

Transformation of Islamic Monetary Policy in A Dual Banking System: Analysis of Transmission Mechanisms, Financing Channels, And Responses of Islamic Banks to Changes in Interest Rates

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ABSTRACT

This study aims to analyze the transformation of Islamic monetary policy in a dual banking system, emphasizing the transmission mechanisms, financing channels, and responses of Islamic banks to interest rate changes. The study employed a qualitative approach through a *systematic literature review* of 11 scientific publications discussing Islamic monetary and banking policy in Indonesia, Malaysia, Pakistan, Turkey, and several other countries. Data were analyzed using content analysis, thematic analysis, and cross-country comparisons based on the objectives, methods, variables, findings, and policy implications of each study. The study's findings indicate that Islamic banks play a role in the transmission of monetary policy through changes in liquidity, fundraising, and financing distribution to the real sector. Although they do not use interest in their contracts, Islamic banks are still affected by interest rate changes through competitive returns, depositor behavior, opportunity costs, and the use of interest rates as a benchmark for margin determination. The extent of the response is influenced by the bank's size, capitalization, liquidity, asset structure, contract type, economic conditions, and the depth of the Islamic financial market. This study concludes that the transformation of Islamic monetary policy needs to be directed at strengthening Sharia-compliant monetary instruments, deepening the money and sukuk markets, developing more independent yield benchmarks, and increasing profit-sharing-based productive financing. This transformation is necessary to build an effective, stable transmission mechanism that is more connected to the real sector.

INTRODUCTION

The development of Islamic banking has encouraged the formation of a dual banking system that brings together Islamic and conventional banks within a single monetary policy framework. This system is implemented in various countries, such as Indonesia, Malaysia, Pakistan, and Turkey, although each has different institutional characteristics and levels of development of the Islamic financial industry. Within this system, central banks must ensure that monetary policy can be effectively transmitted through both types of banks to achieve price stability, economic growth, and financial system stability. According to Khatat (2016), the existence of Islamic banking poses a particular challenge for monetary authorities because most modern monetary policy instruments still use interest rates as operational targets and liquidity control mechanisms. This situation indicates that the growth of Islamic banking has not been fully accompanied by the development of a monetary policy framework independent of the interest-based system.

Conceptually, Islamic monetary policy is based on the prohibition of usury (*riba*) and the principles of justice, risk sharing, benefit, and a direct link between the financial sector and real economic activity. From an Islamic perspective, money is not treated as a commodity that generates profits in itself, but as a medium of exchange and a means to support productive activities. Therefore, Islamic monetary instruments ideally utilize contracts and assets that comply with Sharia principles, such as *sukuk*, *mudharabah*, *musyarakah*, *wakalah*, and commodity-based transactions. Khatat (2016) explains that central banks in countries implementing Islamic banking must provide liquidity management instruments that are not only monetarily effective but also comply with Sharia requirements. However, limited instruments, an underdeveloped Sharia money market, and the dominance of interest rate benchmarks mean that the implementation of Islamic monetary policy remains dependent on conventional financial infrastructure.

Islamic banking holds a strategic position in the monetary policy transmission mechanism because it collects public funds and redistributes them in the form of financing. Sukmana and Kassim (2010) found that Islamic banks play a significant role in the monetary policy transmission process in Malaysia, particularly through the relationship between monetary policy changes, Islamic financing, and real economic activity. These findings indicate that central bank policy can still influence Islamic bank financing distribution even though the operational mechanism does not directly use interest. Akhatova, Zainal, and Ibrahim (2016) also found differences in the responses of Islamic and conventional banks to the monetary transmission mechanism in Malaysia. These differences are influenced by the business model, funding structure, asset composition, liquidity level, and type of contract used by each bank.

In the Indonesian context, Islamic financing channels play a crucial role in the transmission of monetary policy within a dual banking system. Zulkhibri and Sukmana (2017) demonstrate that changes in monetary policy can impact the ability of Islamic banks to channel financing to the public and businesses. The extent of this influence varies depending on the bank's size, capitalization,

liquidity, and financing structure. Ponziani (2020) also explains that Islamic banks play a role in the transmission mechanism of Indonesian monetary policy through the linkages between monetary instruments, fundraising, and financing distribution. However, the dominance of sale-based financing over profit-sharing financing indicates that the relationship between Islamic banking and the real sector does not fully reflect the ideal characteristics of the Islamic monetary system.

