informed about the Ottoman prices. These data collected from the waqf and palace kitchen books indicate that prices expressed in grams of silver reached their peak in Istanbul during the first quarter of the seventeenth century at approximately 80 to 100 percent above their levels in the base year of 1489-90.¹³ In this period two types of coins constituted the prevailing currency in the Ottoman economy; the gold *sultani* and the silver akçe.

The problem with the bi-metallic system, where coins containing gold as well as silver circulated, was that money supply was never fixed as Meera would like us to believe. On the contrary, money supply was subject to fluctuations both caused by chance discovery of gold or silver deposits as well as deliberate debasements. While money supply increased during the late sixteenth century due to the discovery of huge silver deposits in Potosi, South America, it continued to increase further during the next, seventeenth century, primarily by debasements.

¹³ Şevket Pamuk, *A Monetary History*, p. 124. In the Ottoman silk sector I have observed price increases in the range of 100 to 300 percent in the same period. See, Murat Çizakça, "Price History", pp.533-551.

Debasement occurs when a government obliged to increase the money supply mints new coins with lower metal content. Put differently, more coins would be cut from a given amount of precious metals. This is of course, tantamount to increasing the money supply. Thus, money supply in a bi-metallic system was by no means fixed. It fluctuated in tandem with the world-wide discovery of precious metal deposits as well as the need of the state for additional money and the consequent debasements. With money supply not fixed and tending to increase, it was natural that inflation would occur. There is solid evidence that, indeed, this was the case.¹⁴ As explained above, data obtained from throughout Europe as well as the Ottoman Caliphate all tell the same story of rapid inflation. All of these countries were using gold or silver coins. Thus we conclude, having gold or silver based coins as the currency of a country does not in any way provide a protection against inflation.

That not only the American silver from Potosi but also debasements were behind this inflation is demonstrated by numismatists, who have examined the precious metal content of European coins. They have informed us that all the main coins of Europe lost their silver or gold content. In the period 1440-1760 the coins of England, Russia, Germany, France, the Netherlands, Austria, Genoa, Venice and Spain, were all debased and their precious metal contents were reduced – some drastically some at a less extent. To give some specific examples: in this period even the pound sterling, the most stable currency in the world, lost 43.42 percent of its equivalent weight in silver. The French *livre tournois* lost 82.68 percent, the Genoese *Lira* 72.98 percent, the Dutch *guilder* 68.74 percent.¹⁵

¹⁴ Fernand P. Braudel and F. S. Spooner, *op. cit.*, pp. 378-486.

¹⁵ *Ibid.*, p. 458.

In case, the reader wonders about the Islamic world, it should suffice to note that the Ottoman Asper (akçe) was one of the most frequently and drastically debased coins in Europe. In 1585-86 it was drastically debased and lost 44 percent of its silver content. One akçe weighed 0.68 grams in 1584 and only 0.23 grams in 1689.¹⁶

Nor was debasement a special curse of the early modern period. It was observed throughout history. Consider, for instance, the original Roman *denarius*, which was 95 to 98 percent pure silver weighing 4.5 grams by the decree of Caesar Augustus in 15 B.C. By the reign of Nero, its weight was down to 3.8 grams. By the second half of the third century, some 270 years after its initiation, it was merely 2 percent silver.¹⁷

The most important universal reason for these debasements was warfare. When a government suddenly faces an external threat, it has to increase the number of men under arms and improve its armed forces – a very expensive affair. More soldiers, more and better arms - all need to be paid in cash. If cash is in the form of gold or silver currency then the solution is to cut new coins from a given amount of precious metal. In the year 1585, for example, during the long war with Iran, the Ottoman government wanted to nearly double the money supply by ordering the mints to strike 800 *akçes* from 100 *dirhams* of silver whereas the earlier standard had been 450 *akçes* per 100 *dirham*.¹⁸ Another important reason for debasement was the so-called seigniorage. This was the revenue received by the ruler during the debasement process.

¹⁶ Pamuk, *A Monetary History*, p. 122, 136.

¹⁷ Alan Pense, “The Decline and Fall of the Roman Denarius”, p. 213.

¹⁸ Pamuk, *A Monetary History*, p. 124.

Governments desperate to increase the available money supply to cover their emergency expenses or pay their debts, however, faced a further difficulty with the coinage. This is the so-called Gresham's Law and should be explained properly.

We start with the following equation,

$$FV = x + \frac{G}{TW} \cdot P_g$$

where,

FV is the face value of the coin.

x is the cost of producing the coin.

$\frac{G}{TW}$ is the ratio of pure gold to the total weight of a coin.

P_g is the global price of gold.

