Eliminating Interest Costs In Financing Trade Deficits By Pursuing And Maintaining Fully Convertible Domestic Currency

Dr. Mohammad Selim[1]

Abstract

Trade deficits are usually financed by incurring heavy interest cost burden year after year. In Islamic principle, paying interest, devouring, inscribing and being witness in such interest contracts -all are prohibited. Therefore, it is important to find an acceptable solution where all financial transactions including financing trade deficits should be conducted by eliminating interest component into it. As trade deficits continue to climb, the interest costs for financing huge growing deficits also continue to grow at a compounding rate. This paper investigates how to eliminate such interest component in ever increasing trade deficits, and therefore, to avoid interest costs burden altogether by pursuing and maintaining fully convertible domestic currency with its k-1 trading partners where k is 57 OIC member countries, who will be willing to recognize one another's currencies for trade deficit financing, and agree on fully convertible domestic currencies without any spread. Such guarantee of full convertibility will be the cornerstone in paying for trade deficits by their own domestic currencies and therefore, it will eliminate interest costs burden. It will also increase the volume of trade, output, employment and prosperity for all k member countries involved in the group.

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1. Introduction

The developed countries such as USA, Japan, Germany, UK, European Union,Canada and only a few other countries can use their own currencies to pay for their imports and for cumulative trade deficits because such currencies are fully convertible and as a result, widely acceptable for payments for import bills or for settling any international debts.

[1]Department of Business and Finance, Royal University for Women, Riffa, Kingdom of Bahrain; Tel: 973-17764468; Mobile: 973-39573782; Fax: 973-17764 445 E-mail: msalim@ruw.edu.bh

The currencies of the less developed countries (LDCs) are not often convertible, and as such they must buy or borrow internationally accepted currency or currencies in order to import the desired commodities. As a result, the LDCs must carry and incur interest burden on borrowed funds for financing trade deficits. In addition, such costs of borrowing will impose limits on their ability to import because of the natural constraints set by the shortages and limited availability of foreign exchange reserves or poor borrowing power.

Interest financing of any sort including financing for trade deficits by borrowing on interests is strictly prohibited in Islamic Economic System. In the following verses of the Holy Qur'an, interest, defined as *Riba* in Arabic or usury is vehemently condemned and strictly prohibited:

"Those who devour (eat) *Riba* (interest or usury) will not stand (on the Day of

Resurrection) except like the standing of a person beaten by *Shaitan* (Satan) leading him to insanity. That is because they say, "Trading is only like *Riba*," whereas Allah has permitted trading and forbidden *Riba*. So whosoever receives an admonition from his Lord and stops devouring (eating) *Riba*, for him is what is in the past; his case is for Allah (to judge); but whoever returns (to *Riba*), such are the dwellers of the Fire- they

will abide therein forever. Allah will destroy *Riba* and will give increase for *Sadaqat* (deeds of Charity, alms). And Allah likes not disbelievers, sinners. (Qur'an, 2:275-276).

Giving up *Riba* and to fear Allah constitutes the key to attain success and it is clear in the following verse:

"O you who believe, do not devour *Riba* doubled and multiplied but fear Allah that you may be successful." (Qur'an, 3:130)

Those who deal in usury, Allah SWT warns them to give it up and in case they do not comply, war has been declared against them from Allah and His messenger in the following verses:

"O you who believe, fear Allah and give up what remains (due to you) from *Riba* (from now onward) if you are (really) believers. And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums.

Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums). And if the debtor is in a hard time, then grant him time till it is easy for him to repay but if you remit it by way of charity that is better for you if you knew it."(Qur'an, 2:278-280)

Prophet SAS has cursed all involved in *Riba* and it is clear from the following

Hadith. The purpose is to eliminate the roots, all forms and dimensions of *Riba* from Islamic Economic System.

"Jaber RA reported that Messenger of Allah SAS cursed the devourer of usury, its payer,its scribe, and its two witnesses, and he said that they are equal (in sin). -(*Muslim*).

Usury has multi divisions and dimensions and its severity is compared in the

following Hadith:

Abu Hurairah RA reported that the Messenger of Allah SAS said,"Usury has got seventy divisions. The easiest division of them is a man's marrying his mother." – (*Ibn Majah*)

The punishment for those who are dealing in *Riba* or usury is explicitly described in the following Hadith:

Abu Hurairah RA reported that the Messenger of Allah SAS said, "I came across a people in the night in which I was taken to Heaven. Their bellies are like houses wherein there are serpents which can be seen from outside their bellies, I asked: O Gabriel, who are they? He said: These are those who devoured usury." –(*Ahmad, Ibn Majah*)

From the words of Allah SWT and the wise traditions and sayings of Prophet

SAS, it is evident that *Riba* or usury is prohibited and it brings nothing but destruction, exploitation, and eventual eternal punishment in the Hereafter and the wise believers must strive to eliminate usury or interest of all forms for the true success of this world as well as for the Hereafter.