A more complex issue arises when Islamic banks must respond to changes in policy interest rates in a financial environment dominated by conventional banking. Ergeç and Arslan (2013) found that deposits and financing at Islamic banks in Turkey remain affected by interest rate movements, even though these banks do not principally use interest in their financial contracts. Interest rate changes can affect customers' expected returns, encourage fund transfers between Islamic and conventional banks, and alter financing costs and volumes. Zaheer, Ongena, and van Wijnbergen (2013) showed that Islamic banks' responses to monetary policy shocks in Pakistan differed from those of conventional banks and were influenced by the banks' size and liquidity conditions. These findings highlight the paradox that Islamic banks, while contractually interest-free, are not entirely economically free from the influence of interest rates.

The effectiveness of monetary policy transmission through Islamic banks is also influenced by the characteristics of the funding sources and the financing model applied. Hamza and Saadaoui (2018) found that changes in interest rates can affect Islamic banks' financing supply through debt financing channels, while *profit-sharing investment accounts* can play a role in strengthening the stability of funding sources. Caporale, Çatık, and Menla Ali (2020) showed that bank lending channels in the Malaysian banking system can produce different responses between Islamic and conventional banks, especially under different economic conditions and monetary policy regimes. Meanwhile, Boukhatem, Djelassi, and Elgammal (2022) emphasized that monetary policy transmission in a dual banking system is influenced by the balance sheet structure, capitalization, liquidity, and market power of each bank. Thus, Islamic banks' responses to monetary policy are determined not only by their adherence to Sharia principles but also by the institutional characteristics and conditions of the financial system in which they operate.

Previous studies have provided evidence that Islamic banks play a role in monetary policy transmission, but the results have not yet shown fully consistent conclusions. Rafay (2019) identified the existence of a monetary policy credit channel through Islamic banking, but the strength of this channel depends on market conditions and the characteristics of the banking industry. Savon and Yousfi (2025), through a critical review of various empirical studies, concluded that evidence regarding Islamic bank financing channels remains limited and tends to vary across countries. Some studies find Islamic banks to be more resilient to interest rate shocks, while others indicate that Islamic bank deposits, financing, liquidity, and profitability remain sensitive to interest rate changes. These differing results indicate that the monetary transmission

mechanism through Islamic banking cannot be explained solely by a single instrument, a single bank type, or a single country context.

Based on the above description, a research gap exists because previous studies generally analyzed the transmission mechanisms, financing channels, or responses of Islamic banks to interest rates separately and were limited to a single country. Research integrating these three aspects within the framework of Islamic monetary policy transformation in a dual banking system is still relatively limited, particularly those comparing findings across countries and linking them to the need to strengthen the real sector. Furthermore, previous research focused more on explaining how Islamic banks respond to interest rate-based monetary policy rather than formulating a direction for transformation toward more independent, asset-based, and Sharia-compliant monetary instruments. Therefore, this study aims to analyze the transmission mechanisms of monetary policy, the effectiveness of financing channels, and the responses of Islamic banks to interest rate changes in an integrated manner based on a synthesis of international research. The novelty of this research lies in the formulation of a framework for Islamic monetary policy transformation that encompasses strengthening Sharia instruments, deepening the Sharia money market, developing more independent yield benchmarks, and increasing the linkages between Sharia financing and the real economic sector.

LITERATURE REVIEW

Islamic Monetary Policy

Islamic monetary policy is a series of actions taken by monetary authorities to control the money supply, maintain price stability, encourage economic growth, and achieve equitable prosperity while adhering to sharia principles. Unlike conventional monetary policy, which uses interest rates as its primary instrument, Islamic monetary policy rejects the use of interest because it contains elements of usury (*riba*). Islamic monetary policy positions money as a medium of exchange, a unit of account, and a store of value, not as a commodity capable of generating profits without the support of productive economic activity. Khatat (2016) explains that the implementation of Islamic monetary policy must be supported by instruments capable of managing banking liquidity without violating the principle of the prohibition of usury (*riba*). Therefore, the effectiveness of Islamic monetary policy is largely determined by the availability of sharia-based instruments, the depth of the Islamic financial market, and the interconnectedness between the financial sector and the real sector.

