

## Application of International Trade and Islamic International Financing From Islamic Perspective

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### Abstract

International trade is defined as exchange of capital, goods, and services across the countries. In most countries, international trade represents a significant share of gross domestic product (GDP). Principally, international trade is not different from the domestic trade since the purpose and behavior among the parties fundamentally is to obtain benefit or profit though for some reason. This transaction is more costly than domestic trade. Actually, international trade has been performed since many years ago and Muslim scholars have been aware of the existence of this trade. The issue comes up when international trade nowadays is mostly financed by conventional system which exist any prohibited transaction such as interest or *riba*. Therefore, this paper attempts to analyze the Islamic perspective of international trade and its application especially about its financial system involved to support the transaction. The qualitative analysis is presented by presenting some literature analysis to comprehend deeply the concept of international trade and its financing system.

*Keywords: International Trade, International financing, Islamic Perspective*

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## I. INTRODUCTION

International trade is an action of buying and selling goods and services across international borders or territories. This exchange of goods and services represent an important contribution of gross domestic product in most countries.

International trade among various countries is not a new concept. Study indicates that there were several examples of international trade. Traders used to transport silk and spices through the silk route in the 14<sup>th</sup> and 15<sup>th</sup> century. Nowadays, the advantages of international trade are the major stimulus of its growth. Countries with strong international trade have become prosperous and have the power to control the world economy. The global trade, if it is maintain properly, can become one of the major contributors to reduce poverty. Principle of comparative advantage by David Ricardo, a classical economist, explained how trade can benefit all individuals, companies, and even countries involved in it, as long as goods are produced with different relative costs. The net benefits from this activity are called gains from trade. On the other hand, Adam Smith, another classical economist, says, a country can have benefit from trade as long as it has the least absolute cost of production of goods. It is called absolute advantage principle. In Islamic perspective, trading play a significant role in the acquisition of wealth. As the holy Quran stated<sup>5</sup> : *“We are made the day a means of earning livelihood”*. Our prophet Sayyidina Rasulullah (Salallahu Alaihi Wasallam) said ; *“Take to trade, because there are nine portions in trade out of ten portions of provisions”*<sup>6</sup>.

The international trade system is now growing and spreading rapidly. It facilitated by modern production techniques highly advanced transportation systems, transnational corporations, outsourcing, manufacturing and services and also rapid industrialization. International trade has huge potential to be developed and it gives great profit to mankind, particularly for the Muslim countries. It can be seen from the data given by WTO<sup>7</sup> that most trade flows took place within regions, rather than between regions; for instance:

- Intra Europe \$3,998 billion,
- Intra Asia \$2,464 billion,
- Intra North America \$957 billion,
- Intra Middle East \$89 billion,
- Total Middle East Trade \$471 billion,
- with Europe \$108 billion,
- with North America \$79 billion.

The other data <sup>8</sup> represents that international trade among OIC (Organization of The Islamic Conference) countries has been growth and it could be concluded the cooperation among the members has given benefit for each country.

Table 1. Main Intra-OIC Trade Actors (representing 68.68% of net Intra-OIC trade in 2010)

No	Country	Trade Volume (in billion)
1.	UAE	\$ 60.73
2.	Turkey	\$60.45
3.	Saudi Arabia	\$50.08
4.	Malaysia	\$40.52
5.	Indonesia	\$38.78
6.	Iran	\$33.39
7.	Pakistan	\$24.70
8.	Syria	\$22.63
9.	Egypt	\$21.78

<sup>5</sup> Stated in Surah An-Naba 11

<sup>6</sup> Ihya-ul Ulum by Imam Al-Ghazali – Alaihir Rahmah

<sup>7</sup> WTO – International Trade Statistics 2011

<sup>8</sup> The Islamic Centre of Development of Trade 2011 Annual Report on the Trade Among the Member States of OIC

One of the most important issues for traders involved in a transaction is to secure financing so that the transaction may actually take place. They need to be facilitated by a faster and easier process of financing in their global transaction. But this conventional financing system which is constructed by capitalism philosophy built on a doctrine of self-interest and is said to be a value-neutral system, not concerned to moral values. On the other hand, Islamic finance cannot go beyond the scope of Islam as a *diin* (religion). Islamic economic and finance have to go along with the *Shari'ah* which is the basic teaching that cannot be violated at any point in time. This basic teaching represents the basic elements of faith that are described as *Maqashid al-Shari'ah*, which main goal is to promote *maslahah* (public interest) and prevent harm (*mafsadah*). Thus, this paper tries to analyze the Islamic perspective of international trade and its application especially about its financial system involved to support the transaction.