From the worldly perspectives, interest burden often constitutes a significant

percentage of export earnings for many of the less developed countries. For LDCs in Western Hemisphere, accumulated interest cost constituted about 47% of export earnings(World Economic Outlook, IMF (1999)). High interest costs of borrowing not only reduces the potential import demand but it also drains out significant resources from such economies as interest payments for financing trade deficits which could otherwise be used for buying necessary imports and thus alleviating the shortages of both capital and consumer goods. As mentioned above, LDCs often face acute shortages of supplies of essential goods and such shortages often create demand pull inflation in those countries, which are usually overlooked in identifying the causes of inflation. Such built-ininflationary pressures are the direct effects of insufficient imports. As a result, such countries suffer from chronic inflation and people from all walks of life continue to suffer. Higher prices in domestic market for consumer and capital goods as well as for tradable goods may result in the loss in competitiveness and the potential exports from such countries will suffer and it may even reduce the ability to import in future when the demand for imports continue to rise in such trade deficit countries. In such supply shortages, the productive capacities are crippled and potential growth in output, employment and standard of living are often in risk.

Mundell (2000) argued that the dollar based international monetary and payments systems caused uphill capital flow from poor to rich countries and as such, deepened world wide financial crisis. He also added that US dollar is dominating the international monetary and payments system and as such it is inherently flawed because it has been depriving the poor countries the full convertibility of their own currencies into other foreign currencies over a long period of time. Not granting full convertibility into foreign currencies, domestic currencies can hardly be used outside the country. Such lack of automatic convertibility of domestic currency into foreign currency often creates serious problems because such countries can not use their domestic currency to buy imports from other countries while the majority of the developed countries with their fully convertible currencies can pay for the imports virtually for any amounts. As a result, they do not have to put any restrictions on their imports and enjoy plenty of supply of both capital and consumer goods and relatively low inflation rates. In such economies, the plenty of supply of capital goods at reasonable prices often induce further investment, increase in capital per person employed and productivity which will increase both the volume and value of exports and eventually may reduce imports because the productive capacity of the country will be improved and it will be able to produce more of the import competing products. Consequently trade deficits may decline in the long run and the country may even run trade surplus.

If the domestic currency is not fully convertible *at par*, and in presence of high

inflation when the domestic currency depreciates fast, foreign currency will be used as preferred currency for both buyers and sellers, and as such domestic currency will be useless and people will refuse to accept domestic currency, especially in high inflation countries. In LDCs where the countries can’t import the required essential goods because of the shortages of foreign exchange reserves, the supply constraints of essential goods will tend to create hyper inflation. In such inflation prone LDCs, the domestic currency will be considered as unwanted currency and its demand will fall. As demand for domestic currency will fall it will continue to depreciate further.

Central bank will fail to restore the confidence of the people in domestic currency and the Gresham's Law will work in reverse because 'good money (foreign currency) will drive bad money (domestic depreciating currency) out of circulation.' (Guidotti and Rodriguez, 1992). The domestic currency will further depreciate as the demand for domestic currency falls because most people are using foreign currencies or bound to use foreign currencies, inflation rate will continue to rise and domestic currency will tend to be worthless as people will demand foreign currency for buying and selling and completely reject the domestic currency. Such situation is occurring now in Zimbabwe and to some extent in Lebanon.

Accepting only a few currencies from a few handfuls of countries as means of payments for imports provide unfair advantages to those privileged countries over others who must either earn those foreign exchanges or borrow at high interest costs if such countries plan to buy imports from international market. It also provides unlimited and unfair privileges to the owner of those preferred currencies to incur unlimited and ever increasing trade deficits because of almost unlimited convertibility of their currencies into any other currencies of the world. Such advantages must be extended to other countries of the world by acknowledging, recognizing and protecting the full convertibility of the currency of each country in the world *at par*. Such global full convertibility will create opportunities for all nations and each and every nation will participate in international trade to the potential level and potential world output, trade, employment, exports, imports and gains from trade will be maximized and it will be many times higher than the current actual level. As a result, employment, output and standard of living of the people in both developed and LDCs will rise and more and more people will pull themselves up from the shackles of poverty line across the countries. In addition, it will also create confidence and keen interest in maintaining, safeguarding and promoting global financial system.

