CHAPTER 6

GESSEL'S CONCEPT OF FREE-MONEY ELIMINATING INTEREST THROUGH INFORMATION-MONEY

by Edo Omercevic & Ahamed Kameel Mydin Meera

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6.1 Introduction

Choosing the right monetary system and the kind of money to be used within that system is of immense importance. After all, the concept of *riba* that is very much abhorred in Islam, has a lot to do with money and monetary systems. Money and the monetary system laid down the foundation for the exchange, distribution and investment process in the economy and influenced the savings and consumption functions as well. Therefore, choosing a wrong money or monetary system might jeopardise the attainment of the *maqasid al-Shari'ah*, i.e. the objectives of Islamic jurisprudence, and thereby may bring about negative consequences on Muslim societies. For example, the existence of interest rates or its equivalent in the Muslim world despite its strong prohibition in Islam, the abuse of seigniorage of fiat money, the inequitable distribution of income, inequitable taxation through inflation and many more potential negative impacts of a faulty monetary system could be mentioned. Besides the fact that fiat money has successfully replaced gold and silver as the currency in the Muslim world, a current and most evident problem of the existing monetary establishment is the existence of interest rates in the market and the merger of the profit rates charged by Islamic financial institutions with interest rates, that make them similar to the interest rates themselves, i.e. what is normally referred to as the convergence between Islamic and

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conventional banking. Yet, despite being highly condemned, interest rates form an integral part of today's global monetary system, including the Muslim world, regardless of political and ideological differences. Even though there are numerous organisations which are trying to create alternative systems, like the much developed Islamic banking which is growing rapidly, the evolutionary process of the monetary establishment is still stuck within the current interest-based system. This is despite all the criticisms the interest-based system is facing in the literature dedicated to topics related to religion, social economics, development economics, etc. In addition, periodic economic instabilities, called business cycles are accepted as a norm as well, with structural crashes taken as unavoidable part of life.

The question which naturally arises is: Why does interest exist, even though it has all those negative connotations attached to itself? Is it due to the attitude of the people and their ignorance of the prohibition of interest, or is it a structural problem? Why should business cycles exist as part of life?

After a brief review of the common theories on the existence and cause of interest, a theoretical argument is provided on the features of money as a key factor which enables the charging of interest. The main source of the argument is Silvio Gesell's (1862 - 1930 C.E.) views, a merchant, theoretical economist and a social activist. Besides arguing about interest, he also claims that the same features of money and the monetary system that enable the existence of interest rates, are also the main cause of unnatural and periodic falls in economic activity (other than those due to natural catastrophes and man-made conflicts). He also proposed a new system under the term 'free-money' which is capable of disabling the possibility of interest charging, i.e. making its existence impossible even if desired by some individuals or groups, and thereby stabilising the economy. Those features will be elaborated as well in this Chapter.

6.2 Literature Review

Looking at the various theories on interest rates, the major ones may be classified under four main categories (Smithin, 2006). This Chapter reviews all the four theories as below:

a) Classical theory;

b) Liquidity preference theory;

c) Horizontalist theory; and

d) Wicksellian theory.

6.2.1 Classical Theory

The Classical theory is based on the belief that the interest rate prevailing in the market is determined by the forces of demand and supply for real capital. It is also described as a savings/investment theory (Smithin, 2006). Simply said, it is determined by the intersection of the saving and investment functions. The so-called natural rate of interest is the one which prevails under full employment and equilibrium in the capital market. According to Wicksel (1898), as quoted by Smithin (2003):

> This natural rate is roughly the real interest of actual business ... [think] of it as the rate which would be determined by supply and demand if real capital were lent in kind without the intervention of money (page110).

Thus it is the forces in the real market which determine the interest rate charged in the monetary market.

6.2.2 Liquidity Preference Theory

According to John Maynard Keynes, besides having the time-preference for consumption which determines the savings in the economy, there is another decision to be made by the general population which is to determine how much of the future consumption, or delayed consumption, is to be held in liquid form (i.e. money). The liquidity-preference, Keynes (1936) explained, depends on three factors:

- Transactions motive - the need for cash for the current personal and business transactions;

- Precautionary motive - the desire for security as to the future cash equivalent of a certain proportion of total resources; and
- Speculative motive - the objective to secure profit by knowing better than the market what the future will bring forth.

According to Keynes and the liquidity-preference framework, it is the relation between the quantity of money supplied and the liquidity-preference of the market participants (which is affected by the different motives as mentioned before) that would determine the interest rate in the market. Consequently, a rise in the money supply might not result in a fall in interest should the liquidity-preference rise too. The interest rate might even increase if the rise in liquidity-preference is higher than that of the money supply. As Keynes (1936) put it:

> Thus the rate of interest at any time, being the reward for parting with liquidity, is a measure of the unwillingness of those who possess money to part with their liquid control over it. The rate of interest is not the 'price' which brings into equilibrium the demand for resources to invest with the readiness to abstain from present consumption. It is the 'price' which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash (page109).

It is worth noting that the liquidity-preference theory, as can be seen, does not attribute the existence of the interest rate to the market forces of demand and supply of real capital, but simply to the forces of demand and supply of money, the demand being constituted by various motives. This is almost a revolutionary claim, if compared to the classical economist, and hence pushes the attention to the money market itself when discussing the interest rate.

6.2.3 Horizontalist Theory

According to this theory, the interest rate is simply set by the national monetary authority and the money supply is adjusted in such a way that the level of the set interest rate is maintained. This results graphically in a horizontal money supply function, and hence the term "horizontalist theory" (Smithin, 2006).

Looking at this theory, the role of the interest rate then is simply to set the monetary relationships between the participants in the economic system, or in other words, it affects the distribution of income between rentiers, entrepreneurs and workers, as directed by the state.

6.2.4 Wicksellian Theory

The Wicksellian approach, named after Wicksell (1898), is almost a combination of the classical and the horizontalist theories. According to this view, the so-called 'market' interest rate as observed by the public is the one which is set by national monetary authorities (central banks). As a result, the interest rate is purely a monetary phenomenon. Yet, according to this approach, there is an invisible natural interest rate in the market which is not freely observable. That natural interest rate is determined by real economic factors, which, however, cannot be observed. It is not clearly defined and it is supposed to exist 'off-stage' and simply act behind the scenes (Smithin, 2006). By setting the market interest rate, the goal of the monetary authorities is to match the natural one. Failing to match the natural interest rates would result in market disturbances.

