

## **Issues Involved in the Proposal of 'A Global Currency to Stabilize the Monetary System'**

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The lead paper, "A Possibly Shari'ah-Compatible Global Currency to Stabilize the Monetary System", puts forward an interesting proposal to create a Trade Referenced Currency (TRC) at the global level that can be potentially used as a common unit of account and internationally accepted means of payment. The author (Bernard Lietaer) introduces the TRC as a proposed supra-national complementary currency that can be used in parallel with existing currencies and financial mechanisms. It is targeted to address five problems faced in the present-day international financial system, i.e. monetary instability, pro-cyclical money creation, short-termism of financial decision-making, and the involvement of interest (*ribā*) in the money creation process through fractional reserve banking. The paper is not about the nature and role of money. However, one cannot escape highlighting some of the issues associated with money while commenting on the paper.

My comments pertain to three aspects:

1. What is new here compared to other attempts such as SDRs?
2. What economic and implementation issues can arise?
3. What is Islamic in it, how Islam addresses the issues that the TRC is attempting to solve?

### **1. What is new here compared to other attempts such as SDRs?**

The concern for financial stability and global coordination of policies are not new. The proposals to address some of the above listed problems through the creation of a supra-national currency that is inflation resistant and independent from the control of any single national government, that can be used as means of payment and managed multi-laterally to stabilize global finance are also not new.

In the wake of the great depression, the world realized that each nation tends to follow its own monetary and trade policies and it is hard to achieve global coordination in policies among different nation states. For example, 'beggar thy neighbor' policies led to trade and exchange rate wars destabilizing the status quo of the then existing financial system. Hence the idea of Special Drawing Rights (SDR) was born. SDRs were to enhance the stability of the financial system through its role as a supra-national additional currency – composed of a basket of currencies – serve as a unit of account and an official reserve asset, managed by the IMF rather than individual national governments. Its units were to be created as per demands of global economic and financial needs.

However, many legal and practical factors including political resistance by some countries to the idea

of delegating global financial management to multi-lateral institutions hindered the process. El-Erian (2017) in his recent blog post in a project syndicate succinctly mentions that SDRs were not able to achieve their intended role and there is “a substantial gap between the SDRs’ potential and its performance”. He further comments that if SDRs were allowed to serve their potential, “the provision of liquidity could have been made less pro-cyclical.” The world is again facing the same dilemma in the wake of recent financial and debt crises that has led to the pressing need to stabilize financial systems.

There have been also some proposals before, to use a single commodity (for example gold) or a basket of commodities as the base for a global supra-national currency. A recent one is from a group of researchers within the IDB itself, which calls for issuance and allocation of SDRs according to international trade among countries (Nabi, Abdelkafi, Drine, & al-Suwailem, 2015).

What is different in the present proposal of the TRC is that the TRC is backed by a basket of commodities, and that the TRC creation mechanism is based on ‘excess inventories’ of those commodities and hence it automatically leads to an increase in TRCs when inventories rise, and a decrease in TRCs when inventories fall. This is the in-built stabilizing feature; since unplanned inventories accumulate at the downturn of the economy, new TRCs will be created giving purchasing power to the world at the right time. Similarly, unintended inventory depletion takes place when the economy makes an up-turn and business is brisk. The issuance of TRCs will automatically decrease at that time, reducing the purchasing power of the world and hence, provide a control on the abrupt overshoot. Moreover, the TRC mechanism is an additional mechanism alongside the existing international monetary arrangements so there could be lesser resistance to it compared to the case if the TRC were proposed as a replacement mechanism to the existing global financial arrangements. The mechanism works by creating a central inventory-clearing house ‘Terra Alliance’ that buys and sells excess inventories in commodities (those commodities that are part of the pre-agreed basket) in ex

change for TRCs. The TRCs can themselves be used for trade settlement. The cost of operations of the TRC system are to be met by imposing a ‘demurrage’ of 3.5% to 4% per year on the value of TRCs held unused. It is a time related charge on this money to incentivize use of TRCs in transactions and keep them in circulation rather than hoarding it. Similarly, there is a TRC to cash conversion fee of 2% to discourage early encashment.

