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<b>Author (s):</b>	Anila Sultana, Dr. Rizwana Jabeen and Qaiser Sharif
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## Islamic Finance: A Financing Alternative or a Countermeasure to Capitalism's Dilemma

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\*Anila Sultana

\*\*Dr. Rizwana Jabeen

\*\*\*Kaiser Sharif

### ABSTRACT:

*The objective of this study is to present an economic justification regarding Islamic finance. It follows a straightforward methodology. It begins by identifying the main justification for Islamic finance by describing the economic commitments related to the desired reasoning in finance, macroeconomics, money, price and banking theories. The author provides a concise overview of his notion for such an Islamic economic paradigm wherein Islamic finance can operate. When appropriately used inside the author's model, Islamic finance has specific advantages, according to the research findings. As a result, Islamic finance can in this way be an applicant as a change plan for traditional finance. In today's market economies, it paves the path for considerable monetary reform. The findings are unique in that they contradict conventional wisdom and present a non-religious explanation for Islamic finance. The paper's first constraint is that all of Islamic finance's special benefits are exogenous to Islamic finance and financial institutions. As a result, they are unlikely to persuade such entities to follow Islamic finance precisely, without controller's impedance to enforce rigorous adherence. The second constraint is the requirement for Islamic finance to establish regulatory systems and enabling institutional.*

*Keywords: Economic Reform, Islamic Finance, Macroeconomics, Islamic Economics,*

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\* Lecturer, Department of Economics, Federal Urdu University of Science, Arts and Technology Karachi

\*\* Assistant Professor Department of International Relations Federal Urdu University, Karachi.

\*\*\* Lecturer, Department of Humanities, Nazir Hussain University, Karachi,

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**INTRODUCTION:** For centuries, traditional finance, in view of the classical loan agreement, was rehearsed in the old globe. The origins of present-day banking can be followed back to the 12th century in Italy (9, 23, 11 and 12). Meanwhile, Islamic finance has existed since the beginning of Islam, and is based on a variety of finance and investment contracts. However, in spite of it's proceeded with application, it did not appear as banking until 1975 (9).

Beyond the principle of fairness that underpins the ban of interest; Islamic jurisprudence provides little insight into the reason for Islamic finance. Islamic finance has greater contractual and transaction costs. Rather than employing a single standardized contract, such as a traditional loan contract, it employs products dependent on a variety of agreements, with the ability to mix and match. The first part of the study discusses what we can gain from money related, finance and banking theories concerning Islamic finance. The subsequent segment gives a brief overview of the Al-Jarhi dependent (6) Islamic finance concept. Based on these assumptions, the third area endeavors to outline the benefits of Islamic finance. The fourth segment delves into the issues that come with a blended finance and banking framework and how they can be conquered. The last area draws strategy suggestions. Friedman's rule dictates the economy's ideal pace of deflation. This is indicative of a denial of the advantages of price consistency while disregarding the substantial inefficiency and distributive implications of both deflation and inflation (18).

### 1.1. DISCUSSION / ANALYSIS:

**Economic Theory:** This segment briefly depicts exercises we can gain from banking, monetary as well as finance hypotheses with respect to Islamic finance.

**Interest rate:** Islamic finance depends on a basic principle, which is to try not to exchange present for future cash at a higher cost than expected. This successfully kills finance through obligation, in spite of the fact that it doesn't bar giving without interest credits to altruistic purposes. In exchange for rights or equity to partake in well before ratios of revenues, finance is supplied through profit or loss sharing or equity participation. It is additionally given through the lease and sale of assets as a trade-off for obligation to compensate their worth or for their usufruct sometime in the future. It is additionally given against a pledge to convey or make wares. Can we explore any components of economics that justify fears about exchanging present money for future at a higher cost than normal, which is the interest rate? Theoretical work on the connection between optimality of resource provisioning and interest rate level suggests that a "0" nominal rate of interest is a required component for optimum allocation (16, 26)<sup>1</sup>. Conversely, decreased interest rate i.e., zero eliminates all impetuses to swap real resources for cash. The ideal degree of yield can in this way be

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kept up. The utilization of general equilibrium approaches demonstrates that a zero financing cost is both sufficient and fundamental for distributive efficiency (8, 28). According to Correia and Teles (7), these outcomes are discovered to be powerful in an assortment of models. Friedman proposes, "Our proposed rule for the ideal supply of money is would be obtained by a pace of falling prices which renders the cost of capital equal to zero". Friedman's rule entails gradually reducing the quantity of at a rate equivalent to the average household time inclination (17, 16). Friedman's rule dictates a deflation rate that is desirable. In their recommendations for the central bank to pursue an inflation target, economists have endured "low inflation." Obviously, above rule shifts to a deflationary aim. State bankers have embraced an inflation objective in general, yet could never truly support a long-term deflationary policy (29).