## II. LITERATURE REVIEW

Conceptually, the principle of international trade is similar with domestic trade. International trade can define as the process of exchange of goods and services between countries. The theory of international trade has been introduced by Adam Smith<sup>9</sup> which is called the theory absolute advantage. According to Smith in *Wealth of Nations*, trade is the consequence of the human "propensity to truck, barter, and exchange one thing for another"<sup>10</sup>. Furthermore, absolute advantage will occur when a country produces more efficiently in term of lower cost per unit of production than other country. David Ricardo<sup>11</sup> introduced the most fundamental ideas of trade theory which is the law of comparative advantage. This theory latter called as Ricardian theory which explained a country exports commodity which has a comparative labor-productivity advantage. Later in 1990, theory of international trade was established by Eli Heckscher and Bertil Ohlin which commonly known as the Heckscher - Ohlin model. This model emphasizes on differences factor endowments as determinant in international trade. The Heckscher–Ohlin Theorem states that countries export those commodities which require, for their production, relatively intensive use of those productive factors found locally in relative abundance<sup>12</sup>.

From Islamic perspective, the permissible of trade has been mentioned many times in the Quran. Such as in surah Al-Baqarah "...*God has made buying and selling lawful...*" (2:275).<sup>13</sup> Even in the hadith. Trade has been practiced before the period of The Prophet Muhammad (peace be upon him). The city of Mecca has become trading center visited by traders from Middle East such as Egypt and Damascus (Syria), Sham, Yemen and Persian Empire. He was known as successful trader with integrity and bearing the honor title "the trustworthy". After his return to Mecca from Medina, commerce continued apace, although trade was structured under a type of chieftom with taxes allocated to provide care for the poor and strangers, in accordance with Islamic principles. Illustrating the importance of trade during the founding of Islam, it is an "often overlooked fact" that the Prophet Muhammad (pbuh) and "his adherents continued to trade while in exile in Medina"

Indeed, there are Islamic general principles for transaction among Muslim which is applicable for international transaction as well. Primary parties in international trade transaction are importer and exporter. Conceptually, Bank can act as intermediaries, traders, and partners in international transactions. Bank can as mediator in which bank is able to claim a service fee between importer and exporter. Bank may issue a letter of credit as bank's guarantee on behest of an importer to ensure the payment would be

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<sup>9</sup> The father of modern economics who is popular with the book "An inquiry into the Nature and Causes of the Wealth of Nations which was established in 1776.

<sup>10</sup> REINHARD SCHUMACHER, Adam Smith's theory of absolute advantage and the use of doxography in the history of economics, University of Potsdam, Germany, *Erasmus Journal for Philosophy and Economics*, Volume 5, Issue 2, Autumn 2012, pp. 54-80.

<sup>11</sup> who is he?

<sup>12</sup> James R. MARKUSEN dkk, *international trade teory and evidence*, 1995, Mc Graw-Hill.

<sup>13</sup> Quran, Surah Albaqarah.

completed when it becomes due. If bank as trader (importer) it can import and resell the merchandise to the original importer on bai mu'ajjal basis. A Bank can utilize the general mudarabah and *Musharakah* techniques to finance import. In addition, bank can as exporter who provide financing to the local producer/ exporter through buying merchandise on the basis of bai' salam, and resell it to foreign importer. Furthermore, there are some Islamic trade finance products which are letter of credit, trust and acceptance, acceptance bills, export credit financing, working capital, and shipping guarantee.