Each currency should be fully convertible *at par* without any spread or commission. In other words, each currency should be exchanged without any commission and, therefore, there should not be any spread between buying rate and selling rate of each currency and these are implicit in the following Hadith: Please note that gold and silver were used as currency at that time.

Abu Sayeed Al Khodri RA reported that the Messenger of Allah SAS said, "Don't sell gold for gold unless like for like and don't increase something of it upon something, and don't sell silver for silver unless like for like and don't increase something of it upon something, and don't sell the absent there from for the present. In a narration: Sell not gold for gold, nor silver for silver unless like for like." – (*Bukhari, Muslim)*

In the following comprehensive Hadith the idea of spread or commission (gives or takes more) in exchanging gold for gold, silver for silver, wheat for wheat, barley for barely, date for date, salt for salt is defined as *Riba* or usury or interest:

Abu Sayeed Al Khodri RA reported that the Messenger of Allah SAS said, "Gold for gold, silver for silver, Wheat for wheat, Barley for barley, Date for date, Salt for salt and like for like in hand to hand (transaction). Whoso gives more or takes more, then the taker and the giver are equal in taking interest therein." –(*Muslim)*

All the commodities mentioned above such as Gold, Silver, Wheat, Barley, Date, Salt were used as money or currency, and to be more specific, they were used as "commodity money" and such currencies should be exchanged at par or without any spread or commission. For example, now a days, One Bahraini Dinar(BD) is equal to ten Saudi Rial (SR) and all the traders, and all individuals should accept BD1=SR10, not more or not less. In case, the traders want to exchange SRs for BDs or Dinars for Rials can just go to the Bank or Bank machines and can get BD10=SR100 or vice versa. It should be available even in the ATM in each Bank in each country.

In above Hadith it is also clear that gold, silver, wheat, barley, date and salt are the examples of commodity money where face value of the currency is equal to the intrinsic value, while immediately after salt, it is mentioned, "like for like" may indicate among others, paper currency where face value is not equal to the intrinsic value of the currency. However, central bank which issues paper currency in each country guarantees its bearer to pay on demand its equal face value in terms of gold or silver or any other commodities or any foreign currencies the bearer prefers. However, the bearer may get foreign currency at selling rate which is obviously different than the buying rate. In other words, the buying rate is less than the selling rate and the bearer will be worse off in such case. This article calls for introducing the essence of the above Hadith that there should be only one rate where buying rate=selling rate for each currency. Therefore, all currencies should be exchanged without any spread or commission, and the transactions should take place on spot only.

When one reads the above traditions of Prophet SAS, one may wonder why do people should sell gold for gold like for like……without any spread? How there will be any profit but if one thinks in terms of currency exchange *at par*, it opens up the world of transactions, expansion of trade and commerce among the regions and countries that will multiply the bounties and wealth of nations. In addition, it will increase employment, output and income, and the prosperity will transmit from one country to the another. This may be the implicit wisdom of the above Hadith and may be even more which will be discovered in the days to come.

The year 1971 marks the end of an era of convertibility of US dollar into gold because of the increase in gold prices and subsequent depreciation in the value of US dollar. Since that time, US dollar has been losing its value but in absence of a strong and stable alternative currency, US dollar still considered dominant currency and most trade deficits and other debts are settled in US dollar. As a result, the trade deficit countries have to borrow US dollar from IMF or international financial institutions or from other countries at reasonably high interest rates and billions of dollars must be paid as interest costs year after year. D'Arista (2004) has questioned such dollar based payments system and confirms that such system only favors the countries with fully convertible currencies and it is inherently flawed and must be reformed to protect the interests of the countries with limited or no convertibility of their currencies. The inherent flawed payment system discriminates against the poorest nations because their currencies are not internationally acceptable for payments for imports and international debts while the wealthy nations can pay such debts with their own currencies. By establishing and maintaining full convertibility of all currencies *at par* under an umbrella of international central bank or clearing house can guarantee the privileges for all nations concerned to pay for their trade deficits or debts by their own currencies. It may require the commitment of each member country to maintain stable exchange rate system by coordinated monetary and fiscal policies and close monitoring and working with the international central bank. It may also require the member countries to peg their currencies to the market value of the gold. As the value of gold will fluctuate, the cross exchange rate will remain the same and therefore, exchange rate will remain stable. Maintaining stable exchange rates will make it easier to maintain full convertibility of the currency of each member country. As long as cross exchange rates remain stable, each country will spontaneously pursue full convertibility *at par* and such system will help OIC countries to import more and both exports and imports will increase in the long run. All members will benefit because international trade will encourage specialization in the line of comparative advantage of each country and total output, employment, income and standard of living will increase in short run and further increase in the long run through multiplier and accelerator process. In addition, idle transfer of resources in the form of interest payments for financing trade deficits will no longer take place, and such prevention of 'one way' transfer of resources from the trade deficit countries to trade surplus countries and intermediaries such as IMF will reverse the vicious cycle of poverty for many poor nations. If just the annual interest payments are recycled and reinvested in LDCs, many of the starving population can be saved at no extra cost. Since the second world war, interests paid to finance trade deficits by the poor nations of Asia, Africa, Latin America and the rest of the world are in trillions of dollars and have become a very significant transfers from the poorer nations to the wealthy nations and as a result, the desperation, chaos, and shortages of almost all commodities including food, and basic essentials are on the rise. Such phenomenon has also created instability in the global economy both politically and financially and pushing many countries towards bankruptcy, insolvency, cuts in many public services and even towards the failed states. Only guaranteeing the stability of the cross exchange rates and full convertibility of each currency can help each government to get out from such hegemony of a few international lenders and governments whose currencies are fully convertible. Because of full convertibility, they can fund almost anything and they have the luxury of importing almost everything while the poor nations can not even import the basic necessities of life because they can not use their own currencies as their counterparts in the developed countries can.