Market Structure and Risk Distribution: The Islamic economic model is built on the principle of risk sharing. Households allocate transfers of cash to financial institutions on a PLS principle in the financial sector. Financial intermediaries provide cash to individual customers in two ways: on a sale-finance basis and on a PLS principle. Islamic finance is occasionally compared to a participatory game where almost anyone participates (shares risk), as opposed to traditional finance, which itself is compared to a spectator game where only a few participants bear risk while the rest of onlookers bear no risk (4,2). Risk sharing is essentially non-existent in traditional finance. Resource owners contribute their resources in the form of a traditional loan contract when it comes to resource mobilization. As a result, banks that accept deposits would be required to guarantee both the interest and principal on their clients' accounts. Banks only accept risk on collateral, not entrepreneurial operations, when it comes to resource use. Risk sharing is essentially non-existent in traditional finance. Resource owners contribute their funds in the form of a traditional loan agreement when it comes to resource mobilization. As a result, banks that accept deposits would be required to guarantee both the interest and principal on their clients' accounts. Banks only accept risk on collateral, not entrepreneurial operations, when it comes to resource use. The usage of collateral allows banks to reduce the amount of time they spend overseeing their borrowers without raising the danger of default. Similarly, sponsors ensure the payment of principle and interest in bond markets, whereas bondholders need not partake in the business risk of bond issuers and do not oversee them. Bondholders can obtain and analyze information by trading bonds on the open market. Screening the market for a specific bond looks to be less costly than bank surveillance of debtors. This is most likely how is that bond holders are more prepared to absorb lower prices in terms of interest rate than banks. As a result, business bonds are a viable alternative to debt of bank.<sup>2</sup>The comparative dependence upon bonds, on the other

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hand, will be determined by institutional and legal issues, as well as the amount of development of financial marketplaces and the respective levels of data sharing about corporations (13). Debt suppliers and Stock markets battle for market share in financing, while bond markets and banks battle for debt financing.

The Lemon Dilemma, Banking and Finance Principles, and Information Asymmetry: Finance users, as per banking theory, are significantly more knowledgeable against the adoption of funds than finance suppliers. As a result, there is a lot of information asymmetry in debt finance, which can lead to moral hazard and adverse selection, enhancing the chance of default. Simultaneously, equity finance suppliers could be at risk of investing in a failing enterprise plagued by the lemon dilemma. In such a situation, an innovator who is fully educated than fund providers would decide to invest in the company using personally available funds. When more finances are needed than are available locally, he prefers to adopt debt financing (24). The rationale for this is because using equity finance could be seen as an indication that the company's stock is overvalued. Universal banks have used governance to evaluate performance and assure profitability because they take shares in enterprises. They address information asymmetry and the lemon troubles at the same time in this way. As a result, universal banks would be better regulators than commercial (14). Empirical research back up the benefits of combining debt as well as equity financing for both businesses and banks. Banks are theoretically more vulnerable to moral hazard and adverse selection all through economic booms than they are under recessions. Throughout both busts and booms, empirical research has shown that universal banks are less risky than commercial banks. According to Dewenter and Alan, 1997, throughout downturns, risk differences between commercial and universal banks have grown broader and more severe (14).