6.3 Silvio Gessel and the 'Tribute' on Money Usage

As outlined later in detail, Gesell claims that the existence of interest rates is solely a result of the demand and supply forces in the monetary sector. It certainly has nothing to do with the influence on the money market by forces of demand and supply of real capital. According to him, it is actually the other way around, that is, the forces of demand and supply in the money market determine the demand and supply of real capital. But this is beyond the current chapter.

His approach is similar to that of Keynes, but differs in the claim that it is those who are in possession of money, who influence the interest rate in the market by deciding on their liquidity level, instead of the other way around. Should the interest rate be too low (as perceived by the holders of money), the money will not be released into the market, but will be hoarded instead. Conversely, should the interest rate be high enough (again as perceived by the holders of money), those in possession of money will be motivated to decrease their liquidity levels and money will be lent into the market.

The similarity with the Horizontalist theory, is that Gesell also claims that there is a minimum level of interest rate which the money holders (owners) will demand in order to release their money holdings into the public. The difference is, according to him, it is not the monetary authorities (like central banks), but the money holders who will adjust the money supply in order to keep the set interest rate level, and the economy has to adjust itself to provide the conditions for the existence of such a level of interest rate[1]. He consequently characterises the interest charge as a 'tribute' which the money holders demand from those in need of money in order to give it away. Thus, it functions as a gate toll. If a person is unable to pay the tribute, he will not be able to obtain the medium of exchange which is needed to perform economic transactions. Should the targeted interest rate not be obtained by the money holders, the money supply will change in such a way as to affect the real economic structure forcing it to provide the demanded interest rate. Gesell (1918), even claims that the real interest rate, during his time, never fell below 3%:

> But for variations in the price-level, the rate of interest would have remained at 3 - 4% during the last 2,000 years. Why does interest never fall below 3%? Why does interest never, even temporarily, even for one day in the year, even for one year in the century, even for one century in two thousand years, fall to zero? (page 202)

According to Gesell, the best way to understand the existence of interest rates and how to avoid it is by understanding the 'Laws of Circulation', that is explained later in this chapter.

1 It must be noted that Gessel was not living in a pure fiat money system. In the current system it is clear that central banks determine the interest rate by deciding on the overnight policy rate (OPR) and also the quantity of money supply.

6.4 The Importance of Sufficient Supply of the Medium of Exchange

Money is a very important tool for the process of exchange to take place in the economy. It eliminates the shortcomings of direct barter, and speeds up the exchange process, leading to a higher level of economic activity, specialisation and thus material well-being of the economic participants.

Assuming that a certain amount of the medium of exchange is required to cover all transactions intended by a group of economic units, and should there be enough money in the system then all the transactions can take place without any hindrance as shown in figure 1.

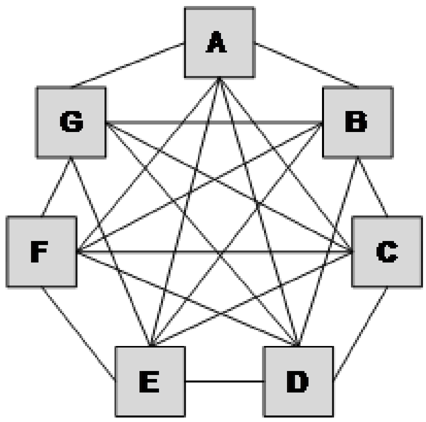

Figure 1. A flawless exchange taking place among a group of economic units, with enough money existing to assist all the transactions.

Now, it is obvious that should the required amount of money cease to be available in the needed quantities, some of the transactions will not take place. As a result, the situation may change to one as shown in figure 2.

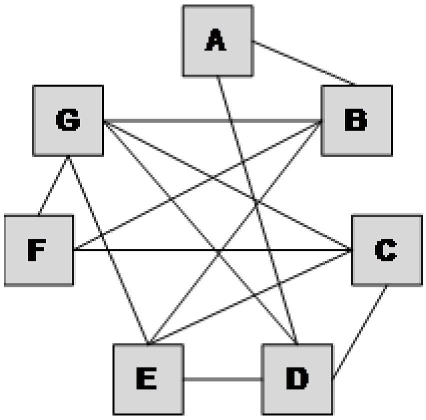

Figure 2. A shortage of the medium of exchange causes some intended transactions not to take place.

The consequences of a disturbance in the supply of the medium of exchange are disturbances in the exchange process itself, given that velocity is assumed to be constant, at least in the short-term.

Since the medium of exchange, or money, is being treated like economic goods,[2] a commodity with a function to act as an intermediary in the exchange process, the result in the money market (referring to the market of supply of money in general and demand for money in general) would be as for any other good. Namely, its 'price' would go up, and those with the highest bid would end up holding it.

The question now is, what is the price of money charged in money markets? The standard text-book answer is, of course, interest. Yes, the cause, also claimed by Gesell, of the existence of interest is simply the shortage of the supply of money.[3] Thus, all the attempts, as for example by Islamic

2 Money falls under the category "Medium of Exchange", a third type of economic goods, besides production and consumption goods (Mises, 1981).

3 In fact, it is the function of central banks to keep the supply of money short. In their words, they 'mop-up liquidity'.

banks, to avoid interest are unfruitful because they have to compete in the same market for money with those who are willing to pay and receive interest. Therefore accordingly, a merging of the interest rate and the profit rate in the banking sector is observed, as shown in Figure 3. Should there be any significant difference between the two rates, arbitrage would take place, and thereby force the merger of the rates. Consequently, Islamic or not, both systems would pay almost the same price for obtaining, as well as charging almost the same price for providing money to society.

Now, the existence of this price indicates that public and private entities have to compete for the medium of exchange, and must be willing to pay the price in order to obtain the money (to conduct their exchange transactions). Since not all can win the bidding process, for otherwise the price of money would be equal to zero, the consequence is that there is a certain amount of economic activity which will not take place simply because enough money is not available to facilitate the transactions.

Yet, this misfortune for many is a fortune for a few, i.e. those who are in the ownership of the medium of exchange can demand a compensation for allowing others to use their money for their transactions. As Gesell (1918) writes:

> Usually, therefore, that is, commercially, the present form of money acts as intermediary for the exchange of wares only on condition that it receives a tribute. If the market is a road for the exchange of wares, money is a toll-gate built across the road and opened only upon payment of the toll. The toll, profit, tribute, interest or whatever we choose to call it, is the condition upon which wares are exchanged. No tribute, no exchange. (page 103)

Thus, interest is not a matter of compensating for postponed consumption, due to savings, but simply an enforced charge due to market conditions, just like the price for any other goods in the market.