Triffin(1968) suggested that all countries must participate and the benefits must be shared by all. It is clearly evident that if all currencies of all countries are granted full convertibility, each country can reap the benefits of financing trade deficits by its own currency. Teunissen (1987) also criticized such unfair system and said, “Ironically, the richest and the most capitalized country in the world is actually being financed by the poor countries through the creation of international monetary reserves”. In absence of full convertibility of their currencies, such countries tend to be sinking into greater trade deficits and shortages of almost everything, rising food prices and at the same time paying billions of dollars to IMF and other financial institutions as debt payments for their cumulative trade deficits while the countries with fully convertible currencies can pay their trade deficits by their own currencies. Furthermore, LDCs must follow tight fiscal and monetary policies imposed by IMF and World Bank as borrowing conditions for financing trade deficits so that public sector can generate enough funds for debt repayments to such organizations. Contractionary monetary and fiscal policies coupled with net transfer of wealth in the form of interest payments for trade deficits from LDCs brought disasters to many LDCs in Africa, Asia and in Latin America and billions of people are falling below poverty line year after year and there is little hope on the horizon. Furthermore, such high cost of borrowing and lenders’ policy prescriptions in the form of high domestic interest rates and cuts in government spending including the elimination of subsidies have already brought ruins, high unemployment, stagflation and political unrest in many LDCs.

This paper attempts to explore the possibilities of incorporating full convertibility of domestic currency *at par* with each of *k-1* trading partners. It is expected that such arrangements will make it easier to pay for imports with domestic currency and therefore, the trade deficit countries can import the required amounts of goods and services necessary for its domestic demand both for consumer and capital goods and the country can do it without loan approval from IMF, World Bank or any other national or international financial institutions and at the same time it will not incur any interest expenses. However, the trade surplus countries will use such accumulated foreign currencies which are definitely export earnings for that country or countries to buy imports either from the same country or other member countries. Trade deficit countries will view such repayments as an increase in exports, employment, output and income - an expansionary effects for the economy and not contractionary or leakages in which the country used to pay interest expenses, often considered as draining out the resources for the trade deficit countries and for their people.

This paper is organized as follows: The model on trade deficits and payments by fully convertible domestic currency is elaborated and discussed in Section 2. Section 3 focuses on the instantaneous convertibility and payments mechanism. Section 4 addresses inflation problems in the newly formed group of countries Section 5 examines the impact of converting trade deficits into opportunities for both trade deficit and trade surplus countries by creating fully convertible currency union, similar to common currency. Fully Convertible Currency Union and its impacts on new trade creation, employment and income are summarized in section 6. Section 7 explains the gains of retaining interest costs in domestic economy and preventing the outflow of resources. The effects of interest savings and increase in net exports on equilibrium income are discussed in section 8. Concluding remarks are summarized in final section 9.

2. The Model

Let us assume there are k number of OIC member countries who agree to engage in international trade, and trade deficits will be paid by fully convertible domestic currency *at par*. Such mutual arrangements will not only increase trade of both imports and exports but will also decrease shortages of all essential consumer and capital goods in domestic economy. In addition, it is expected to increase further employment in domestic economies of trade deficit countries because of the increase in the ability of expanding productive capacities resulting from the imports of necessary capital goods and raw materials which will induce further production through the multiplier and accelerator effects. By removing the constraints on the limits of imports will eventually eliminate shortages and reduce the pressure of inflation in trade deficit countries.