Theory of Money and Prices: First, the difference between real, nominal and semi-real<sup>3</sup> operations is investigated (5). There are two monetary (nominal) counter values in nominal exchanges. When current money is exchanged for future money, this is an example of a nominal trade. Another illustration is when a gamble's price is paid in present money vs an unknown future payoff, like in the context of derivatives. Nominal exchanges include both present and future money trading, and also risk exchanging. In Islamic finance, both sorts of nominal exchanges are prohibited. Nominal exchanges have two types of macroeconomic impact. In the first case, an increase in the amount of nominal exchanges will promote investment decisions with in risk trading businesses as well as debt trading businesses, as well as related services such as clearing, strategic interchange, and implementation of those devices. The resultant wealth restructuring would have an impact on the economy's consumption pattern

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and stimulate resource reallocation to the degree that investment and consumption preferences differ between winners and losers. Only one monetary (nominal) counter-value exists in real transactions, while another is always such a commodity. Of that kind transactions serve as significant indications for resource allocation. More money is raised for expenditure when the pace of money creation rises, either directly or indirectly through increased financial availability. Debt-related and Commodity spending would both rise. As a result, the impact of policy actions that lead to money creation on commodity markets will be determined by how much of the increased quantity of money is spent on nominal versus real exchanges.

Structured upon Al-Jarhi, a succinct Islamic Finance Model:

Based on the aforesaid accomplishments to economics, the evaluation of Islamic finance will be built on the organizational framework that will substitute finance built on interest rate by interest-free finance. The entire market mechanism is preserved in Al-Jarhi's model (6), but characteristics that swap interest-based finance with interest-free finance are introduced. Money allocation, money creation, as well as fiscal and monetary policy, should all be covered by the institutional framework. The model's details are not discussed in this publication. Rather, the goal of this study is to present a high-level overview of how Islamic finance works in such a scenario. In Al-Jarhi's (1980) framework money is issued on the basis of central bank short-term deposits or investment deposits with banks, all of which are based on the PLS. The interest earned on CDs would be returned towards the central bank as seigniorage, which would benefit the government's budget. Al-Jarhi's features a total reserve mechanism. The fractional reserve approach results in an unjustified wealth restructuring in support of bank stakeholders at the expense of the general public. It gives the central bank just under complete and direct command over the supply of money because banks make derivative deposits using multiple sets of the central bank's currency. Total reserves are required to avoid such draw backs. The central bank offers central deposit certificates, which are money-market securities whose proceeds are deposited to the State bank. They would be trade able in the marketplace and available for investment by the general public and to banks. The state bank would base money supply on the rate of return on RCDC, which, unlike interest rates, would be determined by the market. The public, like the state bank, invests their money in PLS-based investment accounts. CDCs can also be held by the general public. They can also put money in demand deposits including banks, which could be treated for operation services but pay no interest. On the financing side, individuals can fund their operations using one of the several Islamic finance contracts. What occurs to state budget deficits is the question. Initially, the government borrows money from banks to fund its revenue-generating activities. Even construction activities

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can be made revenue-generating in order to receive market-rate financing. Next, residents may be fortified to form public basics (*awqāf*) to administer public services, particularly in the areas of health and education. The poor are redistributed outside of the regulatory framework by acquisition of alms giving (*zakāh*), about which banks act as guardians and are authorized to even use the earnings to fund projects at micro level for which the titles are transmitted to the underprivileged, allowing them to become independent and self-sufficient. The benefits of Islamic Shariah principles related to finance are explored in the following section. These benefits are contingent on Islamic finance being correctly applied, with a strict and honest commitment to its paradigm. Despite their prevalence, products like debt, sell and buy-back (*bay' al-īnah*), three-part sale (*tawarruq*), debt sale, and the similar are regarded to be outside the conventional interpretations. Furthermore, banks are expected to establish an equilibrium between sale finance and PLS in order for finance commodities to mirror a sensible mix of debt-creating and equity finance. Islamic Finance's Effectiveness: Plenty of the macroeconomic kinds that really are exogenous to Islamic finance and banking institutions are unique benefits of Islamic principles of finance. These are covered briefly below: Allocation of Financial Resources and Efficiency: In traditional finance, the ability of borrowers to pay back the loans is the most important consideration in distributing financial resources. The profitability of the relevant investment would be the goal of Islamic finance, which would be achieved through PLS and equity mechanisms. As a result, money and resources would be channeled towards the most profitable investments, boosting the financing efficiency and strengthening performance mostly in the sectoral economy. With enough competition within fund users, Islamic finance offered through commodity acquisition modes matches the financing cost just at the boundary to the proportionate value in the adoption of every raw material in use or manufacture. As a result, the best distribution of financial resources would be made. There would be no funds available for risk trading and debt.