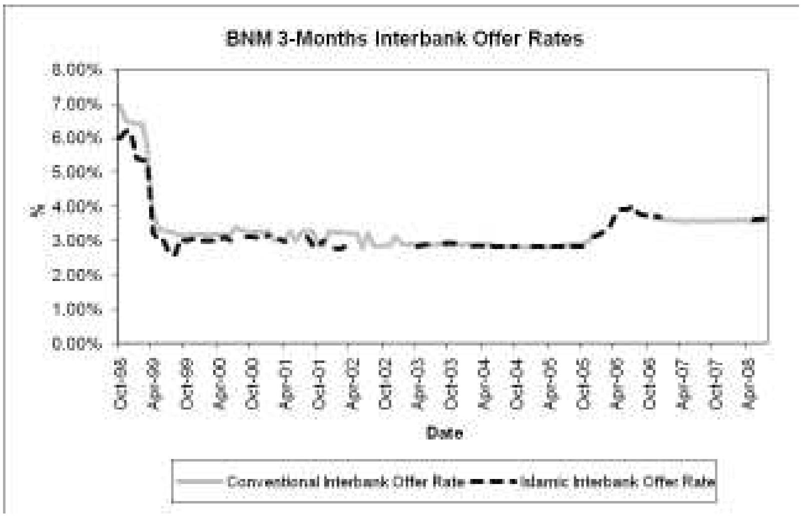

Figure 3. Source: Bloomberg

6.5 Demand for and Supply of Money

Given that every price is determined by the laws of demand and supply, it is of immense importance to understand the forces which constitute the demand for and supply of money. Gesell focused the analysis of the demand component of money to, what we might call in modern literature, transactional demand for money. The transactional demand, of course, depends on the amount of goods and services which are offered for exchange, which depends on the degree of division of labour. The higher the level of specialisation, the higher is the need for the exchange of goods and services. Thus, economic growth and development, which among others are also subject to the degree of division of labour, thereby also depend on the reliability of the exchange system which in the present world is usually the monetary system, since practically all economies have adopted the monetised process of exchange. Improvements of production methods also increase the demand for money. The reason is straight forward - better productivity increases the output of goods, and as a result increases the demand for exchange mediums. According to Gesell (1918), also the improvement of quality of goods and services increases the demand for money:

> Modern products are constantly advancing in quality. Breeding stock and seeds are being steadily improved; the finish given by machinery is becoming finer and finer; purer and more useful chemicals reach the market. With electric chisels and the splendid models furnished by our exploited proletariat, sculptors produce miracles, and the demand for money increases by the full advance of the art of the present beyond the art of the past. (page 94)

Any improvement in transportation, advancements and discoveries are all factors which contribute to an increase in goods and services offered for exchange, and consequently increase the demand for money. However, wars, natural disasters and many others are factors which contribute to a reduction in goods and services supplied to the market, and thus cause a reduction in the demand for money. In short, demand for money (referring to transactional demand) equals the amount of goods and services offered in the market, less the amount of goods and services which are traded by way of exchanging credit (or netting). Consequently, as the amount of goods increases, the demand for money increases, and vice versa. Other forms of demand for money are covered in the section "Laws of Circulation" below.

Money supply is simply the stock of money offered in the money market. In addition to that, money supply depends also on its velocity, or speed of circulation. Thus, technical improvements which lead to a faster circulation of money, or a change in the features of money which cause it to be circulated faster, cause the money supply to increase. The two forces, supply of goods and services (part of money demand) and supply of money affect the price for money itself.

6.6 Laws of Circulation

Other than the fact that money supply is one of the components which determine its price, and the price level of goods and services, another fact needs to be considered as well, which is that money can be used to defer demand, since it can act as a saving medium. This is a very important fact for further analysis.

Comparing wares in general, and assuming that money is a relatively good saving medium, it must be admitted that money as a commodity has a great advantage over other commodities. Looking at producers of everyday food items, like bread, vegetables, fruits, and those who have money holdings, the former are under pressure to monetise their goods, or to exchange them for goods which are of use to them. The latter, however, are not under any pressure at all. In the case of gold as money, the advantage becomes even more obvious given that it is an indestructible commodity which can be held forever, and it would not lose any of its characteristics. The mentioned advantage of money over goods is a very important detail because it explains which manner of saving people prefer. And people are going to save because it is human nature to do so. The motivations differ, but all people, who are able to, will save. The only question is how to save. An individual has the choice between preserving his savings in money or in goods, or by lending and investing the surpluses which are intended to be consumed at some later stage. For reasons which are not the subject of this Chapter, people choose to keep their savings in the form of money, especially if it is a good savings medium like gold, rather than keeping their savings in the form of goods that may deteriorate over time while incurring also storage cost. Now, these savers however pose an obstacle to further exchange process by withholding money needed for the exchange process, and thereby as a result contribute to the shrinkage of the economic activity to a level below the potential economic output (a situation as in Figure 2).

Consider, for example, that person A has sold his goods and obtained a certain amount of money in return, which he intends to hold, then he is stopping others from using that same money for their transactions. Consequently, if persons B and C wished to do exchange, they may need to approach person A and ask for his money. However, person A may not be motivated simply to give away his money holdings, which are a very safe form of savings, but making it subject to risk of theft, loss, etc. In order to obtain the money from person A, persons B and C may also have to pay a tribute which today is in the form of interest. It does not matter in this scenario who is the paying person, B or C, but it is important to understand that a tribute is payable, simply because some individuals have obtained the ownership of the generally accepted payment medium, and thus are able to block further exchange if they keep the medium of exchange in their possession. Consequently, Gesell concluded a simple rule, which he puts into the words "No tribute, no exchange." (1918: page 103)

Gesell differentiates between this kind of income from all other forms of income. It is totally different from those of a merchant, of a farmer, or any other form of economic profit, but is purely profit which is enabled simply by the nature of money, that it can be freely withdrawn from circulation and enable its possessors to demand a tribute for it to be placed back into circulation. Of course, the tribute alone is not enough. Among others, there must be sufficient security against loss. Another condition is that the holder of the money expects rising prices, or at least constant prices in the market. Should he expect a fall in the price level, he might suspect the ability of the borrower to repay the money, and therefore might choose not to lend the money out. As for the holders of goods, the expected changes in the price level do not play such a significant role since their goods are going to deteriorate over time, irrespective of whether the price is going to remain the same, go up or down, and therefore the holders of goods are compelled to pursue exchange.

