

## EVOLUTION OF EURO: LESSONS FOR MUSLIM COUNTRIES

*Muhammad Anwar*

*Economic backwardness in Muslim countries is widespread despite being collectively very rich in terms of financial, natural, and human resources. Monetary problems in the form of financial dependency, inflation and speculation are main contributors to lasting economic backwardness in the contemporary Muslim countries. Some Muslim scholars and politicians are now recommending adoption of the gold coinage system in order to overcome these problems. Historically the gold coinage monetary system has been most stable among all the monetary systems practiced so far. But, despite its historic stability, worldwide acceptance of the gold coinage system is not in sight yet. In fact, only a handful of countries may be interested in adoption of the gold coinage system. Therefore, a second best solution is to form of a currency union, adoption of a single currency by a bunch of countries. European Union (EU) has recently formed a currency union by adopting a single currency called euro. Likewise, a currency union of Muslim countries based on Gold Dinar (GD) may be attempted. Euro and the GD are essentially different in character. Anyway formation of a currency union by all Muslim countries seems infeasible under current circumstances. Therefore, introduction of GD as a parallel currency in interested Muslim countries is recommended to mark a beginning towards formulation of a GD currency union of Muslim countries.*

### **Financial Dependency, Inflation and Speculation in Contemporary Muslim Countries**

Financial dependency of Muslim countries is reflected in capital mismanagement and capital flight from Muslim countries; need for foreign borrowing to finance deficits despite damaging conditionality imposed by International Monetary Fund (IMF) and denial of any role to Muslim countries' currencies for international trading and capital transactions. Muslim countries are also victims of rampant inflation resulting from financing government deficits by printing money, money creation through unbridled banking loans and repeated devaluations in response to pressures from creditors. Above all, speculative currency trading encouraged by the prevalent exchange rate systems has crippled monetary systems and led to further economic backwardness in Muslim countries.

The Muslim countries have accumulated huge financial reserves abroad. Domestic savings deposited into the banks are not utilized within the Muslim countries; they are exported to foreign countries on the pretense of diversification of risks and unavailability of profitable projects at home. In addition, whatever foreign countries pay to obtain products from Muslim countries (e.g. Arab oil for their energy needs) with one hand is grabbed

away with the other hand in different forms. For example, as demonstrated by Abdul-Rasool (1980, 392), most of the investments of the Arab surplus countries are placed abroad in European and US financial markets in the form of liquid assets. Ironically, these assets are exposed to all forms of monetary, commercial, non-commercial and political risks. Monetary and commercial risks of inflation, exchange rate fluctuations and serious decline in the value of the dollar<sup>1</sup> erode purchasing power of those assets (Ali, 1980, 315). There are numerous examples of losses to the assets of Muslims abroad, particularly subsequent to the September 11 attack on the World Trade Center in New York, resulting from freezing and confiscation of Muslims' assets. In addition, risks of embezzlement, nationalization, hazards of war and civil disturbances (Abdul-Rasool, 1980, 392) are also real.

Remaining payments made for products and also credits given to Muslim countries are drawn back against counseling, preparing feasibility studies and sale of technology for mega projects in the countries. Any capital invested in domestic markets of Muslim countries is also channeled into the international foreign markets (Morsi, 1980, 425). In a nutshell, bulk of the financial capital of Muslims remains abroad under foreign control. Repatriation of the capital for investment and utilization in the Muslim economies (Dajani, 1980, 101) is essential to address economic backwardness in Muslim countries directly rather than through financing channels controlled by foreign powers.

Domestic owners of financial wealth feel that the purchasing power of their assets is not sufficiently guaranteed at home and so they prefer to buy foreign assets. Similarly, purchases of domestic assets by foreigners are also discouraged, even when rate of return in Muslim countries is higher than the rates abroad. In sum, capital outflows take place irrespective of the real characteristics in the Muslim countries (Medio and Sakabani, 1980, 353).

In addition, residents can now hold deposits in foreign currencies accounts due to global tendency towards financial liberalization. Since foreign currency deposits are mostly reinvested in the international markets, the foreign banks have been able to offer more attractive interest rates on deposits in domestic currency. This has further compounded the problem of capital drain from the Muslim countries as Muslim governments are deprived of much needed remittances and deposits denominated in foreign currencies (Nashashibi, 1980, 112). Basically bulk of the surpluses of Muslim countries goes into direct control of foreigners who are not interested in fostering economic development in the Muslim countries. On the contrary, if their interest conflicts with the objectives pursued by Muslim countries, they will not hesitate to use force to prevent the achievement of the objectives (Hussein, 1980, 141) as currently done on the pretense of campaign against terrorism.

Despite owning huge capital, Muslims are obliged to turn to the world market to borrow money on terms imposed through financial markets in control of the foreign powers. Weak and largely agrarian Muslim countries rely on foreign borrowing to survive the economic problems that has created a situation in which further borrowing is necessary to repay existing debts. National economies have lost their credit-worthiness in the international money markets. In fact, several Muslim countries have exhausted the possibility of financing their deficits through the commercial international banks and are being forced to seek credit from the International Monetary Fund (IMF) with conditionality (Gunter, 1980, 63). The IMF conditionality not only forces painful adjustments, they have invariably lead to further deterioration in already crippled economies<sup>2</sup>.