## 2. What economic and implementation issues can arise?

While the mechanism seems attractive, several issues arise.

### 2.1 The issue of valuation of the commodities and their storage

The formula used to calculate the commodity valuation in TRCs is given as follows:

$$\frac{(\text{Commodity value per unit}) \times (\text{Number of units})}{\text{TRC Unit Value}} = \text{TRCs}$$

By taking Commodity Price per Unit at the market price, it is assumed that the market price will not be affected by the sale of excess inventory to the TRC Alliance. However, if the inventory is large enough, this sale itself will change the market price and, in anticipation of this, the market price will start changing if markets are efficient. This feedback loop renders it difficult to know the market price with certainty. All we could hope for is expected market price, and this expectation varies and can become debatable among the Alliance members as well as among others. Thus, the TRC units created become less concretely determined. A similar argument can also be made for the denominator in the formula. The TRC Unit Value is also an expectation, not real.

Who pays for the physical storage of inventory purchased by the Alliance? Where will the commodities be stored? How will the storage be managed? Who is responsible for risk of damage etc.? These are some real questions involving logistical and institutional capacities in various countries and these are much deeper concerns than just covering the costs through a demurrage tax.

## 2.2 Issues in retiring TRC at cash-In

In the proposed mechanism, each TRC remains in circulation as long as the users buy and sell their goods in TRCs. When a recipient of TRCs wants to convert them into cash, the TRC Alliance sells the necessary volume of commodities from its basket to the market and obtains funds to pay in conventional currency.

The assumption is that the TRC Alliance (i) will always be able to sell its basket to the commodities market, and (ii) transactions are settled in cash. However many times, particularly during stress periods, this assumption can fail. Moreover, a buyer in the commodities market may not opt for spot purchases but purchase on credit or simply do netting. In such cases: How will the cash needs of the seller be met?

Should we assume that all the sold TRC units as retired or only allow for gradual retirement of TRCs as a proportion of cash is received? Here the accounting issues of recognition on sale or recognition on an accrual basis will come into play.

## 2.3 How to make TRC a money and the issues involved

If the TRC acquires the status of a medium of exchange, it will become easy to use. However, the difficult part is to make TRCs widely acceptable as money. Money (particularly commodity money) usually evolves naturally and organically. Such that, commodities that have longer storability at lower cost (i.e. store of value), and sufficient divisibility to serve as unit of account, become gradually accepted widely. This medium of exchange role and wide acceptance aspect make money a money<sup>(1)</sup>.

In principle, any public signal that is correlated (either positively correlated or negatively correlated) with economic fluctuations can be used as a coordination device among central banks of various countries in order to increase or decrease money supply. This is so far a hypothetical consideration only, unless we can ascertain that there are incentives for, or strong commitment by, the central banks of indi-

vidual countries to adhere to this rule even when local conditions and political pressures demand otherwise. We also need to ensure that private traders trust this currency as a medium of exchange for their transactions. This trust can stem either from the strength of the underlying asset or from the strength and commitment of the issuing entity.

One such way to elevate the status of TRCs to money is to make it a requirement that all excess inventories should be sold to the Alliance. Alternatively, mandate that all transactions (of all commodities at least) should be in TRC and not in any other currency<sup>(2)</sup>. Both are practically difficult to implement and politically difficult to agree among all nations.

There are several aspects that should also be analyzed in a proposal of a currency solely backed by inventories. One among them is the issue of the nature of the commodity itself whose inventory is used as the basis of the TRC. If the reference basket includes some basic commodities as its constituents, then excess supply and hence excess inventories of agricultural commodities can also be due to weather and other exogenous factors that are not a sign of economic slowdown. However, under the TRC mechanism more TRC units will be created and the supply of the supra-national currency increased, while it should perhaps have been decreased to reign in faster growth.

Similarly, there is a timing issue. Several commodities (e.g. oil, grains, and metals, etc.) are not manufactured goods but only used as inputs by firms and used as consumption items by households. The business cycle first effects the inventories of manufactured goods and only later the prices of basic commodities are affected. When unsold inventories pile-up, producers cut production and start demand-

(1) See for example, Kiyotaki and Wright's (1993) model of how commodity money evolves, and the subsequent literature built on it.