A non-falling price level is thus one of the requirements for money to enter the market. Yet, the demand and supply relation determining the price level is subject to change, which might affect the price level positively or negatively. Should the price level be affected negatively, that is, it decreases (or is expected to decrease), the holders of money might become suspicious of the ability of the borrower to repay the borrowed money, and as a result cease to lend money out. In other words, money conceals itself because " ... it is insufficient to affect the exchange of wares at the present price-level (Gesell, 1918: page 104)." Thus, mistrust in the price stability, i.e. expecting a falling price level, will cause the money supply to be disrupted. Once the money supply becomes insufficient, either due to destruction of the fiduciary monetary base, or by the withdrawal of the gold-based monetary units or simply because the increase in economic output is not being matched by a corresponding increase in the monetary base, commercial and with it the economic activity has to reduce in size as well. Should the monetary base become insufficient to maintain the price level in the economy, it will withdraw even more and therefore actually contribute to even further fall in prices.

Usually, when there is a mention of money not being enough, people think of money flowing out of the country. Nevertheless, this is not necessarily the case. The money can still remain in the country, but simply withdrawn from circulation, the effects of which are same as if it had been drawn out of the country. Thus, simply by expecting a fall in prices, demand will decrease, and the consequent market changes will become a self-fulfilling prophecy.

Accordingly, even when the monetary base is sufficient to maintain the price level in the economy, pessimistic expectations of price falling (which might be wrong) can also lead to a fall in commercial, and thus economic activity.

Yet, in the real sector, economic agents continue to push new products into the market. The farmer still will offer his harvest and the labourer will still offer his labour. Consequently, the demand falls in relative terms (given that less money enters into circulation) while the supply increases (meaning more goods are accumulated in the market which are offered for sale). The end-result is, as Gesell puts it, "demand becomes smaller because it is already too small, and supply becomes larger because it is already too large." (1918: page 105)

It is worth noting that credit sales also play an important role in determining the price level in the market. Namely, sales can be done for cash, or on credit, or simply through a barter transaction. Those sales which are on credit or done through bartering are not constituencies of the demand factor for money in the market, which is, as noted before, determined by the supply of wares offered for money. But the volume of credit sales increases in the case when an increase in price level is expected, and conversely, the volume decreases if the price level is expected to decrease, and that affects the demand for money. As Gesell (1918) describes it:

> Credit sales decrease when prices fall, when selling prices fall below cost prices, when a merchant usually loses upon his stock of wares, when on stocktaking day he can buy for 900 those articles in his warehouse which cost him 1000, and must therefore write them down to 900 in his inventory. The solvency of the merchant increases or decreases with the prices of his wares, so credit sales also increase or decrease with the increase or decrease of prices. (page 105)

Hence, once the price level starts falling, credit sales will decrease. That will result in more goods being offered against money, and will consequently increase the demand for money even further, resulting in even higher pressure on prices to fall. This will motivate even further withdrawals of money or, in other words, even further falls in the supply of the exchange medium, the price level, and consequently limit the economic activity. On the other hand, when prices start increasing, or are expected to increase, market participants are entering into more credit-based transactions, affecting negatively the demand for money and consequently contributing to a rise in the price level. Hence, credit sales, and consequently their effect on money demand, are conversely related to the movements in the price level.

Having discussed the view of Gesell on the situation in which the price level is going to or is expected to decrease, the focus now shall shift to the situation when prices are going to or are expected to rise. Once the holder of money expects the price level to rise, he is more than willing to lend, for he is much confident that the borrower will be able to return the money. At this moment, the velocity of money also tends towards its physical maximum for traders are also optimistic and do not think twice whether to enter a purchase or not. Given the high confidence level, many purchases will also be done on credit, and thus credit sales and purchases will also increase substantially.

Given that more money is being put into circulation, the demand in the market increases and since the velocity has also increased, the demand increases, too. As mentioned before, credit sales are conversely related to money demand, but are directly related to the price level. Consequently, as the credit sales increase, fewer goods are offered against money or, in other words, the supply of goods which is offered against money decreases. The effect is obvious; the price level rises.

Gesell (1918) concludes his analysis of the law of circulation of gold-based money system, but applicable also to our modern interest-based fiat monetary system,[4] with the following words:

> Yes, our gold standard, offspring of the theory of value, stands the test. That our investigation has clearly proved. It causes an increasing demand *for goods* and *services* when demand is already too large, and restricts demand to the personal bodily wants of the few holders of money the moment demand becomes too small! A starving man is deprived of nourishment because he is starving, and a glutton is filled to bursting because he is a glutton (pages 106-107, italics added).

To understand why this criticism on gold also applies for a fiat monetary system, it must be mentioned that in fractional reserve banking, only a small portion of money in the market is in the form of hard currency, while the huge majority is in the form of demand deposits which are convertible into hard cash. This fractional banking of demand deposits results in a multiple creation of demand deposits as against the hard currency which has been injected into the monetary system as well as multiple destruction should the hard currency be withdrawn from the system. How this affects the economy is similar to the critics on the gold-based monetary system as outlined by Gesell. Thus, during times when the population is optimistic that the price level will increase and the economy will be stable, the money is put into circulation (either directly in the market or through an intermediary, typically a bank). Yet, given the fractional reserve banking system, assuming a 10% required reserve ratio and a perfect usage of the fractional banking system, the banking sector is able to create for every RM100 an additional RM900 in demand deposits, which are then put into circulation in the form of loans. But once market participants decide to increase their money holdings (including holdings

4 This is actually true for any form of money. As a result, Islam uses religious doctrine to keep money in circulation - discouraging hoarding, abhorring interest and charging *zakat* on savings.

of hard currency), given the fractional reserve system, a withdrawal of RM100 in hard currency results with a decrease of the money in circulation by an additional RM900 (demand deposits), or altogether RM1,000. The domino effect which would follow would very quickly decrease the size of the monetary base to a minimum which is required for maintaining a minimum economic activity.

The speculative potential of such a fragile system is of course obvious. Thus, individuals with large sums of money are able to use the structural features of the monetary system to influence it according to their will. This ability is intensified in the current interest-based fiat monetary system. As a result, when Gesell proposes the use of fiat money instead of gold, he not only proposes fiat money, but also another form of monetary establishment and regulation as discussed bellow.