For each country which incurs trade deficits, the total payable (TP) includes imports for current period, M, interest payments on outstanding unpaid trade deficits, $r\sum d_i$ and installment payment for unpaid trade deficit amounts for n periods, $\frac{\sum d_i}{n}$.

TP amounts can be written as follows:

$$TP = M + r\sum d_i + \frac{\sum d_i}{n} \tag{1}$$

In above equations, d_i=trade deficits and i=1,2,3,………..,k. Equation (1) indicates that the trade deficit countries must pay current year's imports M, plus interest on accumulated trade deficits and installment payment on borrowed amount for financing

trade deficits. As a result the trade deficit countries are seriously constrained by the TP rather just payments for current year's imports.

Now the interest costs for trade deficit country will be zero if this country can

pay off its debt by its own fully convertible domestic currency and there will be no outstanding interest burden in foreign currency which often become a big liability for the governments of LDCs and the countries with limited foreign exchange reserves. In such cases, LDCs must borrow foreign exchange from IMF or other financial institutions just to keep up the installment payments both for accumulated interest and for paying principal amount. In such framework, there is a built-in transfer of real wealth and resources from LDCs to the lenders of developed countries and as such, poor countries remain poor over a long period of time and there is no way out in the horizon. Under the arrangements of fully convertible currency system, such trade deficit countries will also be able to pay off their installment payments by the fully convertible domestic currency as well.

Now each country will finance its trade deficits by its own currency. The trade

surplus country may use the surplus foreign currencies for importing goods and services from the other countries or can invest in those countries. Such opportunities will increase foreign direct investment, trade, employment and income in both trade deficit and trade surplus countries. Initially trade deficits may increase because of the increase in imports but eventually, increase in import demand will induce further increase in production and exportable surplus may rise which will translate into an expansion of trade and all trading nations will benefit. Total demand for different domestic currencies will increase worldwide and it will help LDCs to increase financial deepening without creating the threats of inflation. It will provide added resources in the hands of the governments of LDCs which will be extremely useful for providing much needed public goods and reducing poverty, mass starvation, illiteracy and unemployment.

The *k* countries in the group will finance their own trade deficits by their own domestic currencies and the accumulated burden of interest for financing trade deficits will be eliminated. In following equation (2), $dc_1 + \quad dc_2, ... + dc_k$ will be the responsibilities of each of the *k* countries and there will be no resource transfer from one country to another rather mutual increase in demand for imports will be translated into the additional increase in exports, and prosperity will transmit from one country to the other. The sum of total trade deficits for each country can be paid by the domestic currency of each country. The sum of total domestic currency required to pay for the deficits can be written as:

$$\sum dc_i = dc_1 + \quad dc_2, ... + dc_k \tag{2}$$

Here dc_1 is the domestic currency required for financing trade deficits for country 1, dc_2 for country 2, and dc_k for country *k*. No matter what is the size of trade deficits, each and every country will be able to pay for it from its own domestic currency and as soon as they will pay with their domestic currency, the supply of domestic currency will increase as foreign exchange reserves will grow for the exporting trade surplus country or countries. In such case, the increase in supply of foreign exchange reserves will create its own demand for imports from other countries including trade deficit countries.

The size of trade deficits may depend on population, import demand, and the degree of openness or any other factor and additional increase in imports, especially capital goods which will eventually induce further increase in output, employment and exportable surplus for the trade deficit countries. In the long run, both exports and imports will increase and intra -industry trade will thrive throughout the group of countries and the consumers will have more choices and freedom to enjoy the varieties of products.

Still a Central Bank for such Group of countries, CBG, will facilitate, guide, restore confidence, and clear any excessive build up of deficits by a particular country or countries and advising them to clear up such backlog or disequilibrium by increasing exports. Each country in the group may retain a branch of CBG in each capital city of member countries and will act as central clearing house similar to the one proposed by John Maynard Keynes as international clearing agency (ICA) for all the countries concerned and it will administer, advise, foster and facilitate the efficient working of full convertibility of currencies *at par* and stability of financial system as well as currencies in the group.