Monetary dependency is particularly evident in the determination of the type of currency that can be used for settlement of payments between the Muslim countries and their counterparts. During the post-Second World War period, the Bretton Woods agreements effectively established the dollar as the international medium of exchange. The dollar has been used by USA as a weapon to control international financial and monetary relations. The dollar is still the world currency. For this reason, the crisis of the international monetary system persists, with its negative effects on foreign exchange, trade and finance among countries. Muslim countries, like other developing countries, continue to suffer from their dependency on the dollar for international transactions. Unfortunately, because of internal hostilities among Muslim countries, they trade far more intensively with the foreign countries than with each other (Medio and Sakabani, 1980, 355-56).

Mismanagement of money and consequent inflation are symptoms of a more basic disease. Monetary expansions by governments and financial institutions leading to accrual of seigniorage indicate that they have tried to do good by wrong methods. Friedman rightly states that “When you try to do good by using other people’s money, two things follow: In the first place, nobody spends other people’s money as carefully as he spends his own. The result is waste and the tendency towards fiscal crisis. But in the second place nobody can spend other people’s money without taking it away from them” (1984, 42).

Since 1973 the world monetary system has operated on the basis of flexible exchange rates. Under this system, currency values are no longer determined by the flow of international trade in goods but by movements in financial capital (Owen and Cole, 1999, 85-86). This fact strongly encourages speculative activity and has led to impairment of domestic currencies of Muslim countries. For example, currency traders motivated by greed were responsible for depreciation of Malaysian and Indonesian currencies in 1997<sup>3</sup>. There is no doubt that currency trading has caused irreparable damage on the economies of the Muslim countries whose currencies were devalued by the currency traders. In several instances, according to Mohamad (2000, 56), the financial and economic turmoil due to devaluation was accompanied by massive unemployment, shortage of food and fuel, demonstrations, riots, the burning of business premises, looting, rape and murder. The current system of capital investment and flooding of world reserves, especially dollar, “makes it absolutely impossible for either floating or fixed exchange rates to function satisfactorily” (Triffin, 1980, 46).

A large proportion of domestic funds are used to finance external trade. The international capital flows are transacted only in convertible currencies (dollar, euro, etc). Unfortunately none of the currencies issued by the Muslim countries enjoys convertibility status. If a currency is convertible then non-residents can exchange the surplus they earn in any particular currency against another currency at the official exchange rate. Hence, Muslim economies are obliged to secure (through exports or borrowing) enough foreign exchange to conduct international transactions. Refusal of foreigners to deal in currencies of Muslim countries and necessary multiple currencies conversions undertaken by the Muslim countries erect formidable barriers to competitive trading of their goods.

Therefore, search for a more suitable monetary system is a must in order to tackle the problems of capital mismanagement, capital flight, inflation and speculation in the presence of current exchange rate systems. An historical account of monetary regimes is presented next in order to identify a suitable monetary system that could free the world from these problems.

## **A Brief Review of Monetary Systems**

In the real world, prices do change and they change unpredictably as they assimilate information resulting from changes in events unexpectedly. People want stable medium of exchange with least uncertainty about future prices that breeds inflation and speculation. The uncertainty would be minimum “if the risk of making mistakes in anticipating future prices in one direction is balanced by the risk of making mistakes in the other direction” (Hayek, 1984, 33). Such money would shield people from the harms inflicted by inflation and speculation. .

Basically world has been using either gold money or a fiat money in recent centuries. Different forms of gold money standards prevailed in major countries prior to adoption of fiat money standard in early 1970s. Gold standard, particularly gold coinage system, had been found to be most stable so far. For example, when USA returned to a gold standard in 1879 the wholesale price index decreased to its 1861 level, the period before the gold standard was suspended (Gustin, 1984, 137).

According to Owen and Cole (1999, 55) major industrialized countries had all moved to a gold standard by 1890. In fact, period between 1879 through 1914 is commonly referred to as the ‘Golden Era’ when the classical gold standard was in effect without a central bank in USA (Gustin, 1984, 137). Under the gold standard, each country’s supply of money and credit varied, in principle, according to the inflow and outflow of gold as determined by their balance of payments, thereby maintaining stable exchange rates. The system was essentially managed by the UK, dominant industrial and financial power in that period. This was a period of “general economic stability and prosperity” (Owen and Cole, 1999, 55). Unfortunately, the economic upheaval caused by the First World War destroyed the gold money system.

At least, three main forms of gold standards have been in practice: gold coinage standard, gold bullion standard and gold exchange standard. A gold standard can operate alone or in combinations with other forms (like paper money). All forms of gold reduce, to varying degrees, state control of the money supply. State control of money supply has been the root cause of inflation and speculation.

Under gold coin system, national currency was pure gold minted into coins. Sometimes, part of the money supply was in gold coins with the rest convertible into gold coins. The coins circulated as legal tender without government intervention and, therefore, without devaluation and inflation.

There are no gold coins under the gold bullion standard. National currencies were fixed in terms of gold so that gold was the monetary base. This standard requires that parity exists between the number of gold bars and paper currency issued by a monetary institution. As the gold bullion standard supported the paper currency money standard, it was susceptible to government manipulation. Paper currency backed by gold was also problematic because in times of over issue of bank notes, frequently to finance wars, inflation ensued and convertibility of banknotes into gold was inevitably suspended.