6.7 Interest vs. Profit

Just as a note of comparison, we would like to highlight the difference between profit and interest. Profit is generally explained through the Theory of Value. It is basically the measure of additional utility gained by exchanging good or services with lower marginal utility with those with higher marginal utility. The exchange process will give additional utility until the ratios of marginal utilities to their respective quantities (or price) are all equal. Collective marginal utilities of every individual define the demand and supply curves and thereby determine the equilibrium market price and quantity. With the introduction of money into the economy, profit therefore is a measure of additional utility possible but not consumed yet.

Accordingly, profits are rooted in the different skills people possess or specialise in. Therefore it is possible for everyone to record profit since it basically is the recognition of creation of value (wealth) in the exchange process.[5]

5 A loss is, on the other hand, the reduction in utility or loss of value, i.e. the opportunity cost of input lost due to inability to exchange, unfavourable exchange rate, depreciation etc.

Interest, on the other hand, arises from the control and hoarding of the medium of exchange by the money holders, particularly when the medium of exchange is a good store of value. Therefore, interest simply brings about transfer of wealth within the economy. It does not contribute towards creation of wealth but rather takes wealth from the economy. Interest is therefore a zero-sum game, i.e. the interest paid is interest gained to another. Unlike profits, it is impossible for all subjects in the economy to record net interest income. Hence interest involves the wrongful transfer of wealth from Islamic perspectives. This is clearly spelled out in the Qur'an:

الَّذِينَ يَأْكُلُونَ الرِّبَوٰاْ لاَ يَقُومُونَ إِلاَّ كَمَا يَقُومُ الَّذِى يَتَخَبَّطُهُ الشَّيْطَـٰنُ
مِنَ الْمَسِّ ج ذَلِكَ بِأَنَّهُمْ قَالُوٓاْ إِنَّمَا الْبَيْعُ مِثْلُ الرِّبَوٰاْ
وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَوٰاْ

> Those who devour usury will not stand except as stand one whom the evil one by his touch has driven to madness. That is because they say: "Trade is like usury," but Allah has permitted trade and forbidden usury.
>
> *Al-Qur'an Al-Baqarah 2: 275*

6.8 The concept of Free-Money

Gesell wanted to alter money in such a way that it becomes a stable and reliable supporter of the exchange process and that it ceases to be misused as a gate for toll collection. In order to achieve the stated targets, he argues in favour of two major features:

1. Paper should be used as the raw material for money;[6] and
2. Money should have an inbuilt rate of depreciation.

Gesell argues that the quality of money depends on the lack of positive properties, and even better if it has negative properties. According to him, the reason why gold became the naturally chosen kind of money is

6 In the modern context, electronic money should be acceptable.

because "of all natural products gold has the fewest properties, the fewest uses in industry and agriculture. To no substance are we so indifferent as to gold, hence the facility with which it could be adopted as money (1918: page 78)." Of course other features that made gold the choice for money is that it is indestructible and that it yields more commodities than other money materials. And yet, gold still has some industrial use, like for the production of jewellery, which makes paper-money in this aspect more advantageous since paper-money has no significant positive properties. Most probably, Gesell would support the shift from paper to electronic money as well, since electronic money has no positive properties at all and thus would make an even better choice.

Another problem of gold is the mentioned indestructibility. As a result of such a feature, Gesell claims that gold does not harmonize with the character of goods in general, or simply said, "the possession of a gold coin is incontestably more agreeable than the possession of goods (Gesell, 1918: page 121)." Consequently, gold became the favourite choice for the money holders, so claims Gesell, because it puts the holder of money, i.e. the buyer in the market, in an advantageous position over the seller of wares causing a potential situation in which the latter becomes the " ... sport of caprice, greed, speculation and chance (Gesell, 1918: page 121)." Therefore, money should cease to function as a superior saving medium.[7] Even more, he wants money savings to lose value, in the same way as goods lose value due to deterioration, and hence his favouring for a certain level of negative properties to be inherent in money. Silvio Gesell, therefore, opposes those who are calling for a stable value of money.[8] He calls for a monetary unit, which will have a stable and inbuilt loss function, making it as desirable, or undesirable, at a similar level as other goods in general. Such money would be in a way under compulsion to circulate in

7 Prophet Mohammed (p.b.u.h.) chose a superior savings medium, i.e. gold, yet its hoarding has been discouraged through the teachings of Islam as well as the imposition of *zakat*.

8 The inbuilt loss function refers to the loss in quantity of money, not in purchasing power. Hence money is still a stable unit of account but one now has less of it. The same effect is achieved through the imposition of *zakat*, which keeps the purchasing power of money, i.e. its value, stable but decreases the amount owned.

order to avoid losses, in a similar manner to the supply of goods which is naturally compelled to be offered in the market. The solution which Gesell proposes is an inbuilt depreciation function. He proposes that money should lose value on a weekly basis by 0.1% amounting to a total of about 5.2% per annum.[9] As a result, the holder of the money has to suffer holding expenses in the same manner (or even worse) like the holder of goods. This is his 'medicine' to make money unworthy of being hoarded, as surplus goods are to the producers (and that is why they offer the goods for exchange). In this way, the demand for money and the supply of money will be equally compelled to enter the market and ensure a continuous process of exchange. Such a feature of money, so claims Gesell, will ensure a stable circulation of money, resulting with a stable money supply, or the demand component in the market (the amount of issued money times the velocity allowable given the existing commercial establishment). There will be no private hoarding of money for such an action would result in loss. Market participants would only accept money in the event they wish to use it again in the market as soon as possible.

Besides causing a stable supply of money in the market, another by-product of such a scenario is the ability of the market to know how much demand there is in the market (or how much money is in circulation), at all times, in the same way as the supply of goods is known. The whole amount of money would be in circulation, and as a result the amount of money produced would equal the amount of money in circulation.

It remains to be explained why market participants should adopt Gesell's free money concept. Especially those who enjoy the control exercised over their money holdings would most probably resist the replacement of the 'old ways'. Browsing through Gesell's explanation why paper-money could function at all, one can construct his recipe for the implementation of the 'free-money' concept:

1. The state should provide no other money than 'free-money';

9 The amount of 0.1% seems to be chosen arbitrarily, with the only objective to make money "... worse as a commodity if we wish to make it better as a medium of exchange (Gesell, 1918: page 121)." For comparison, Allah, in His infinite Wisdom, has chosen the rate to be 2.5%, in the form of *zakat*.

2. The state should demand the payment of taxes, fines, etc. in 'free-money'; and

3. The state should sell postage-stamps, tickets on the state railway, timber from the state forests, salt from the state mines, etc. only for 'free-money'.