Based on Monzher khaf, there are three kind of Islamic financing for international trade which are sharing modes, sales mode and leasing modes. Firstly, sharing modes is used by Islamic banks to provide financing with share on the return and lose together in which form of application is full equity sharing and non- voting equity sharing. Sharing mode serves international trade financing in providing working capital for procedures through *Musharakah* and simple Mudharabah.<sup>14</sup> Secondly, the concept of sales mode is used by bank to buy goods and sell them to producers or consumers on future payment. The two forms which are commonly practiced by Islamic bank are construction / manufacturing contract and deferred delivery contract. Last but not the least, the form of leasing mode is utilized for equipment, machinery, and other fixed asset with purchase to lease order. Under the contract of Ijarah Wa iqtina or diminishing lease, Islamic bank can purchase equipment and lease order to the importer.

Based on Sayyid Tahir, two possible transactions for foreign trade is *bai' mu'ajjal* and *bai' al-salam*.<sup>15</sup> Bai' mu'ajjal is a sale in which the parties agree that payment of the price shall be deferred. The rules of bai' mu'ajjal as follow as

1. Bai Mu'ajjal is valid if the due date of payment is fixed in an unambiguous manner. The due time of payment can be fixed either with reference to a particular date or by specifying a period like three months if the time of payment is unknown or uncertain, the sale is void
2. The deferred price may be more than the cash price, but it must be fixed at the time of sale.
3. Once the price is fixed it cannot be decreased in case of earlier payment nor can it be increased in case of default. If the commodity is sold on installments, the seller may put a condition on the buyer that if he fails to pay any installment on its due date, the remaining installments will become due immediately
4. In order to secure the payment of price the seller may ask the buyer to furnish a security whether in the form of a mortgage or in the form of a lien or a charge on any of his existing assets.
5. The buyer can also be asked to sign a promissory note or a bill of exchange but the note or the bill cannot be sold to a third party at a price different from its face value.

*Bai' al-salam* can define as trading transaction involving advance payment for future delivery. According to Ibn 'Abbas<sup>16</sup>, there is particularly verse to address *bai' salam* in the Quran "O you who believe! When you contract a debt for a fixed period, write it down" (Qur'an, 2:282). The rules of bai' al-salam as follow as

1. The seller of the thing must be its producer
2. The specification of good in term of quality and quantity of merchandise must clear along delivery date.
3. Price is fix with payable in advance
4. The transaction being settled with delivery goods not on the margin
5. The Bank would require authorization of taking seller on for onward sale before taking possession.
6. If the original seller is not on time, bank must have safeguard to its interest.

On the other hand, the basic principle of conventional trade transaction is financed exclusively through credit.

<sup>14</sup> Monzher Khaf , Financing International trade an Islamic Perspective

<sup>15</sup> Sayyid Thahir, IIIIE's BLUE PRINT OF Islamic Financial System , Report of the IIIIE Workshop on Islamization of the Financial System 1997, International Institute of Islamic Economic, International Islamic University, Islamabad

<sup>16</sup> Salam Contract in Islamic Law: A Survey Obaid Sai Al Zaabi, 2011, international association for islamic economics Review of Islamic Economics, Vol. 14, No. 2, 2010, pp. 91–122.

### III. FINDINGS AND DISCUSSION

#### 3.1. International Trade from an Islamic Perspective

Basically, international trade has the same hukm as domestic trade in Islam. The difference is mainly about different territories or actually, international trade is more costly since there are some extra fees or taxes imposed. Furthermore, trading is permissible in Islam and it is supported in Quran and Sunnah which states below.