Under the gold exchange standard, gold was used as medium of exchange between different currencies in the international monetary system. Under this standard, at least one national currency (dollar) must be fully convertible into gold at a fixed price. Other currencies were defined in gold through the currency (dollar) fully convertible into gold. In addition, central banks had to maintain the value of their currencies with other gold standard currencies in the foreign exchange market. Under international convertibility, balance of payments accounts were settled using gold. However, excessive balance of payments flows would destabilize a domestic economy due to changes in the domestic money supply resulting in government and intervention inflation (Gustin, 1984, 137).

According to Gustin (1984, 137-141), most countries were forced to abandon the gold standard during the First World War in order to protect their gold reserves. However, by 1927, most other countries had returned to gold system accepting both pound and dollar as key currencies convertible into gold at fixed rates. Other currencies were pegged on these two currencies. But, due to the depression and the resulting disruption in the international flows of gold, over 40 countries suspended gold standards by 1932 as protection of international reserves became difficult due to significant fall in foreign exchange earnings of exporting countries. For example, when Britain abandoned the gold standard in 1931, the USA experienced a substantial gold drain as many foreign countries converted their dollar reserves assets into gold. In 1934, Gold Reserve Act was passed in USA whereby gold coinage was terminated and, instead, international gold bullion standard was established to serve as the new backing for paper currency. The gold bullion standard gave way to gold exchange standard created under the Bretton Woods agreements in 1944 because of pre-World War II protectionist trade policies, controls on capital movements, exchange controls and competitive currency depreciations experienced under the gold bullion standard. The Bretton Woods agreements created a system of fixed exchange rates that could be changed only with the consent of the International Monetary Fund created under the Bretton Woods Agreements. Under the new standard, exchange rates were pegged to the dollar. So, unlike previous gold standards, all currencies were fixed in relation to the dollar. As a result, the dollar, rather than gold, acquired the status of international reserves and medium of exchange for international trade transactions. But, flooding of dollar reserves by USA made it absolutely impossible for the fixed exchange rates to function satisfactorily (Triffin, 1980, 46). Eventually, President Nixon terminated convertibility of the dollar into gold in August 1971 and countries of world moved to the floating exchange rates system as of March 1973 (Pentecost and Poeck, 2001, 6).

It is evident that departure from the gold standard has triggered high inflation and interest rates, low productivity, and uncertainty of monetary policy in the United States. Therefore, dismayed by the fiat money system, United States Congress recently established the Gold Commission in 1980 to determine possibility of returning to a gold standard because (Gustin, 1984, 135) only a gold standard can be trusted to stabilize prices and remedy the inflation problem<sup>4</sup>. Among the gold standards, gold coinage system was most stable and least problematic. This justifies moving forward with the gold dinar money system. Knowing that world is not ready for universal return to a gold coinage system, attempts can be made to establish a currency union of gold dinar. In this regard, advantages of currency unions are explored in the next section before tracking formation of euro currency union by European Union and evaluating feasibility of gold dinar currency union of Muslim currencies in later sections.

### **Advantages of Currency Unions**

If a bunch of countries agree to use a single currency as their legal tender then the countries have formed a currency union. Advantages of a common currency for member countries are many including efficiency, transparency, stability and reduction in currency speculation.

The advantages of forming a currency union are similar to those of introducing a monetary exchange system over the barter system (Basevi and others, 1978, 39). The introduction of money in a barter economy has comparative advantage in transmitting information and reducing uncertainty. A currency union frees resources previously absorbed by economic agents in finding appropriate exchange rates between different currencies like the introduction of money frees resources used for finding appropriate exchange rates between goods. In other words, a common currency brings efficiency by eliminating transactions costs resulting from money changing. In a currency union there is no need to calculate prices in different currencies and to hold cash balances in different currencies.

Currency transaction costs on intra-union trade are eliminated as companies save costs due to exchange rate spreads, hedging and maintenance of their exchange rate departments (Owen and Cole, 1999, 66). It reduces information costs, because with common currency it is easier to compare prices within member countries and there is no need to collect information about present exchange rates, future exchange rates and exchange market regulations in the member countries. A common currency also eliminates the risks connected with nominal exchange rate changes and exchange controls. Thus a common currency has a potential to improve the international allocation of financial capital (Lehment, 1984, 248-49).

The flexible exchange rate regime, assumed since 1971, has increased importance of currencies as financial assets, rather than as a medium of exchange. So maintaining a separate currency has become more costly because currency is subjected to unpredictable speculative attacks irrespective of the strength of economic fundamentals in a country<sup>5</sup>. The costs of maintaining a separate currency will be eliminated under a currency union.

Money has a stable purchasing power if price of any commodity, in terms of the money, is as likely to rise as to fall (Hayek, 1984, 33). A single currency with stable purchasing power would serve the Muslim countries better as a store of value than the existing arrangement of many currencies. A single stable money is better than multiple currencies, even as a medium of exchange, as socially unproductive transactions between currencies are entirely eliminated including the exchange risks that cannot be eliminated by forward operations (Basevi and others, 1978, 39).