3. The Instantaneous Convertibility and Payments Mechanism

This paper focuses on a framework by bringing a group of countries together such as the members of the OIC countries to a common consensus of instantaneous convertibility of each other's currency *at par* and accepting them as fully convertible for payments for the trade deficits countries. In addition, this paper also suggests establishing a common central bank for the group to oversee the smooth functioning and clearing of such transactions at no additional costs. For such settlement of debts on accumulated trade deficits into cash in domestic currency will increase the velocity of money and facilitate further transactions and multiply economic activities in all the economies. Such stimulus and expansion of trade will bring forth engines of growth in currently stagnant economies where volumes of international trade are somewhat slow and most of the economies are shrinking and world wide recession seems to be deepening day by day.

4. Addressing Inflation Problems in the Newly Formed Group of Countries

All the domestic currencies of the member countries are to be recognized as fully convertible into any currency of the group. If any country among the group has high inflation rate and as a result, its currency depreciates faster, that government has to adopt appropriate fiscal and monetary measures to control inflation. Until inflation rate is under control, it may follow a fixed exchange rate with the market price of the gold. If all countries in the group peg their currencies with gold, the cross rates will remain stable for all the currencies in the group. All the countries should follow cooperative monetary, fiscal and supply side policies for correcting inflationary pressures and maintaining sustainable growth, stability, and lowest possible misery or discomfort index. Discomfort index is the sum of unemployment rate and inflation rate and it is an acceptable measure of performance and economic stability for each of the member country. In such cases, trade deficit will most likely lead to direct foreign investment and it will automatically increase the supply of goods and services in trade deficit countries where the inflation rate is running higher than the average inflation rate for the group. Such increase in output of goods and services will reduce shortages of goods and services and inflationary pressure will die down. Automatic conversion of domestic currency into the other currencies of the group will place a nation on a better position in both increasing imports as well as increasing exports. It will increase imports because the importing country is not constrained by the availability and the supply of foreign exchange anymore because this country can pay import bill by its own domestic currency and does not have to persuade and cave in to demands of the international donors or IMF or World Bank or to any other foreign governments.

Therefore, imports will increase and increasing imports by one country implies increase of exports for *k-1* countries. Such linkage effects in interdependent group of countries will bring increase in foreign trade, employment, output and prosperity for all nations. It will also increase exports because the trade surplus countries will be holding the currency or currencies of other member countries. It is in the interest of the trade surplus countries either to use the foreign currency reserves to buy the imports and build the super infrastructure of the country or to invest in those trade deficit countries in the form of establishing industries for producing high valued manufactured products, financial and academic institutions, and other strategic key industries for generating more income. Such mutual economic interests will drive all the countries to a new height of development and prosperity.

5. Converting Trade Deficits into Opportunities for Both Trade Deficit and Trade Surplus Countries by Creating Fully Convertible Currency Union, Similar to Common Currency

Fully convertible currency works similar to common currency or even better than common currency in many respects. For example, in such case, each country is free to strictly control its own money supply and at the same time can be flexible to adjust its money supply according to the level of economic activities. In many cases, introducing the fully convertible currency could be the first step before a group of countries plans for common currency.

For convertibility purposes, each currency can be pegged to gold or a basket of

stable currencies within the group or can be pegged to a combination of major stable currencies. Such careful selection of the market price of gold or stable currency will bring stability in cross exchange rates. If the group of countries decides to go for a common currency, it must be carefully planned and thoroughly examined prior to its introduction. To encounter the problems associated with common currency, the group must explore and investigate in details the relative advantages and disadvantages between national currency with full convertibility *at par* and common currency where each nation will be under the constraints of being allocated a given amount of common currency where the flexibility in money supply will be somewhat restricted. If the group of countries opts for common currency, the inflation prone and poorly performing member countries may plunge into long term chronic debt crisis and the common currency may suffer from instability as it has been observed in case of Euro for Greece, Portugal and Spain. The individual free convertible currency *at par* for each of the member country may just work fine without adding multiple problems that may come with the introduction of common currency.

The stability in multiple currencies can be guaranteed just by pegging eachcurrency with the ongoing market price of gold. Such pegging to the market price of gold will definitely bring stability, financial solvency, low discomfort index, financial deepening and a perfect host country for foreign investment which in turn will multiply employment, income, output, standard of living and enormous opportunities for the people of such trade deficit countries. The continuous linkage and spillover effects may induce further investment and development in less developed areas of the domestic economy as well as in less developed countries in the group. Consequently, all the members of the group will enjoy the opportunities for potential growth and prosperity.