By means of the above, the state would thus enforce the circulation of 'free-money'.[10] Gesell also offers a way how to manage the supply of his proposed exchange medium. Having the full amount of money produced also fully circulating in the economy it becomes a simple game of managing the monetary system. As the factor determining the necessary amount of money in circulation, Gesell proposes to use a price index, with the aim of stabilising the general price level. Thus, should the index start falling, the currency office would immediately either alter the rate of depreciation or, even better, just "... pay new money into the public treasury which will expend it by means of a proportional reduction of taxation (Gesell, 1918: page 125)."[11] Should the price level start rising, the government would again alter the rate of depreciation or simply " ... do nothing. Any surplus consumes itself automatically *given the inbuilt depreciation* (Gesell, 1918: page 125, italics added)."

The revenues to the currency office would be the depreciation rate charged on money holdings,[12] or effectively on the outstanding credit amount in circulation. However, in the current real life scenario, it is the money borrowers who are paying the revenue for the Currency Offices (their role today being taken over by banks) in the form of a positive interest rate, not the money holders in the form of a negative inbuilt loss rate. Such a twist deprives the system of the motivating element for the circulation of money

10 It is obvious that a similar recipe is being used by contemporary governments of nation states to enable the implementation of current national fiat currencies. In addition to the mentioned, modern nation states, directly by means of law, simply impose their fiat currencies by giving them the status of legal tenders.

11 As a result of such a policy, Gesell actually proposes the use of the seigniorage obtained from the newly created money to be utilized by the government.

12 The Islamic government collects this in the form of *zakat*.

as advocated by Gesell, but more importantly, it requires the borrower to repay the principal amount plus the interest rate portion in cash which might not even be in existent and thus consequently would result with certain defaults of some debtors.

Gesell not only offers a new concept of money, but he also proposes certain evaluation criteria upon which the success or failure of monetary system could be measured. Firstly, the monetary establishment must be able to solve the following problems:

i. The holders of money evaluate those demanding the medium of exchange on their ability to provide sufficient security against losses and demand a tribute for the use of the exchange medium;

ii. The money is not able to maintain the price level in the economy, and it has the ability to withdraw from circulation; and

iii. Pessimistic/optimistic expectations (which might be wrong) that are affecting the circulation of the money.

Secondly, the chosen money must maximise the following characteristics:

a) That it shall secure the exchange of goods - which shall be judged by the absence of trade depressions, crises and unemployment;

b) That it shall accelerate exchange - which shall be judged by the lessening stocks of wares, the decreasing number of merchants and shops, and the correspondingly fuller storerooms of the consumers; and

c) That it shall cheapen exchange - which shall be judged by the small difference between the price obtained by the producer and the price paid by the consumer.

Therefore, money should only have one purpose; it should be used for exchange only (supporting, accelerating and cheapening it). Thus, when someone sells his goods for money, the person needs to use the same to buy either some other goods, or if he does not wish to do so, buy his goods back or lend it out. But he should be discouraged to hold on to the money for such an action would block further exchange by depriving the market of the medium of exchange, and maybe impose a tribute on the market in return for making the money available.

6.9 Free-Money and the Islamic Perspectives

The Islamic scholars, classic as well as modern, looked into the money issue as well. Imam al-Ghazali (1058 - 1111 C.E.) discussed the wisdom behind the use of money, its role and functions, circulation as well as the issue of its treatment as a commodity (asset). In short, his conclusion is that money is to be used in order to solve the problems of valuation and exchange (Sadeq, 1992). As a result, its functions should be limited to that of a unit of account and a medium of exchange, which coincides with the views of Gesell. Imam al-Ghazali dislikes the idea of money playing the role of a store of value even though he accepted the existence of such use but he did not recommend it, since it might be an inviting feature of money to be hoarded. Its treatment as an object of trade (for interest) is *ẓulm* and thus, money should not be treated as a commodity.[13]

This view is also supported by Ibn Taimiyyah (1263 - 1328 C.E.) who argued that the functions of money are only as a measure of value and to be used to acquire goods (Islahi, 1992). In addition he also supports the view that money is not to be subject of trade and that its possession cannot be the end objective.

Ibn Khaldun (1332 - 1406 C.E.) recognised the reality that people were using money as a store of value and that money has become one of the end objectives of trade (Dawood, 2005):

> Furthermore, God created the two minerals, gold and silver, as the measure of value for all capital accumulations. These the inhabitants of the world, by preference, consider treasure and property. Even if, under certain circumstances, other things are acquired, it is only for the purpose of ultimately obtaining (gold and silver). All other things are subject to market fluctuations, from which (gold and silver) are exempt. They are the basis of profit, property, and treasure (page 298).

13 Commodity having an end objective as against money which should be used only as a medium of exchange to obtain the desired things.

Allah (s.w.t.) also mentions gold and silver in the Holy Qur'an to be treasure desired by men as part of comforts offered by the transitory life of this world (3: 14). Yet, in a similar manner as is explained by Gesell, Islam discourages hoarding of money. Thus Allah (s.w.t.) proclaims in the Qur'an a painful punishment " ... to those who hoard gold and silver and do not spend it in the way of Allah ... (9: 34)".[14] It must be noted however, that it is not the accumulation of wealth, but its misuse that is condemned.[15] Thus, when the mentioned verse was revealed, the Muslims were grieved about it given that some were wealthy and as a result worried how to act rightly. After being approached on the issue, Prophet Mohammed (p.b.u.h.) explained that Allah (s.w.t) has ordered for the Muslims *zakat* as a tool for purifying wealth as well as inheritance to ensure that the wealth might reach the rightful successors and as such should be executed and practiced by Muslims.[16] The mentioned *zakat,* functions in a similar manner like Gesell's requested inbuilt loss function, the difference with *zakat* being that it is applicable only on gold and silver balances,[17] which is idle for a duration of one year (as against a weekly depreciation as proposed by Gesell) and is applicable only to those whose idle balances are above the minimum *nisab*[18] value while in Gesell's 'free-money' concept everyone is equally

14 Yusuf Ali translated the verse as "... those who **bury** gold and silver and spend it not in the way of Allah ... (9: 34, bold added)", to which he added a note listing the following three ways in which misuse of wealth, property and resources is being condemned: [1] acquiring anything wrongfully or on false pretences; [2] hoarding or burying or amassing wealth for its own sake but use it freely for good, whether for yourself or for your neighbours; and [3] be particularly careful not to waste it for idle purposes, but only so that it may fructify for the good of the people.