Functioning of economic system would be more transparent because it is much easier to compare the prices when all prices are quoted in the same currency. Thus, it becomes difficult for producers of, for example, automobiles to charge different prices when a single currency allows consumers to readily compare prices across countries. Similarly, banks cannot practice unreasonable rates on deposits and loans as elimination of currency risk due to common currency encourages savers and investors to seek competitive rates elsewhere. It also makes labor unions to act sensibly otherwise labor costs comparability would encourage employers to establish plants in other locations (Eichengreen and Frieden, 2001, 7).

High volatility, in the presence of flexible exchange rate regime, of a currency undermines the liquidity value of money. Stability in exchange value of a currency makes a currency liquid and acceptable as a means of payment. Higher the exchange rates fluctuations, lower the stability of the currency (Owen and Cole, 1999, 86-87). Establishment of a currency union should eliminate speculative flows among participating countries and the cost associated with their control. It might also reduce speculative flows between the currency area and the outside world. Membership of a currency union offers the possibility of stabilizing inflation expectations (Jacobsen and Tomann, 2001, 79) and so reduces currency speculation.

The above advantages of a currency union are expected whether the common currency is of gold standard or a fiat standard. European Union has established a currency union of a fiat currency, euro, as part of their Economic and Monetary Union (EMU) project completed recently. But, Muslims are interested in a gold dinar currency union. Establishment of euro as a single currency is reviewed next before discussing feasibility of establishing a gold dinar currency union of Muslim countries.

## **Background and Character of Euro**

Formation of euro by the European Union can be best understood within the context of the grandeur Economic and Monetary Union (EMU) project that was completed with introduction of euro, a common currency for the European union. Important steps taken for establishment of EMU are reviewed here in order to track formation of euro and also to draw distinction between euro and the GD, a currency union proposed for Muslim countries.

Dollar inflation was the primary economic motivation and compulsion to seek a European substitute for the dollar. In fact, there was no justification for creation of a single European currency if the unpredictable fluctuations in the dollar inflation rate did not occur (Klein, 1978, 84). Speculative crisis experienced by the European countries in 1992-93 strengthened that motivation and accelerated the move for adoption of the common currency, euro, within the framework of EMU. Primary aim under the EMU was to guarantee price stability through monetary policy conducted by an independent European central bank (ECB) using a single European currency (Caravelis, 1994, 23).

Most European countries confronted serious economic difficulties after World War II. Demand for imports, especially for goods from the dollar area, exceeded the limited supply of exports beyond their overall balance of payments capacity. Therefore, all European countries struggled to earn surpluses in gold, dollar or any currency convertible into dollar, without success. So it was realized that a joint European effort is essential to overcome balance of payments difficulties of individual European countries. This realization led to formation of the European Payments Union (EPU) by 18 countries on 1 July 1950. The EPU provided some relief as all bilateral deficits and surpluses among the European countries were netted out into one overall net monthly position with the EPU (Gros and Thygesen, 1992, 4). These balances were netted in terms of the European Unit of Account (EUA) adopted by the EPU. The EUA, that became the European Currency Unit (ecu) later, was defined as the gold content of one dollar, the international monetary standard at the time.

However, a new problem emerged out of this arrangement. Countries becoming EPU area creditors desired settlement in gold, or dollars to finance imports from other countries. But, the EPU area debtors were interested in obtaining credit from the EPU so that they could keep gold and dollar reserves. Consequently, a new institution, European Monetary Agreement (EMA), succeeded the EPU in 1955 that offered financial safety nets to participating countries (Gros and Thygesen, 1992, 8). In addition, meeting of the foreign ministers of the European Coal and Steel Community (ECSC) held on 3 June 1955 favored adoption of economic policy route to achieve European integration. This led to establishment of European Common Market and European Atomic Energy Community incorporated in the Treaties of Rome signed on 25 May 1957 (Owen and Cole, 1999, 21-22). Later, Hague summit in 1969 decided to initiate the EMU for Europe (Pentecost and Poeck, 2001, 6). Therefore, in October 1970, Werner report recommended integration of Europe's capital markets, setting up a European central bank and fixing irrevocable exchange rate parities among the European currencies for establishing a common currency (Owen and Cole, 1999, 29). The Werner recommendations were not implemented, however.

The Bretton Woods system of par values, which had provided framework for holding European exchange rates vis-à-vis dollar within fluctuation bands of plus or minus 2 percent, collapsed in 1971. The floating rate regime that replaced the Bretton Woods system led to great volatility in exchange rates. Consequently, the European Community resolved to hold their currencies within 2.25 percent bands in an attempt to control exchange rate fluctuations between European currencies (Owen and Cole, 1999, 29). This was the so-called snake arrangement. The snake was not very successful in maintaining exchange rate stability.

This motivated the EU members to resurrect the idea of having a single European currency that would be independent of American influence and also would serve to deepen European economic integration. Thus, process to achieve EMU began with the establishment of the European Monetary System (EMS) in March 1979, which “made exchange rates fixed but adjustable between member states” (Pentecost and Poeck, 2001, 7). The EMS was a pseudo exchange rate system, with three institutional features: a fixed but adjustable exchange rate system of European currencies, known as the Exchange Rate Mechanism (ERM); the European Monetary Cooperation Fund (EMCF) set up to facilitate the circulation of credits between central banks of European countries; and the European currency unit (ecu) to serve as a unit of account (Pentecost, 2001, 21-23). Immediate reason for the establishment of the EMS was the “depreciation of the dollar and its impact on exchange rate stability among the European currencies” (Gunter, 1980, 60). Therefore, crucial objectives of the ERM were to create a zone of exchange rate stability and to reduce inflation in the EU economies.