6. Fully Convertible Currency Union and its Impact on New Trade Creation, Employment and Income

The introduction of fully convertible currency *at par* will increase the productive capacity of the economy. Each firm in the economy will be able to expand the profit maximizing level of output and employment by expanding the plant size because of the availability and access to new capital goods, latest technology, raw materials, and a biggest possible market. As a result, employment, output and labor productivity will increase and the average cost of production will fall. Fall in average cost will help such countries to earn new comparative advantage in international trade for many products in which the country did not have comparative advantage in the past. 'Earned comparative advantage' will increase the supply of goods and services and eventually will increase exports. Simultaneous increase in exports, imports, employment and income will continue to modernize such economies and will speed up the process of transformation from pre-conditions for take-off to the stages of take-off and eventually to maturity. Such process and transformation are the key factors for the LDCs to step into the stage and rank of developed countries.

7. Retaining Interest Costs in Domestic Economy and Preventing the Outflow of Resources

The introductions of fully convertible currency system will not only increase trade volumes by increasing both exports and imports, but billions of Dinars will be saved in interest costs and such amounts will be retained and invested in domestic economy and further output and employment will increase through accelerator and multiplier effects. Because of the high interest cost of borrowing funds for trade deficits as well as constraints and conditions imposed by the lenders, many LDCs import lot less than required import that essentially creates enormous shortages and excess demand and as a result, inflation rate in such trade deficit economies accelerates.

Paying interest on accumulated trade deficits is not only wrong from the *Shariah* points of view but it also constitutes a net transfer of resources from the trade deficit countries with non-convertible currencies to the lenders for trade deficits including IMF, World Bank and foreign governments. Such cost was about 40% of the export earnings for some countries in the Western Hemisphere (World Economic Outlook, IMF 1999). Such interest payments and constraints imposed on imports are affecting real and financial sectors of such trade deficit economies and much of the turmoil, chaos and sufferings of the people in LDCs are the immediate cause and consequences of such policies. Only fully convertible currency system *at par* and using such currencies for paying for imports will definitely solve much of such problems and eventually will bring prosperity and an end to the vicious cycle of poverty in the long run.

8. The Effects of Interest Savings and Increase in Net Exports on Equilibrium Income

Consider standard open economy macroeconomic model without taxes for keeping the model simple; the aggregate expenditure function (AE) with TP for trade deficit country can be written as:

$$AE = C_0 + bY + I_0 + G_0 + X_0 - M_0 - mY - r\sum d_i - \frac{\sum d_i}{n}$$

$$or,\ AE = C_0 + bY + I_0 + G_0 + (X_0 - M_0) - mY - r\sum d_i - \bar{d} \qquad (3)$$

$$where\ \ \bar{d} = \frac{\sum d_i}{n}$$

In above equation (3), C is consumption expenditures, 'o' stands for autonomous expenditures, Y denotes income, the letter 'b' is marginal propensity to consume (MPC),

I is gross investment spending, G is Government spending, X is exports, M is imports, and the letter 'm' is marginal propensity to imports (MPM).

If a country plans to finance its current trade deficits, Xn=X-M by borrowing at

market rate of interest, r, from IMF or World Bank or international financial institutions, or from foreign governments, then obviously an additional cost factor will be added to the import bill. In such case, a new AE can be written from Equation 3 above:

$$AE = C_0 + bY + I_0 + G_0 + r(X_0 - M_0) - rmY - r\sum d_i - \overline{d} \quad (4)$$

The equilibrium income of the economy will be determined when:

$$Y = AE$$
$$or, \quad Y = C_0 + bY + I_0 + G_0 + r(X_0 - M_0) - rmY - r\sum d_i - \overline{d}$$
$$or, \quad Y - bY + rmY = [C_0 + I_0 + G_0] + r(X_0 - M_0) - r\sum d_i - \overline{d} \quad (5)$$

From above equation 5, we can find equilibrium income Y* as follows:

$$Y^* = \left[\frac{1}{1-b+rm}\right] A + rXn_0 - r\sum d_i - \overline{d}$$
$$or, \quad Y^* = \lambda r[A + r(Xn_0 - \sum d_i) - \overline{d}]$$
$$or, Y^* = (\lambda r)\Psi r \quad (6)$$
$$where \lambda r = \frac{1}{1-b+rm}; \quad \Psi r = A + r(Xn_0 - \sum d_i) - \overline{d}$$
$$A = C_0 + I_0 + G_0 \quad (7)$$

In above equation 7, λr is the multiplier when trade deficits are financed by borrowing at market rate of interest 'r' and Ψr is autonomous expenditures if trade deficits are financed with interest as well.