In Transitions, Efficiency and Cash Savings are Essential:

Islamic finance doesn't even use interest-based lending at the macro level. The RCDC takes the place of the interest rate. This rate mirrors the temporal money value in relation to commodities rather than against itself. The Friedman optimal money supply guideline (deflate the economy at interest rate) is designed to avoid economics agents from swapping resources for money in operations, which will lower output level just below the optimal level. Others who put their own cash in banks do so in the shape of PLS-based investment and saving accounts. The rate of return in this instance would be unpredictable. The principal of deposits or such accounts is not guaranteed, nor is the return on them. Then there will be no motivating force

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to reduce cash usage in exchanges in order to receive more predictable income, like in the instance of a traditional loan agreement.

**Stability:** A traditional bank's liabilities, such as savings deposits, demand and time are insured by the bank. Contrastingly, its assets are debt instruments for whom the quality is determined by the ability of borrowers to repay. Collapse, which might be expected during crisis situations owing to macroeconomic issues or bank-specific asset-side situations, jeopardizes banks' ability to fulfill their obligations. A different category of liability exists in an Islamic bank. Deposits are held on a PLS foundation, however just demand deposits are ensured. Investment clients unquestionably share default hazard and investment upon the asset side whenever a financial institution experiences bank-specific or macroeconomic catastrophe. The banks are less probably to collapse, and a bank run is less plausible. An Islamic financial framework would be more reliable than traditional banking due to the distinctive character of banks' assets and obligations. One other source of instability is the prevalence of an interconnected debt market, that is one of the traditional economic system's most important institutional elements. It has exceeded the real subdivision in terms of size and has achieved a high level of economic integration. Interconnected debt markets, as seen in the world financial crisis (2007-2012), are bases of both contagion and local financial disruption. Debt is formed in Islamic finance by selling products on credit. The debt instruments that results are exclusively negotiable at face value. For each item, there is a credit market under which the supply and demand to purchase it on credit sets the mark-up rate.<sup>4</sup> A main dimension of stability has been that, when done correctly, Islamic finance never exchanges present money for future money. Money and commodities are involved in all Islamic financial modes.<sup>5</sup> Islamic finance has a direct link between commodity and monetary flows. The distinction between financial and non-financial operations has been effectively abolished. There is no room for unsustainable credit expansion as every aspect of financing supplied is inevitably allocated for particular applications. The exclusion of debt trading and risk trading, in which policymakers' fluctuations in money supply are instantly translated into adjustments in surplus demand and supply of products, is the fourth pillar of stability. The quantity of production produced reacts to market pressures more quickly. As a result, markets are more likely to run smoothly and efficiently.

**Asymmetry in Information:** Conventional finance's only contract suffers from knowledge asymmetry. Information asymmetry is also a problem in some Islamic finance arrangements. Information asymmetry is especially prevalent in *wak'alah* (unrestricted and restricted agency investment), *mud'arabah* (unrestricted and restricted profit-sharing initiatives), and *salam* (agreement of deferred commodity supply). With the exception of

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those five agreements, the vast mainstream of Islamic finance contractual arrangements is not affected. Islamic banks, such as universal banks, can own equity in the firms they finance while generating funds under *salam, mud' arabah and wak'alah*, or any other agreement. Because of their closeness to universal banks, they are more equipped to deal with adverse selection issues and moral hazard than commercial banks [Al-Jarhi, 2003](3).

**Financing and Development:** To circumvent the issue of information asymmetry, Islamic banks must imitate some characteristics of universal banks' activity, as stated above. Universal banking, which includes all aspects of financial resources, has been credited in share for Japan's and Germany's industrial progress and economic prosperity. It has resulted in improved scope and efficiency, allowing more finance to be delivered at reduced costs, stimulating investment in industries [Greenwood and Bruce, 1997; Vaona, 2005; Nyankomo and Zhanje, 2015](19, 25, 20). German banks, in particular, are thought to have long-term, close partnerships with industries, which has influenced their attitudes on multi-period optimization. [Temin, 1998] (27) agrees with this viewpoint, although Miwa and Ramseyer (2000), and Fohlin (1998) disagree (21, 15).