Subsequently, Single European Act was agreed in December 1985 for advancing European integration further. It identified about 300 impediments to the free movement of goods, people, services and capital (Owen and Cole, 1999, 34) and called for removal of controls on the movement of goods, capital and persons within the European Union.

In this context, the Delors Committee was formed in June 1988 that recommended a three-staged process, similar to Werner report, in April 1989 for completion of EMU (Owen and Cole, 1999, 34-35). In December 1991, the Maastricht Treaty, echoing the Delors Report and the Werner Report, presented plans and schedule for a three-stage transition to the EMU. Stage I, beginning in 1991, put emphasis on coordinating national economic and monetary policies (Owen and Cole, 1999, 35) by elimination of Europe’s remaining capital controls, the accession of all members to the ERM, and hardening of the exchange rate commitment (Eichengreen and Frieden, 2001, 4).

In stage II, beginning on 1 January 1994, member states were to reinforce the independence of their national central banks and strive to satisfy an eligibility criteria, for participating in stage III. The criteria were designed to facilitate harmonization of their economic policies and to distinguish member states prepared to live with the consequences of a single monetary policy. The criteria covered inflation rate, long-term interest rate, devaluation, government budget and national debt (Pentecost, 2001, 26-27). The criteria required the countries to maintain inflation within 1.5% of average of the three lowest inflation countries; long term interest rates within 2 per cent band from the interest rates in the three countries with least inflation; exchange rates within the permitted bands of the ERM for at least two years; a budget deficit to remain up to 3% of GDP and gross national debt up to 60% of GDP (Owen and Cole, 1999, 37). Thus, free movement of capital and payments, prohibition of monetizing public debt and financing public deficits, nominal convergence and reduction of public deficits, independence of national central banks and freeze on the composition of the ecu basket were accomplished (Caravelis, 1994, 3) in stage II.

In addition, a European Monetary Institute (EMI) was created in stage II, as an antecedent of the European Central Bank (Eichengreen and Frieden, 2001, 4) to oversee move to a single currency. A European System of Central Banks (ESCB) was set up to assume all monetary functions and to coordinate national monetary policies (Owen and Cole, 1999, 35). In December 1995, the European council meeting adopted recommendations of the EMI for merging individual currencies into a single currency.

At the start of stage III on 1 January 1999, exchange rates among currencies of the participating countries were fixed irrevocably with a view to creating a single currency. Thus formally abrogating monetary policy autonomy at the national level (Cohen, 2001, 180).

The intergovernmental conference in May 1998 declared eleven (out of twelve)<sup>6</sup> members eligible to move on to stage III as of 1 January 1999 (Owen and Cole, 1999, 39) when the EMU was launched officially. An autonomous European Central Bank (ECB) replaced the EMI on 1 June 1998. On 1 January 1999, the ECB gained control over European monetary policy (including interest rates and money supply) for the Euro-zone (Howarth, 2002, 89). Euro currency banknotes and coins were issued on 1 January 2002 that symbolized completion of the EMU with the establishment of euro as a single currency for the European Union.

The ecu<sup>7</sup> was born in 1974 as the European Unit of Account (EUA)<sup>8</sup>. The European unit was also defined as a basket of fixed amounts and initially, on 28 June 1974, one EUA was set equal to one Special Drawing Right (SDR) of the International Monetary Fund that was equivalent to 1.2 dollars. Composition of the basket representing ecu was based on economic criteria taking into account the share of each country in the GDP of the Community, its share in intra-Community trade and its share in the EMS financial support system. However, since 1979 they serve only as broad indicators<sup>9</sup>. The eua was renamed as European Currency Unit (ecu) when the EMS was created in 1979 (Gros and Thygesen, 1992, 203-4). National central banks under the EMS had to deposit (through automatically renewable three-months swaps) 20 percent of the (approximate) market value of their gold and dollar reserves with the European Monetary cooperation fund (EMCF) to receive corresponding amounts of ecus, marking origin of the 'official ecu'. These official ecus could be held only by central banks and, since 1985, by other officially designated institutions. The way in which these official ecus are created shows that they were neither regarded as a currency nor a reserve asset. The ecus were primarily a bookkeeping device for exchanges of the underlying dollar and gold reserves (Gros and Thygesen, 1992, 207-8). However, the private sector started using the ecu (convertible into component currencies) as a convenient hedge against exchange rate variability during the first half of the eighties because of the importance of the "diversification effect inherent in the basket nature of the ecu" (Gros and Thygesen, 1992, 214).