The left side of the equation shows the face value and the right side the intrinsic value of the coin. This is a precarious equality. As long as the face value of the coin is greater than or at least equal to the intrinsic value, there is no problem and the coin circulates in the economy without any problem. If, however, P_g increases in response to a world-wide increase in gold prices, then the Gresham Law dynamics would be set in motion. This is best illustrated with the following numerical example: Assume that we are considering a gold coin with a face value of RM 1,000. Assume further that the cost of producing this coin is RM 50. This coin, moreover, is 90 percent pure gold. The global gold price is RM 1,000 per ounce. This would give us the following:

$$\text{RM } 1,000 = 50 + 0.9 (1,000)$$

$$\text{RM } 1,000 > 950$$

Thus, the face value of the coin is greater than its intrinsic value. Coin circulates without any problem.

Now assume that the global gold price has increased to RM 1,200 per ounce. The equation now becomes:

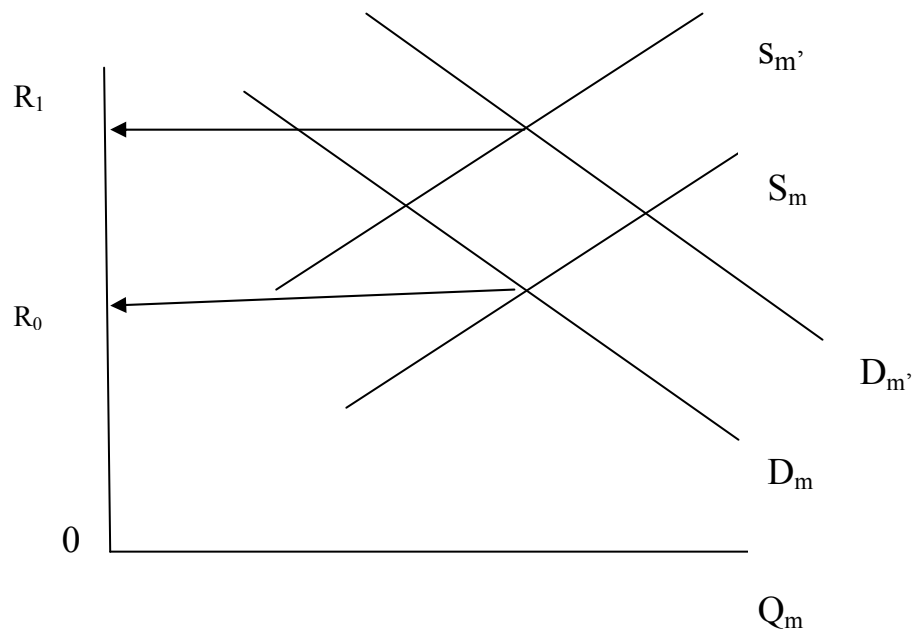
$$\text{RM } 1,000 < 50 + 0.9(1,200) \text{ or,}$$

$$\text{RM } 1,000 < 1,130$$

Thus, the intrinsic value of the coin has now surpassed its face value. It pays every citizen to melt the coin he possesses, extract the pure gold it contains which he can sell in the market and obtains RM 1,080 (intrinsic value minus the cost of production). With the RM 1,080 he obtains, he buys another gold coin and makes RM 80 profit, *ad infinitum*.

There would be two consequences of all this. First, the demand for coins would increase shifting the aggregate demand curve for money to the right. Second, the coins obtained by the speculators would simply disappear from the circulation – they would be melted away! This shifts the aggregate supply curve for money leftward. Combining the first and the second shifts gives us the new equilibrium rate of interest, r_1 . Thus, the rate of interest would increase in an Islamic country because of global gold prices – not a very desirable situation. Equally important, a substantial increase in the rate of interest, through its negative impact on investment and unemployment, can be deflationary and curb our economic growth. These dynamics are depicted in the following graph.

GRESHAM'S LAW DYNAMICS



The government, wishing to avoid a deflation, would have to respond to all this by increasing the money supply. In coinage systems, this is done by debasement, i.e., by reducing the gold content of the coin, or the G/TW ratio. The government does this by striking more coins from a given amount of pure gold. In short, the government issues new coins with lower gold content. But this too would put in motion the dynamics of the Gresham Law.

Indeed, when the public realize that new coins with lower intrinsic value are being issued, they immediately would take out their old and better coins from the circulation and hoard them. Since the new coins issued would inevitably cause inflation and bring down the fiat value, the old coins would be either hoarded or melted. Consequently, “bad money” always drove “the good” out. This is the famous observation made by Sir Thomas Gresham back in the sixteenth century. Known unfairly¹⁹ as Gresham’s Law, it is expressed as “bad money drives out the good”, and means that issuing new and lower quality coinage is actually a self defeating process. Indeed, new coins issued in order to increase the money supply to combat deflation or to cover the emergency expenses of the state, end up leading to the disappearance of the old coins altogether.

From the Islamic perspective Gresham’s Law has the additional harm that it encourages hoarding –a situation, strongly forbidden by the Qur’an.²⁰ Furthermore, unless the amount of new coins issued is much higher than the old coins that disappear, the disappearance of the old coins means a leftward shift in

¹⁹ The phenomenon was known as long ago as the fifth century B.C.

²⁰ 9: 34

the aggregate money supply, which would increase the rate of interest – once again an undesirable situation for Muslims.