15 Ibn Al-Qayyim (1292 - 1350 C.E.) already argued in favour of riches and wealth, since it is that which enables one to perform all kind of good deeds easily (Islahi, 1992b).

16 The full *hadith* as narrated by Abdullah ibn Abbas is: "When this verse was revealed: "And those who hoard gold and silver," the Muslims were grieved about it. Umar said: I shall dispel your care. He, therefore, went and said: Prophet of Allah, your Companions were grieved by this verse. The Apostle of Allah (peace be upon him) said: Allah has made *zakat* obligatory simply to purify your remaining property, and He made inheritances obligatory that they might come to those who survive you. Umar then said: Allah is most great. He then said to him: Let me inform you about the best a man hoards; it is a virtuous woman who pleases him when he looks at her, obeys him when he gives her a command, and guards his interests when he is away from her (Sunan of Abu-Dawood - Number 672)."

17 *Zakat* is also imposed on other assets, which however is not a subject of this paper.

18 One of the wisdoms behind the *nisab* value could be to allow Muslims to keep money for precautionary purposes.

exposed to the loss function, regardless of the minimum money holding or economic wellbeing. In addition to discouraging the idleness of money, Allah (s.w.t.) also encourages spending in a rightful manner in numerous verses in the Qur'an (see for example 13: 22, 14: 31, 2: 177, 2: 195 and 2: 215) which of course coincides with Gesell's objectives of continuous circulation of money by means of spending.

Having mentioned gold and silver, it is worth noting that Gesell argues against these two metals, while recommending fiat money. This is interesting, since the Prophet Mohammed (p.b.u.h.) did not choose a fiat currency to be the money for Muslims. Instead he chose gold and silver, despite the fact that most of the coins had non-Muslim origins. But not only that, he also linked to them the *nisab*, *diyyah* (blood-money), the minimum value of stolen property that could result in the cutting of hand; or were gold and silver simply the Prophet's (p.b.u.h.) choice for money and consequently as the unit of account to express value, benchmarks and threshold? Allah (s.w.t.) mentions them as well in the Qur'an as examples for money (3: 75, 12: 20, 18: 19). On top of that, the Prophet (p.b.u.h.) did not manipulate the face value of the chosen currencies, nor did he impose any exchange rate between the currencies but made their value subject to the market, i.e. the forces of demand and supply. On the other hand, Gesell's proposed choice, namely fiat money, is not acceptable from the Islamic point of view because of its usurious nature.[19] The fact that it lacks significant positive attributes and thus intrinsic value, but it acts as settlement tool in transactions, makes one party provide value (in whatever form of commodities with positive properties), while the other provides nothing (fiat money, or money with negligent positive properties). This fact has been acknowledged by some Muslim scholars, who consequently declared at the 5th Conference of Islamic *Fiqh* held in Granada, Spain, that fiat money (including today's national fiat currencies)

19 The element of usury comes from the treatment of fiat money as commodity (also proposed by Gesell), and thus settlement currency. However, if fiat money would be treated only as a carrier of information, i.e. the credit relationship between the debtors and creditors, even fiat money could be used. For it is not the tool that is usurious, but its way of application.

is *haram* (Vadillo, 1991). The fact that fiat money has exchange value does not come from its positive properties but from the fact that national fiat monies are legal tenders that are legally enforced as payment medium. This is acknowledged by Gesell as well, and that is why he gives instructions that need to be undertaken by the state in order to ensure that the 'free-money' concept could be based on fiat currencies. He even acknowledged the existence of seigniorage, and he recommends it to be collected and used by the state. Yet, given that seigniorage is being harvested by means of inflation, the selection of the payer does not take place according to his or her economic status or wellbeing, a process in which it is usually the weak who are most disadvantaged.

Yet it must be made clear, gold and silver might not be the exclusive, but only preferred choices for money. Haneef and Barakat (2002) made a summary of the *Fiqhi* opinions on the choice of money and specifically on the issue of gold and silver being the obliged choices of money as per *Shari'ah* rulings and concluded that Islam seems very flexible when it comes to the possible choices for money. Even wheat grain, dates, or barley could play the role of money,[20] but not at the same level of performance as would gold and silver. The more important thing is that money should have its own positive attributes which will form its value and thus make it a fair reciprocal in the exchange process.

But if Islam does not accept fiat money as proposed by Gesell, and if Islam is relying relatively more on moral guidance than on an inbuilt loss function for the circulation of money, are those who follow Islam then exposed to potential market fluctuations, manipulations and tributes on exchanges as highlighted by Gesell?

The next section discusses this.

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20 An indication on the possible wide range of monies might be a *hadith* as narrated Ubadah ibn as-Samit:

> "Do not sell gold for gold, or silver for silver, or wheat for wheat, or barley for barley, or dates for dates, or salt for salt except equal for equal, kind for kind, payment being made on the spot; but sell gold for silver, silver for gold, wheat for barley, barley for wheat, dates for salt and salt for dates, payment being made on the spot, as you wish (Al-Tirmidhi Hadith - Number 853)."

6.10 The Proposed Model: A Gold-based Information System

In order to understand the problem and the proposed solution, one first needs to differentiate between money and the exchange process. Money has been identified in Islam as commodity money, and of all, the preferred choices for currencies are gold and silver. It is to be used as a generally acceptable medium of exchange and unit of account, meaning prices and thus relative values are to be established using the chosen monetary unit.

However, there is absolutely no restriction that all exchanges have to be undertaken using money. Bartering, for example, is still allowed in Islam and so is mutual credit clearing. This flexibility in Islam is of immense importance when defining the Islamic monetary system and generally Islamic economic system in general.

Thus, any fluctuations in the supply of gold and silver money, due to whatever reasons, can be stabilised by complementary exchange systems. The colonial merchants in the United States who experienced a shortage of the medium of exchange during the period between 1750 and 1850 used a very simple accounting method to establish a credit barter clearing system in order to overcome the problem of an insufficient supply of money (Kreiser, 1976). The merchants would simply record their mutual sales and purchases as debit and credit balances, which would be cleared on a monthly basis. Only the outstanding balances would then be settled using money.

Today's ICT technology, which was not available during the times of the colonial merchants of the United States, offers of course, opportunities for more sophisticated exchange systems which would drastically minimise the reliance on physical money and thus make shortages in money supply virtually impossible. Should the ICT technology be used wisely in the mutual credit industry, the issuance of credit would no longer be the business of bankers alone but of all, who simply would record the credits taken by members according to predetermined and fixed rules and regulations. By creating various forms of certified compensation bills,[21] the outstanding credit balances would even be freely exchangeable in the market (at par value as required in Islam) for goods and services, leading to an efficient and cost effective (if not almost costless) way of automatic credit clearing. Gold (and silver) would be used as a unit of account, store of value and of course as a medium of exchange while being the settlement tool for outstanding credit balances.