The character of the ecu changed as the stages of EMU unfolded. In the first stage, the ecu remained a basket currency, composed of fixed amounts of the twelve currencies. The ecu had no independent existence. It originated when an initial supply of ecu by the European Fund for Monetary Cooperation (EFMC) was created against 20% gold and 20% dollar deposits by the member countries. Second, the ecu did not have an independent value because it was a basket of twelve currencies and its value changed as the exchange rates of its component currencies changed (Caravelis, 1994, 6). After ratification of the Maastricht Treaty, however, change in currency composition of the ecu basket was prohibited. The frozen ecu coincided with the second stage of EMU. From the start of the third stage the value of the ecu was irrevocably fixed so the ecu itself acquired status of a new currency (Caravelis, 1994, 4), called euro.

### **Gold Dinar Currency Union: Opportunities and Obstacles**

Potential advantages of a GD currency union for Muslim countries are tremendous. But, unfortunately, establishment of the currency union under current circumstances is not feasible due to presence of insurmountable economic and political obstacles. Anyway, relevant advantages and obstacles are reviewed here to gauge viability of GD currency union of Muslim countries.

A GD currency union of Muslim countries would provide stable money serving as excellent medium of exchange that would minimize speculation, promote trade and dilute socioeconomic evils (Meera, 2002, 79-87). Basic reasons for search of a stable currency are to protect assets from damages inflicted by currency speculations and loss of liquidity value due to volatility in exchange rates.

Muslim countries offer a wide diversity of production and trading patterns. Some with their oil wealth concentrate on trade and services. Others concentrate on production of primary commodities, mostly agricultural. According to Williamson (1980, 16), at least three recent studies have demonstrated that trade volume of developing countries is significantly affected by instability of exchange rates. Therefore, stability in exchange rates due to elimination of exchange costs; exchange rate risks and exchange controls through a common currency would promote beneficial trade.

The currency union would shield financial assets of Muslims from the impact of currency devaluation and inflation (Dajani, 1980,84) if the assets are held in GDs rather than dollar as GD would be a much more stable currency than dollar and euro. Similarly, loss to Muslim individuals, institutions and countries due to frequent freezing of deposits by foreign powers to serve their ulterior motives would be checked provided the deposits are recalled and deposits in a neutral and stable standard of value, GD, at home. These are invaluable potential benefits of GD currency union, as then the capital of surplus Muslim countries would be reverted back for investment in deficit Muslim countries. Movement of private and public capital from some surplus countries to deficit countries would occur only if economic environment in Muslim countries becomes conducive to profitability (Nashashibi, 1980, 147-48).

Currently, national currencies of the Muslim countries have lowest recognition in the international markets and for settlement of international trading and capital transactions. Dollar has almost zero intrinsic value and euro is backed by 20% gold reserves while GD would be 100% gold carrying a full intrinsic value. This may encourage people with surplus funds from Muslim as well as non-Muslim lands to transfer their deposits from the dollar and euros into GD deposits. Such move may reverse the trend of capital movement from the powerful foreign countries into the Muslim countries. Thus, the GD will gain international recognition. Each country in the union will enjoy proportionate benefits of the currency recognition. So, emergence of the GD currency union of Muslim countries, as rival to the dollar and euro in the international money markets, would effectively revert resources (Christie and Fratianni, 1978, 6) to the Muslim world due to greater perceived credibility of GD compared with fiat dollar and euro currencies.

Muslim countries seek to solve their problems and overcome difficulties individually without an ummatic reference. The attitude of overly nationalistic tendencies needs to be addressed. In case of European Union, “same set of countries is engaged in negotiations over defense, social policy, competition policy, and, of course, monetary policy, and the way those negotiations are structured and institutionalized means that failure to reach agreement on one issue places agreement on the others at risk. The fact that countries stand to lose all the grounds they have made from cooperation on a variety of issues has thus tended to lock in agreement on monetary matters” (Eichengreen and Frieden, 2001, 16). Lack of such interdependence among Muslim countries is a formidable barrier in the way of forming a successful GD currency union. Every Muslim country must give up the idea of doing everything in isolation from other Muslim countries, otherwise a successful GD currency union cannot be established. Cohen (2001, 179-196) contrasting the experience of three surviving monetary unions (the CFA Franc Zone, the East Caribbean Currency Area, and the Common Monetary Area) with three that failed (the East African Community, the Latin Union, and the Scandinavian Union) concludes that even though economic and organizational factors matter, the success does not occur without political cooperation under a strong leadership. Strong cooperation and leadership are certainly lacking as evident from general failure of the Organization of Islamic Conference (OIC) to achieve its objectives.

A country with its own money issued by a central bank under its own control always has the power to finance budget deficit by printing money rather than selling its debt obligations in competition with other assets. Most Muslim countries rely on inflation tax (seigniorage) because their fiscal systems are poor and gravely inefficient. Such countries are not good candidates for joining the union. Similarly a country that has a government debt, most of its fiscal activity is engaged in servicing the debt (Owen and Cole, 1999, 110). The money creation power is necessary to command real resources without levying formal taxes, to fight economic depressions or even to fight wars. This is a power that governments typically exploit to the maximum. To abandon this power, in the name of GD currency union, is to accept a quite significant curtailment of the state's freedom of action in crisis situations (Williamson, 1980, 18).