*“...but Allah has permitted trade and forbidden usury...”<sup>17</sup>”*

*“O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves (or one another). Indeed, Allah is to you ever Merciful.”<sup>18</sup>”*

*“And it is He who subjected the sea for you to eat from it tender meat and to extract from it ornaments which you wear. And you see the ships plowing through it, and [He subjected it] that you may seek of His bounty; and perhaps you will be grateful.”<sup>19</sup>”*

*“The Prophet (pbuh) was sent to mankind while people traded among themselves and he accepted that practice. He said : “The truthful and honest trader is among the prophets, the righteous, and the martyrs”<sup>20</sup>”*

Muslim scholars have also agreed that sale contract are allowable since the people need to cooperate each other to fulfill their needs (foods, house, clothes, etc) and it is met by performing buying and selling activities. Hence, generally rule of trading or international trade in this case is permissible in Islam.

*“Al-Imam Al Shafi’i ruled : “The general rule for all sales is permissibility as long as they are concluded by consenting capable decision makers, except for what the Messenger of Allah (pbuh) has forbidden; and anything different from those is permissible following the permissibility of sales stated in the book of Allah Almighty”<sup>21</sup>”*

As ruled in general trade, there are some ethics in international trade as well. The considerations in sales are included as mentioned above<sup>22</sup>:

1. The avoidance of excessive profits as all religions forbid to take benefits excessively from the buyers as it is cheating form. Actually, in Quran and sunnah, there is no regulation about how much sellers are able to get their profit since taking advantage in Islam is clearly admissible. However, some scholars agreed that if sellers take too much profit, the contract is deemed to be unauthorized. In addition the Maliki scholars are considered profit as one third or less.
2. The sellers must give full and righteous information about products, including its type, origin, and cost. It is reported by following Hadith on the authority of Rifa’a : *“All merchants are resurrected on the day of judgement as sinners, except for those who feared Allah, treated their customers well, and were truthful”<sup>23</sup>”*

<sup>17</sup> Stated in Surah Al Baqarah 275

<sup>18</sup> Stated in Surah An-Nisa 29

<sup>19</sup> stated in Surah An-Nahl 14

<sup>20</sup> Al-Tirmidhi in Zuhayli, “Financial Transactions in Islamic Jurisprudence” (Damascus: Dar Al-Fikr, vol 1, 2007) p.6

<sup>21</sup> Zuhayli, “Financial Transactions in Islamic Jurisprudence” (Damascus: Dar Al-Fikr, vol 1, 2007) p.7

<sup>22</sup> Zuhayli, ibid, p.7

<sup>23</sup> Reported by Al-Tirmidhi in in Zuhayli, “Financial Transactions in Islamic Jurisprudence” (Damascus: Dar Al-Fikr, vol 1, 2007) p.7

3. The sellers and buyers should not to be rude or insist when decide the price of the product as stated by following Hadith on the authority of Jabir : *“Allah is merciful to the man who is easy when he sells, when he buys, and when he collects his loans<sup>24</sup>”*
4. Swearing in the name of Allah is not recommended in any sales as it is disrespectful as it is mentioned in the Hadith on authority of Abu Hurayra : *“Swearing destroys the goods and wipes out their blessings<sup>25</sup>”*. Quran also stated *“And make not Allah’s name an excuse in your oaths against doing good or acting rightly or making peace between persons<sup>26</sup>”*

Actually, there is a significant point that makes international trade and general trade is distinguished namely currency. In international trade, inevitably foreign exchange will be conducted as requirement of the trade. When firms or institutions demand of a merchant from the other countries, they should purchase it with the foreign currency. For example when Malaysia firm is willing to import PC from U.S, it has to convert ringgit Malaysia to US dollar thus the transaction will be occurred. Basically, there is no problem with concepts of spot and forward in foreign exchange market. Surely, the forward transaction has to satisfy with the rule for credit transaction in Quran.