(2) From 1973, the US Dollar (USD) is 'to a certain extent' an oil-backed currency. Since as a rule, oil is required to be sold only in USD in the international market, the supply of USD thus becomes tied to the production and sale of oil. Moreover, since in every country a large number of economic sub-sectors depend on oil, the supply of USD de facto becomes tied to global economic activity. However, tying the USD to inventory of oil will also not help because countries maintain oil inventories for strategic reasons too; it is not reflecting excess supply.

ing fewer inputs. As a result, the prices of inputs decline in the second round. The basic commodity prices go rapidly down (or up) if a deep trough (or high peak) has occurred in the business cycle. So, the creation of TRC units can become asynchronous to the need with a delayed response.

### 3. Realignment of Financial Interests with Long-term Concerns: Islamic view

Islam will not object to any development for the betterment of society and creation of new currency for realignment of financial and real sectors or for the realignment of short-term interests and long-term concerns of society. In fact, cooperation for any move to improve the condition of people in general will be encouraged. The real question is do we have better means to achieve similar objectives?

I think, Islamic teachings of the prohibition of interest, its rules for carrying out trade, prohibition of trade in debt, observance of rules of *sarf* (monetary exchange), and prescription of *zakāh* are some of the key measures that can keep the financial and long-term economic interests aligned irrespective of the kind of money used. Of course, a better kind of money, as the one proposed in the lead paper, can give better results but only if the above stated Islamic rulings are followed. Otherwise, the new currency mechanism can also be manipulated for speculative purposes.

One can conceive TRCs (or even the SDRs) as alternate currencies that remain independent of local conditions and hence, countries and economic agents, such as banks and their regulators, can utilize it in times of need when there is shortage of other types of monetizable assets and currencies. This is the argument of the diversity of the ecosystem for the structural stability of the financial system. However, if a market for speculation in TRCs (or the SDRs) is created, then it will not remain independent of other currencies where similar speculation is already the norm. Similarly, if a debt market or a forward market in TRCs (or the SDRs) is created, again the same problems of monetary instability, short-termism in financial decision-making etc. will creep in. Therefore, the core solution is in the Islamic rules mentioned earlier.

To make a small point of the importance of Islamic rules, take the case of *zakāh* and its impact upon economic behavior. Note that *zakāh* is applicable on all business inventories kept for a year at the rate of 2.5%. Thus, the hoarder of money and inventory will have to pay *zakāh*. This pushes for quick circulation of money and wealth (including inventories). *Zakāh* is levied on completion of a year, on unsold inventories. Hence, it does not distort incentives in shorter periods of less than a year but discourages hoarding for longer periods. This is another good aspect of *zakāh*.

The demurrage charge in the TRC is a cost to society for keeping the system in place (can it be termed a deadweight loss?). Note the way the Islamic system approaches the issue of incentivizing circulation of money. *Zakāh* works as a 2.5% tax on idle money (and inventories) incentivizing the circulation of money and dis-incentivizing its hoarding. The *zakāh* collected is transferred to the needy and poor of the society or it is put to use for other remaining prescribed categories of *zakāh* beneficiaries. Administrative overheads of the system are minimized by putting an efficiency benchmark of 1/8th of *zakāh* collection for its administrators. The reinjection of *zakāh* money into the needy segment and into the other categories of *zakāh* beneficiaries further boosts the circulation of money and helps generate economic activity and social development.

Finally, a change in the direction of TRCs or of the Islamic financial system will require continuous efforts and a big push. It is naive to assume that any major change that affects the controlling powers of big countries over the financial and economic system would come within the existing legal, taxation, and financial setup. It ignores the political realities and coercive behavior of incumbent powers who do not allow any move away from the USD even when no international agreement is required. Some countries have tried to use the Euro or gold or other currencies as their primary medium of exchange in international trade but faced retaliation from the power centers whose interests were threatened by such moves.

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