All Muslim countries are in the category of developing countries. Joining the GD currency union means acquiring (purchase) sufficient gold to mint that into GD coins. Can the developing Muslim countries afford to bear the costs necessary to replace national fiat currency by proposed GD currency? Most Muslim countries have accumulated debts from the foreign countries that are denominated in either dollars or in the currencies of the donor countries. Of course, the Muslim countries will have to manage reserves to pay and service those debts. Formation of the GD currency union will raise price, to be settled in foreign currencies, of gold in the world market due to worldwide increase in demand for gold. That means need for additional reserves for adopting the GD currency union. Can the debt-ridden Muslim countries afford necessary reserves?

Suppose that country X has enough reserves to replace its fiat currency with gold dinar currency. The replacement can take place against the high-powered money issued by the central bank, but, what about the expansion of money supply beyond the high-powered money? The high-powered money has expanded manifold because of bank lending practices under the prevailing fractional reserve banking system. Is it possible to replace all the existing money supply by GD currency to allow debtors and creditors, carrying fictitious amounts of national currency in their accounts, to do business as usual? Obviously none of the Muslim countries has the ability to perform this feat of replacing all current fiat money supply with equivalent gold money. In fact, most Muslim countries already depend on institutions like IMF and the World Bank to meet their financial needs. How can they afford to amass additional resources needed to embark on a currency union under the proposed gold standard? If certain countries could afford it, even then, is it possible for the Muslim countries so dependent on Europe, USA and their effigies in the form of IMF and World Bank to break away and chart an independent course for managing their economic vows? Recent line-up of Muslim countries behind USA for lambasting and shattering their own citizens in Afghanistan, Pakistan, Palestine and elsewhere provide enough proof of the hurdles in the way of forming a successful GD currency union of the Muslim countries.

In sum, call for creation of a GD currency union of Muslim countries is backed up by sound economic arguments. The GD will provide a strong and stable currency capable of assuming a prominent place among the major world currencies. It would shelter the funds of Muslim countries from many losses including the periodic currency devaluations that are now affecting their currency deposits in foreign countries. However, formation of the GD currency union of Muslim countries is not viable because of factors such as: variety of animosities among Muslim states, lack of political will, lack of indigenous resources to tackle own problems, impracticality of replacing fiat national monies with equivalent amount of GDs, dependence on foreign powers, and fears of reprisal from USA and the West. Therefore, a parallel currency approach is recommended in the next section to, at least, start a process of forming a GD currency union of Muslim countries.

## **Gold Dinar Currency Union Using Parallel Currency Approach<sup>10</sup>**

Introduction of the GD currency means using the currency as a standard of value, unit of account, store of value and means of exchange. It is obvious from the above discussion that adoption of GD to perform all these functions of money, by a single or a group of Muslim countries, in one shot is not feasible. However, gradual movement towards that goal is viable.

The gradual movement may be either market-based or institutions-based. European Union used institutional approach to establish the euro currency union. It was practical for the European Union to do so because a vast network of institutions among the European countries was in existence. Secondly, European Union was interested in combining their national currencies into a single fiat currency put under the control of a central bank. Thus, institutional approach towards a common currency (euro) made perfect sense. In case of Muslim countries, institutional network suitable for establishment of a common currency does not exist. In addition, their interest is in adoption of a common gold currency, not a fiat currency. The gold coinage system can function perfectly without assigning any role to a monetary institution. Therefore, a market-oriented approach, called parallel currency approach, is recommended that would facilitate establishment of the GD currency union of Muslim countries in due course. Parallel currency approach refers to a situation whereby various nations permit use of a new currency along side their existing national currencies (Pentecost, 2001, 18). Thus, adoption of GD requires one major political decision on the part of each government: to permit their residents to use and to hold GDs in competition with national money. The GD will only work if it were declared legal tender by the national governments, so that it could be used to pay for purchases and settlement of debts. The GD may be launched as a parallel currency simultaneously at the national as well as international fronts. However, economic agents operating in the market place will determine its success (Basevi and others, 1978, 41).

Use of GD as a unit of account and, partially, as means of payment and store of value in international transactions may be initiated. For example, it has only been possible to purchase oil with dollar until today. This creates a guaranteed demand for dollars. "If the oil-producing nations were to ask for their oil payments in the form of GDs, much of the strength and purchasing power that the dollar gains from being the oil-producers' currency of choice would now switch to an Islamic gold backed currency" (Muhammad, 1998, 1-2, part II). The GD will primarily be first used internationally by those companies and individuals who are most active in trade, travel and capital transactions between the member countries and who face particularly high costs of information exchange and portfolio management when entering into international transactions. The GD will spread as a store of value mainly in those member countries in which high rates of inflation have left least money and exchange rate illusion (Vaubel, 1978, 117-119).

In making their currency choice, economic agents weigh usefulness of each currency as standard of value, stores of value and means of payments. Money with lower transactions is more efficient as a means of payment (Vaubel, 1978, 114-115). The attractiveness of a money as a store of value depends on risk and yield. The public will choose the best money, presumably the one that is most convenient because it offers the most stable purchasing power (Gros and Thygesen, 1992, 329). Markets will swiftly adopt the GD currency if the gains from use of GD currency are deemed real. Thus, 'good money (GD) will drive out the bad (fiat) money' through working of the market mechanism. Use of GD as a medium of exchange in a domestic economy will be slow as residents are in the habit of using their national currencies for a very long time and breaking away from old habits takes time. Thus a process of currency substitution will see a gradual displacement of national currencies by GD. If the GD is sufficiently more attractive then it will drive the national currencies out of circulation faster.