*“O you who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice. Let no scribe refuse to write as Allah has taught him. So let him write and let the one who has the obligation dictate. And let him fear Allah, his Lord, and not leave anything out of it. But if the one who has the obligation is of limited understanding or weak or unable to dictate himself, then let his guardian dictate in justice. And bring to witness two witnesses from among your men. And if there are not two men [available], then a man and two women from those whom you accept as witnesses - so that if one of the women errs, then the other can remind her. And let not the witnesses refuse when they are called upon. And do not be [too] weary to write it, whether it is small or large, for its [specified] term. That is more just in the sight of Allah and stronger as evidence and more likely to prevent doubt between you, except when it is an immediate transaction which you conduct among yourselves. For [then] there is no blame upon you if you do not write it. And take witnesses when you conclude a contract. Let no scribe be harmed or any witness. For if you do so, indeed, it is [grave] disobedience in you. And fear Allah. And Allah teaches you. And Allah is Knowing of all things.<sup>27</sup>”*

Although international trade has positive impacts for economy, but there is a shortcoming exist, namely lack of Islamic financial assistance. Conventional system always dominates financial assistance for this sector though its rule or system it is not compliance with shariah regulation such as the existence of interest, gambling, or uncertain transaction within. However, Islamic financial system has grown so fast and its existence has a great potential to develop trading activity particularly among the Islamic countries. The next sub-theme discusses about financing for international trade from Islamic system.

### 3.2. Islamic International Financing

Transactions in Islamic finance for foreign trade, mostly involves Islamic banks as its intermediary. Islamic trade financing facilities include<sup>28</sup> Islamic letters of credit, Islamic trust receipt, Islamic accepted bills, Islamic export credit refinancing, Islamic bank guarantee, and Islamic shipping guarantee. In this paper, we only discuss about letter of credit provided by Islamic bank.

Islamic letter of credit (LoC) is offered by Islamic bank mostly in three kinds of *shariah* contracts, namely *wakalah* (agency), *murabahah* (cost-plus profit), and *musharakah* (partnership). Under

<sup>24</sup> Reported by Al-Bukhari in in Zuhayli, “Financial Transactions in Islamic Jurisprudence” (Damascus: Dar Al-Fikr, vol 1, 2007) p.7

<sup>25</sup> Reported by Al-Bukhari and Muslim in in Zuhayli, “Financial Transactions in Islamic Jurisprudence” (Damascus: Dar Al-Fikr, vol 1, 2007) p.7

<sup>26</sup> Stated in Surah Al Baqarah 224

<sup>27</sup> Stated in Surah Al Baqarah 282

<sup>28</sup> ISRA, “Islamic Financial System Principles and Operations,” (Kuala Lumpur: International Shari’ah Research Academy for Islamic Finance, 2010) p. 335.

the principle of *wakalah*, Islamic bank performs as an agent of the customer. The customer fully pays the merchandise by Islamic bank to the supplier. The term *wakalah* or *wikalah* is defined as preservation. For example, in the Quran it is stated<sup>29</sup> “*They said: ‘for us, Allah suffices, and He is the best Disposer of affairs (the best wakil)’*”. The Prophet (pbuh) was also urged in verse (73:9) to take Allah (swt), the only true God, as his preserver and protector (*wakil*), as explained by Al-Farra.

Hanafi scholars defined *wakalah* as the delegation of one person (the principal) for another (the agent) to take his place in a known and permissible dealing<sup>30</sup>. In this regard, the *wakil* (agent) commits to the others property and prosecutes it. On the other hand, Shafi’is substantiate the following more restrictive definition for *wakalah*: It is the delegation of one living person to another of the performance of an act that allows delegation, and that the first person is authorized to perform himself. In this case, they determine that the delegating party must be living to distinguish the agency contract from a person’s will. Dealings that are permissible for agency contracts include financial dealings such as trading, as well as many other actions that allow for legal representation.

The Hanafi’s decided valid offer and acceptance as cornerstones of the agency contract<sup>31</sup>. While the Hanafi’s restricted the contract’s foundations to offer and acceptance or actions implying acceptance, the other jurists figure four cornerstones which are principal, agent, object of the agency contract, and the contract language. Jurists approved that it is not important for acceptance to be denoted verbally. This follows from the fact that delegation is a consent similar to consent to eat, and therefore acceptance of the offer may be developed through many different actions. Furthermore, jurists agreed that acceptance may adhere immediately after the offer, or it may be postponed. This regulation is based on the historical fact that some of the Prophet’s (pbuh) agents only received the agency after some time. Hence, if the agency offer and acceptance were not set up, the contract is not concluded.