**Mobilization of Fund:** Many adherents of interest-free religions (Christianity, Islam, Hinduism, Judaism and Buddhism) keep their funds outside of the financial and banking sectors, effectively keeping some of their finances out of the project developments. Islamic finance makes it possible to mobilize such resources, which would otherwise be dormant in several Islamic countries.

**Responses to Policy Shocks:** When you delve deeper into the restriction of interest, you'll discover that it's essentially the restriction of selling present money for future at a premium. To put it another way, prohibiting interest is the same as prohibiting nominal exchanges (Al-Jarhi, 2017) (1). From an economic standpoint, the ban of interest (*rība*) can be understood as a restriction of debt- and risk-trading.

**Integrity of the System:** Hazard is a significant element of speculation. In customary finance, venture is funded by value (the financial exchange) or through obligation (acquiring from financial institutions and giving bonds). Banks acknowledge just collateral hazard. They generally try not to bear business hazards. Corporate bondholders observe a similar principle and their obligation (debt) conveys rank over investors' privileges. As a result, risk is absorbed by a small group of experts including shareholders and entrepreneurs. Only a small percentage of risk takers face the burden of financial failure. Even if the danger per capita for the entire community is modest, the risk concentration over a small minority could be too much to tolerate. The commodity industry and the financial industry would be worlds apart, as each follows its own path. Risk is shared between financial

institutions and Islamic banks and people who receive financing. Depositors can shape banks' investment choices by having representation on the board members of Islamic banks, which allows them to participate in the decision-making procedure. This suggested reform will expand decision-making and risk sharing to both liabilities and assets.<sup>6</sup>

2.9. Debt Sustainability: Because of the data asymmetry related with traditional finance, moral risk prompts utilizing acquired assets for non-recommended purposes, prompting default. Interestingly, the more noteworthy capacity of Islamic finance to stay away from data unevenness and good peril through blending and coordinating among the various Islamic finance agreements, ensures that the progressive resources are utilized distinctly for their endorsed purposes. Default coming about because of good peril would in this manner be generally far-fetched.

2.10. Equity: If given the proper instruments, Islamic banks can aid in the fight against poverty in society. *zakāh* can be viewed as a poverty-reduction strategy based on tax subsidies. Anyone whose wealth surpasses a specified minimum threshold in relation to their income or property must pay it out.

3. Obstacles in Mixed Systems: The benefits of Islamic finance described above appear to be externalities that benefit the society as a whole but would not directly benefit any financial entity or Islamic bank. This poses an incentive dilemma, as Islamic bankers would be under no need to adopt the Islamic finance framework. The reward dilemma can be handled by absorbing the positive externalities in some way.

They keep their notional brand title and imitate traditional finance to preserve a competitive edge. This allows them to reduce costs by streamlining documentation and procedures. This necessitates the implementation of particular laws to compel Islamic financial institutions to adhere to their Islamic financial institutions licences. Islamic finance would never be willing to own up to its objective without such controls (Al-Jarhi in 2014) (2).

4. Conclusions: Beginning with some price, macroeconomic, finance and banking theories, which is discovered that Islamic finance has significant advantages when used as per Al-Jarhi's (1980) (6) perspective. It also offers a sound prescription for restructuring the modern capitalist economy. As a result, the notion that Islamic finance has an economic rationale can be acknowledged. These findings come with one crucial caveat. The notable benefits of Islamic finance are insufficient to persuade Islamic bankers to follow the Islamic finance concept. Because such benefits are primarily external, they can only drive behavior after they have been internalized, which is entrusted to finance and banking authorities. Islamic bankers will avoid imitating conventional finance only if the Islamic banking licence is rigorously controlled by monetary authorities.

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1This runs as opposed to the assessment of Naqvi (1977).

2Contessi et al. in 2013

3Semi-real exchanges are those in which one currency is traded for another and all these counter-values are received spot.

4The difference between the deferred prices and spot prices expressed as a percentage of the current market price is the mark-up rate.

5This definition encompasses all sale financing. Cash advanced for participation in future profits deriving from commodity-related operations might be deemed investment and partnership agency finance.

6Al-Jarhi in 2014