Now if fully convertible currency system is introduced and each country can buy all the required imports by using its domestic currency then such system will not require trade deficit credit financing and, therefore, it will eliminate interest expenses, r, for such group of countries. In such case, r will be zero in equations 6 and 7. In addition, eventually in the long run, the country will be able to import technology and capital goods and will be able to produce many import competing goods and will also specialize in the line of its comparative advantage and will produce exportable surplus with previously unemployed work force. It may also open the opportunities for such countries to earn comparative advantage in many new areas where they did not have such comparative advantages before because of the lack of technology, training of its workforce, necessary raw materials, and access to a large market. Consequently such earned comparative advantage will increase potential growth for exports and reduce potential imports in the long run, and net exports, (Xn=X-M) will increase. Suppose, such increase in net exports is denoted by ∂ and ∂>0. Now setting r=0 and incorporating the positive effects of ∂, the above equation can be written as:

$$Y' = \left[\frac{1}{1-b}\right] A - \bar{d} + \delta$$

$$or, \quad Y^{**} = \lambda[A - \bar{d} + \delta]$$

$$or, Y^{**} = \lambda\Psi \qquad (8)$$

$$where \lambda = \frac{1}{1-b}; \quad \Psi = A - \bar{d} + \delta$$

$$A = C_0 + I_0 + G_0 \qquad (9)$$

Now if the countries in the group can also pay the installment payments for accumulated trade deficits by their fully convertible domestic currency, $\bar{d}$ will also be paid and it will be zero. In such case, equations (8) and (9) can be written as follows:

$$Y^* = \left[\frac{1}{1-b}\right] A - \bar{d} + \delta$$

$$or, \quad Y^{***} = \lambda[A + \delta]$$

$$or, Y^{***} = \lambda\Psi^* \qquad (10)$$

$$where \lambda = \frac{1}{1-b}; \quad \Psi^* = A + \delta$$

$$A = C_0 + I_0 + G_0 \qquad (11)$$

Now we can conclude from above equations that the introduction of fully convertible currency at par will increase the value of multiplier and autonomous spending and as a result, the equilibrium income will increase further which can be easily understood from the following equations:

$$Y^{***} > Y^{**} > Y^*$$

$$because\ \lambda > \lambda r; \quad \Psi^* > \Psi > \Psi r \qquad (12)$$

$$where \lambda = \frac{1}{1-b}; \quad \lambda r = \frac{1}{1-b+rm}; \quad \Psi^* = A + \delta; \quad \Psi = A - \bar{d} + \delta;$$

$$\Psi r = A + r(Xn_0 - \sum d_i) - \bar{d}; \quad A = C_0 + I_0 + G_0 \qquad (13)$$

From the above equations (12) and (13), it is clear that maximum possible income, Y^{***} will be realized when the above fully convertible currency system will be introduced because the value of multiplier will be maximum at λ.and autonomous spending will also be maximum at Ψ^*.

9. Conclusion

With the introduction of fully convertible currency system and recognizing each other's currency as valid currency for payments for trade deficits will not only help to eliminate interest payments on borrowed funds for financing trade deficits but it will also revolutionize and multiply the entire global trade, and investment, output, employment, and prosperity for all nations. In fact, with the rising demand for imports, the demand for current fully convertible currencies such as US dollar, Euro, GBP, Yen, etc. may even rise further as the global trade will increase both in volumes and values across the world. In addition, both exports and imports will increase because of the increase in intra-industry trade. Increase in intra-industry trade will take place when the average income of the people will increase resulting from the increase in world trade, output and employment. Such surge will eventually foster further increase in consumers' preferences and choices for varieties of differentiated products. Therefore, all the countries will gain from such fully convertible currency system and every nation will actively participate in such global payments systems for securing the mutual benefits for all. In addition, it will also increase the confidence in global financial and payments system. Such system will help in breaking up the vicious cycle of perpetuating trade deficits and cumulative ever ending interest payments on such debts and the resulting poverty for most nations of the world. Furthermore, the trade surplus countries will find markets for their products and investment opportunities to reinvest the trade surplus amount and it will foster further growth and prosperity. For the trade deficit countries, billions of dinars in interest costs will be saved and all forms of exploitation resulting from interest financing can be avoided. As a result, imports will increase, shortages will disappear and inflationary pressure will decline and stability in the economy with full employment and low inflation rates will be restored. Foreign direct investment from trade surplus countries into trade deficit countries will flow and it will increase further employment, output and eventually exports until the country will overcome the chronic trade deficits. Such system will also foster goodwill, harmony, honor, mutual respect and understanding among all the nations and much of the tensions in today's world can easily be avoided and diffused.

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