Until that happens, governments could continue to collect seigniorage by maintaining their individual national currencies while obtaining major benefits of a unified currency area (Klein, 1978, 85).

## **Concluding Remarks**

Both the euro and gold dinar (GD) currency unions are result of experiencing problems of financial dependency, inflation and speculation<sup>11</sup> and consequent realization to shelter economies of member countries from their harmful effects. However, euro and GD are different in character as their intrinsic values vary. Euro is a fiat currency backed by 20% gold and 20% dollar reserves for imparting credibility and stability to the euro while GD would be 100% gold currency. Euro has been adopted as a common currency by 12 states having similar socioeconomic structures. But, adoption of GD is proposed for more than 54 states with divergent socioeconomic and political structures<sup>12</sup>. Euro was gradually adopted through institutional reforms spanned over several decades. The euro is under control of the ECB for conduct of monetary policies to influence economic events in the member countries. But, GD would be immune from such manipulations as its value will be determined purely by market variables.

The Central Bank of Europe earns seigniorage, the difference between face value and intrinsic value (Anwar, 1987, 295) by issuing euros in order to achieve economic objectives using monetary policy. Countries in the GD currency union will be deprived from such privilege. Banking community operating on the basis of fractional reserve system will continue to earn seigniorage through their lending operations in the euro as well as in the GD areas. The banking seigniorage, a potential threat to a stable money, can only be stopped if banks are required to operate on the basis of 100% reserves.

In case of euro, several institutional arrangements paved the way for establishment of euro currency union due to the EMU project while Muslim countries can hope to achieve economic union on the heels of the GD currency union leading to a monetary union.

Monopoly of dollar has already been challenged with the emergence of euro. Introduction of GD currency union would further reduce hegemony of dollar rendering the international monetary system more competitive. In other words, creation of a single currency of Muslim countries would create a counterweight to the dollar and euro that, in turn, would lessen the effects of American and European policy choices on Muslim countries.

Unfortunately, a gold dinar currency union of all Muslim countries is not viable at present. Consequently a parallel currency approach has been recommended to initiate move towards establishment of the currency union. However, countries confident of establishing GD currency union in one shot may attempt to form sub-regional common currency areas comprising countries with similar problems, priorities, traditions, structures and relatively homogeneous thinking. For example, adoption of GD currency union may be independently tried by the existing sub-groups of Muslim countries including the Developing-8 (D-8) comprising Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan and Turkey); Gulf Cooperation Council (GCC) comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates; and Economic Cooperation Organization (ECO) comprising Iran, Pakistan, Turkey, Afghanistan, Azerbaijan, Kazakhstan, Kirghizia, Tadzkistan, Turkmenia, Uzbekistan. The GCC and ECO have advantage of geographical closeness while, on the other hand, the D-8 consists of countries that are at a relatively advanced stage of development.

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**Notes :**

<sup>1</sup> Dollar means US dollar throughout the study.

<sup>2</sup> See Mohamad, (2000, 19-26) for a detailed account of consequences of IMF conditionality.

<sup>3</sup> Speculators' modus operandi in Malaysia has been elaborated by Mohamad (2000, 31-38) and Meera (2002, 44-51)

<sup>4</sup> Unfortunately, the gold commission has failed to reach an agreement for return to a gold standard.

<sup>5</sup> Even the powerful countries of the West are not immune from the harmful effects of speculation as is evident from 1992-93 episodes in Europe. In fact, IMF has conceded "Even countries that succeeded in maintaining sound economic fundamentals can find their currencies vulnerable to strong exchange market pressures triggered by currency depreciation in other participating countries" Caravelis (1994, 84).

<sup>6</sup> Greece, the 12<sup>th</sup> member became eligible on 1 January 2001.

<sup>7</sup> The European Council in December 1995 changed the name of the European currency from ecu to euro to pacify Germans because the ecu "sounded too French" while euro sounds linguistically neutral (Howarth, 2002, 97).

<sup>8</sup> 'Europa' ( not ecu) was the term used in academic discussions on single currency for Europe.

<sup>9</sup> Numerical examples showing composition of ecu in different periods are available in Gros and Thygesen (1992, 205-207).

10. Idea of adopting a parallel currency was proposed under the name of the All Saints' Day Manifesto on European Monetary Union in 1975. Detailed discussion on parallel currency is available in *One Money for Europe* by Fratianni and Peeters (eds.)

<sup>11</sup> The speculative crisis in 1992 shook the European monetary system (EMS) forcing United Kingdom and Italy to exit the ERM. Thereafter, a speculative attack of great fury occurred at the end of July 1993. Consequently, exchange rate margins were widened from 2.25 to 15 percent in August 1993 (Bordes and others, 1995, 1). Also refer to Eichengreen and Frieden, (2001, 4-6) and Bordes and others (1995, 2-3) for reasons behind the speculative moves and modus operandi of the speculators in Europe during 1992-93.

<sup>12</sup> Organization of African Union (OAU) comprising 53 countries was announced on 9 July 2002 in Durbin, South Africa citing objectives similar to that the European union.