A possible structure is shown in figure 4. A key element is the Communications Network. It is needed in order to overcome information asymmetry and enable an automated credit clearing procedure, limiting the actual exchange of commodity money to outstanding account balances only. For it to function effectively, standardised procedures for transfers of information need to be agreed upon, as well as a common mutual credit framework. That would be the task of the Regulatory and Auditory Body (RB), which would act as a common platform for the market participants to agree upon the mode of credit issuance, its tenures and requirements as well as to audit the market implementation of the agreed-upon elements. The determined rules would be applied universally, avoiding any possibility of discrimination against and biasness towards any fraction of the society involved in the exchange process. On the other side, the RB would not have direct access to money and credit management. That would be the task of the financial institutions (FI) which would compete against each other to provide the service to the customers. Those services would be limited to accounts management (for both, money and outstanding credit balances) as well as the issuance of the mutual credit balances as per agreed conditions within the RB. The approval process at FI's would then not be based on their own companies' policies, but simply on a check-list method as instructed by the RB. The RB would monitor the issuance of credit facilities, implementation of non-discriminatory policies as well as monitor FI's modes of generating income which would be limited to fees, charges and provisions, making the FI's mode of operations and income generations indeed similar to that of accountants' and vaults owners'.

21 In today's terminology such bills might be classified as *bona-fide* or credit money, but will be avoided in this paper in order to reserve the term "money" only for the commodities which are the chosen units of account.

The RB would also monitor the account balances against the actual commodities stored in the specialised bullion vaults and ensure that no fraud occurs by FI's issuing monetary balances without underlying commodities as well as ensure standardised and genuine coinage.

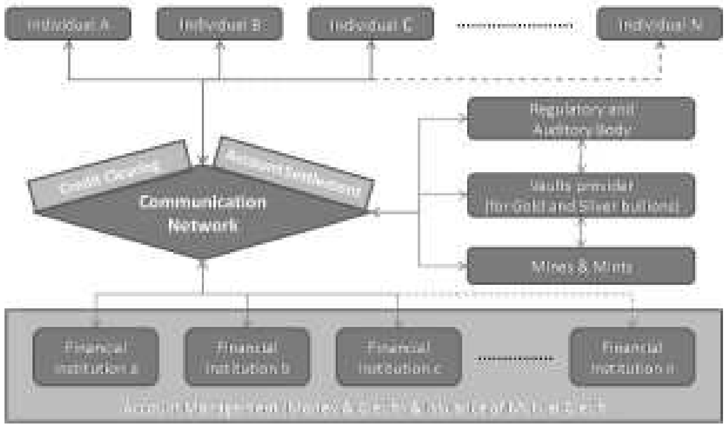

Figure 4: Proposed Model: A gold-based information system.

A cohesive exchange structure (such as the one illustrated above), which is based on commodity money providing a stable and reliable unit of account and store of value, aided by a well developed mutual credit and credit clearing institutions providing a strong supporting information system should result in a wide availability of exchange media which would eliminate the possibility of market and money manipulation to deviate prices and demand tributes against the exchange process. A monetary system as such need not impose a legal tender law. Yet, it would provide the aimed freedom to the exchange process and disable the existence of tributes in form of interest or so called profit rates in Islamic banking. Combined with the implementation of *zakat* and the moral values of Islam, the circulation of money would be encouraged, velocity would be increased, redistribution of wealth would take place, and the Muslims would have a genuine Islamic monetary system, which would have nothing to do with the current interest-based fiat monetary system.

6.11 Conclusion

Gesell claims that the existence of interest is enabled by the ability of money to act as a savings medium and the ability of the money holders to withdraw money from, and to restrict the entrance of money back into circulation for use by economic participants in the process of exchange. In addition to enabling the existence of interest rates, he argued that the ability of money to be used as a store of value also causes economic instabilities.

Gesell has accepted a familiar preposition in his argument as well. For example, he still treats money like a commodity which has a function as a medium of exchange in the society. The only thing he was trying to avoid is the intentional limitation of its production and quantity in circulation, i.e. the instability of its supply in the economy. As a solution, he proposes the use of a fiat currency, whose production is unlimited. He acknowledges the existence of seigniorage in such a process and as a solution, he suggests the government to use it as a source of revenue.

What Gesell ignored is the fact that exchange does not have to take place using money only. Various barter circles, mutual credit clearing institutions existed since long time ago even before the development of ICT. However, with the development of ICT, alternative exchange methods have become simple, inexpensive and widely applicable that they can aid commodity-based monies to achieve the same effects in the economy as desired by Gesell.

Gesell also calls for an inbuilt loss function which would periodically decrease the amount of money held as savings. Such a function already exists in Islam in the form of *zakat*, but implemented differently, with less pressure on the money holders as that compared with Gesell's proposal.

The conclusion is that the 'free-money' concept which is based on fiat money is not the answer for the Muslim world, or for that matter the whole world. Commodity money, most of all gold and silver, are the chosen forms of money in Islam. Yet, the possible manipulations as explained by Gesell are a potential threat to the stability and reliance of a system based on gold and silver, and thus in order to avoid the possible negative consequences of a monetary system based on commodity money, the Muslim world needs not only to work on returning to gold and silver as money, but work parallel on developing supporting alternative and complementary exchange systems in the form of mutual credit as well as mutual credit clearing institutions, which would aid gold (and silver) in providing a stable and cohesive Islamic monetary system with all the benefits as outlined in the 'free-money' concept, resulting with a gold-based information system that prelude the existence of interest-charging.

It would be wrong to assume that this Chapter has provided all the answers and solutions needed for the establishment of a just and genuine Islamic monetary system. Rather, it has just touched the tip of the iceberg, in the hope of inspiring further research on the issue of money, monetary, exchange as well as credit systems. It would be of immense practical use if Muslims could establish alternative exchange mechanisms in order to study the practical implications of various systems and forms of exchange arrangements. However, a sound theoretical foundation would be a necessary prerequisite for serious experimentation. Consequently, theoretical arguments and models must be followed by small-scale projects of complementary exchange mechanisms. The theoretical and empirical findings and experiences would surely contribute to the enrichment of Muslim academia and the development of a truly Islamic money and monetary system.

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