Another reason which would lead to an increase in the rate of interest with coinage is the cost of production of the coinage. Each coin costs a substantial amount to produce, which includes not only the global price paid for the gold/silver that is contained, but also the actual cost of transforming the metal into coins. Moreover, seigniorage that the state always takes should also be added to this cost. In short, the price of coin (rate of interest) is formed by three elements: the global price of bullion, the actual cost of production of the coin and finally the seigniorage. By contrast, the cost of production of paper money, in comparison to coinage, is negligible. Once again, the *denarists* are invited to think about the consequences of their proposals. Do they really want a monetary system that encourages Muslims to hoard and, even worse, through the workings of the Gresham's Law ends up raising the interest rate?

Another huge disadvantage of the gold dinar is that among all the Muslim countries only Indonesia is an important producer of gold – 6.6 percent of the global production. Other Islamic countries are insignificant producers. This would put the Islamic world at the mercy of the significant producers (South Africa 11.8 percent, the U.S.A 10.4 percent, China 8.9 percent and Russia 7.2 percent).²¹ The Islamic gold dinar would give these countries quite a substantial leverage to play havoc with the monetary system of Islamic countries – if they so wish, the largest producers can collude and play with gold prices and therefore, indirectly, the rate of interest in the Muslim world using gold coins. If such speculations are possible, this would create a huge uncertainty – *gharar*.

²¹ Z. Hasan, "Ensuring Exchange Rate Stability", p. 18.

Now, *gharar* is a complicated concept. But Ibn Taymiya has shown that in a transaction involving two or more partners, mutually agreed shared risks are permitted and constitute no *gharar*, risks unshared and imposed solely on one of the partners are not permitted and constitute *gharar*. This can be considered as a corollary of the prohibition of *riba*.²²

The reason why the Islamic Gold Dinar may be subject to *gharar* and might be prohibited is that any speculation by the major producers of gold would not harm them but would harm the Islamic world. Risks would not be shared fairly by all transacting partners but only by the Islamic world. This is *gharar* of the worst sort – because we are not talking about an ordinary risk but a massive risk that would put the entire monetary system of the Islamic world in danger.

Conclusion:

We are now at a position to summarize the arguments presented above.

1. Combining the interest prohibition in the Qur'an with the rulings of Ahmad Ibn Hanbal, Muhammad al-Shaybani and Ibn Taymiya, some of the greatest classical jurists, we deduce the following position of Islam regarding money: Anything that is generally accepted by the public can fulfil the role of money. Thus money is, primarily, a medium of exchange and not a commodity. The price of this money (interest) must be zero.

2. Economic histories of early modern Europe as well as the Ottoman Caliphate have vindicated that money, indeed, is not a commodity but a medium of exchange. Economic historians have observed throughout history that the

²² M. Çizakça, "Gharar in Public Finance".

precious metal content of coins in the long run has always been reduced. Thus there is a natural tendency for money to lose its commodity character, metal content, and to progress towards being a pure medium exchange. With the advent of paper money, the intrinsic value of money approached zero. With the e-money, which we transfer billions with the click of a mouse, it has become absolutely zero. Thus, the Islamic view that money is not a commodity but purely a medium of exchange is vindicated.

3. Japan as well as several other western economies, though inadvertently, showed that with paper money it is possible to reach to a state of zero percent interest rate – hence a zero price for money, Islamic position, is possible.

4. With coinage it would be much more difficult to reach this stage. This is because; every coin has two different values. While the fiat value can be controlled by the Central Bank, the intrinsic value is beyond such control. Indeed, for the intrinsic value to be zero, the global supply of gold should increase at such a rate so as to completely balance the demand for it – not a very likely scenario. Consequently, a return to coinage would compel a country into a position where zero rate of interest cannot be achieved. This is an un-Islamic position and represents not progress but regress.

5. Throughout history governments have increased the supply of coinage through debasement. This supply could also increase when new gold or silver deposits were discovered. In short, the supply of coinage was never fixed as the *denarists* claim.

6. It follows then that with money supply constantly changing, coinage can not avoid inflation – another *denarist* claim that must be discarded. For those who

are worried about inflation in the Islamic world, the solution does not lie in the type of currency in circulation but in granting central banks autonomy from the pressures of unscrupulous and short sighted governments.

7. Introducing the Islamic Gold Dinar, despite this pretentious name, is not only un-Islamic due to its worsening impact on the rate of interest, it is also of no practical value since it cannot control inflation.

8. Introducing the Islamic Gold Dinar would create unshared uncertainty, and therefore *gharar*, at a massive scale. Islamic law prohibits *gharar*.

9. Items 4-8 above indicate clearly that introducing the Islamic Gold Dinar would be harmful for the Islamic world and therefore constitutes *mafsada*. This means that attempts to introduce the Gold Dinar might be prohibited.

10. Finally, introducing a common currency for all Muslim countries accepted throughout the world is a noble idea, providing the currency in question is made of paper, not of gold or silver.

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