The Hanbalis also allowed so called automatic or cyclic agency. In this contract, the principal says: “I have appointed you as my agent, and if your agency is expired for any reason, then I am automatically re-commissioning you as my agent. Similarly, they allowed automatic termination of agency: “If I ever commission you as my agent, then I am set that this agency will be automatically end upon commission”.

Under the principle of *murabahah*, Islamic bank purchase the merchandises to the exporter and issues LoC, then sells to the customer. The basic *ahkam* of *murabahah* in international trade is the same with general *murabahah*. *Murabahah* or cost-plus sale is a legally allowable contract by the testimony of the majority of jurists and companions of the Prophet (pbuh). Yet, the Malikis found it less desirable. The proof of its permissibility is come up from the following<sup>32</sup>

1. There are many verses in the Quran that explicitly permit sales in general, “...and Allah has permitted trade..”(2:275), “But let there be among you traffic and trade by mutual good will.” (4:29). In this case, cost-plus sales are clearly concluded by mutual consent.
2. A legitimate narration reported that Prophet (pbuh) while planning for emigration to Madinah, learned that Abu Bakr had purchased two camels. He asked him to sell him one at the price at which he obtained it “*wallini ahadahuma*”. Abu Bakr said: •It is yours at no price, but the Prophet (pbuh) replied: “Not without a price”.
3. It was reported that Ibn Mas’ud ruled that there was no harm in declared lump-sum or percentage profit margins
4. This type of sale satisfies all the legal requirements for trade, and it provides a valuable service in economic markets as it permits those knowledgeable of market conditions to make a profit and those without such knowledge to obtain the goods at a good price.

<sup>29</sup> Stated in Quran Al-Imran 173

<sup>30</sup> Zuhayli, *ibid*, p.631

<sup>31</sup> Zuhayli, *ibid*, p.631

<sup>32</sup> Zuhayli, *ibid*, p.354

Under *musharakah* contract, Islamic bank issues LoC and both financier and customer contribute to purchase the goods under LoC, and later share the asset based on the pre-agreed profit-sharing ratio. In this case, losses are burdened proportionally based to the capital contribution. The basic ahkam of *musharakah* in international trade is the same with general *musyarakah*. The legality of *musharakah* contracts was built in the Quran, Sunnah, and consensus of the Muslim scholars<sup>33</sup>:

- The Quranic verses stated: “*If more than two, then the share in a third*”. (4:12), and “*truly many are the partners (in business) who wrong each other: not so do those who believe and work deeds of righteousness ..*” (38:24).
- Proof of legality of partnerships is found in the Hadith Quds where Allah (swt) says: “I am the third of every two partners as long as neither one betrays the other. However, if one betrays the other, I leave their partnership.” This Hadith Quds was reported on the authority of • Abu Hurayrah by Abu Dawud and Al-Hakim, who approved its chain of narration.
- The Prophet (pbuh) found the people using the partnership contract and did not question this behavior, and there are many Hadith s that indicate his approval of the contract. One such Hadith is: “Allah supports the partners as long as they do not betray one another.” Generally, Muslims have legitimated the legality of partnerships, with differences in opinion only existing over specific types. The wisdom in allowing partnerships is obvious. The contract permits individuals to mix their properties in a manner that permits them to produce more wealth than they could each produce individually.

#### IV. CONCLUSIONS

International trade has big potential for developing the economy, particularly in Muslim countries. From an economic perspective, foreign trade results in more income and this opportunity has to be used for mankind. In Islamic perspective, basically there is no problem with foreign trade as long as no Shariah regulations are violated.

So far, conventional financing has dominated financing system in international trade. With the rapid growth in Islamic finance and its systems and regulation, it is hoped that it will give more choice for the financing of foreign trade. The services offered by Islamic finance for international trade actually have similar ahkam with domestic or the other transactions, for example *wakalah*, *murabahah*, and *musharakah*.

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<sup>33</sup> Zuhayli, *ibid*, p.448

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