The objectives of Islamic monetary policy extend beyond price stability to achieving distributive justice, employment opportunities, sustainable economic growth, and safeguarding financial system stability. The principle of profit and risk sharing underpins the channeling of funds from capital owners to businesses. Within this framework, growth in the money supply should be accompanied by increased production of goods and services, thereby reducing the likelihood of inflation stemming from an imbalance between the monetary and real sectors. Khatat (2016) emphasized that developing Islamic monetary policy requires an operational framework that can accommodate the liquidity

needs of Islamic banks while maintaining effective monetary control. Therefore, Islamic monetary policy must integrate the goals of economic stability with the values of justice, sustainability, and public welfare.

Dual Banking System

A dual banking system is a financial system that allows conventional and Islamic banks to operate side by side within a single jurisdiction and under the supervision of the same monetary authority. Conventional banks conduct intermediation activities based on interest, while Islamic banks utilize sale and purchase, lease, profit-sharing, and other contracts in accordance with Islamic principles. This system is implemented in various countries, including Indonesia, Malaysia, Pakistan, and Turkey. The existence of two banking models provides a wider choice of financial services to the public, but also poses challenges in the formulation and transmission of monetary policy. Zulkhibri and Sukmana (2017) explain that monetary policy in a dual banking system can produce different responses because Islamic and conventional banks have different balance sheet structures, funding sources, and funding distribution models.

In practice, Islamic banks and conventional banks interact and compete with each other to collect public funds and channel them to the economic sector. When conventional bank interest rates rise, some Islamic bank customers may transfer their funds due to the perceived higher returns. This situation encourages Islamic banks to adjust their profit-sharing rates to remain competitive, even though the determination of returns should be based on the performance of Islamic assets and financing. Ergeç and Arslan (2013) found that the fundraising and financing activities of Islamic banks in Turkey remain influenced by changes in interest rates. These findings demonstrate that the dual banking system creates a close link between interest-based financial markets and Islamic financial intermediation activities.

Monetary Policy Transmission Mechanism

The monetary policy transmission mechanism explains how central bank decisions influence the financial sector and subsequently impact consumption, investment, production, price levels, and economic growth. In a conventional system, this process occurs through interest rates, credit, exchange rates, asset prices, expectations, and corporate balance sheets. Changes in policy interest rates will affect the cost of banking funds, deposit and credit rates, financing demand, and the economic decisions of households and firms. In a dual banking system, the same mechanism can indirectly affect Islamic banks through changes in liquidity, depositor behavior, competitive yields, and asset prices. Savon and Yousfi (2025) state that the actual asset structure of Islamic banks allows for the transmission of fixed interest rate-based monetary policy impulses through their financing activities.

The role of Islamic banks in monetary policy transmission has been identified in various empirical studies. Sukmana and Kassim (2010) demonstrated that Islamic banks play a crucial role in the monetary policy transmission process in Malaysia because Islamic financing is linked to the development of the real economic sector. Akhatova, Zainal, and Ibrahim (2016) found that Islamic and conventional banks exhibited different response patterns

to monetary policy shocks. These differences indicate that monetary transmission is determined not only by changes in central bank instruments but also by the banks' operational characteristics. Thus, the effectiveness of monetary policy transmission through Islamic banks depends on the intermediation power, financing structure, liquidity availability, and the level of development of the Islamic financial market.

Islamic Bank Financing Channels

The Islamic bank financing channel is a monetary policy transmission channel that operates through changes in the ability and decisions of Islamic banks to channel funds to the public and businesses. Tightening monetary policy can reduce bank liquidity, increase the cost of obtaining funds, and reduce banks' ability to provide financing. Conversely, loosening monetary policy can increase liquidity and encourage financing growth and economic activity. Zulkhibri and Sukmana (2017) found that Islamic bank financing in Indonesia contributes to the monetary policy transmission process, but its strength is influenced by the individual characteristics of the bank. Banks with stronger capital and liquidity are generally better able to maintain financing when monetary policy changes occur.

Islamic bank financing can be conducted using murabahah, mudharabah, musyarakah, ijarah, salam, and istishna contracts. Murabahah financing provides income in the form of a margin determined based on the sale and purchase transaction, while mudharabah and musyarakah use the principle of profit and risk sharing. The dominance of murabahah tends to make Islamic banks' income structure more similar to fixed income, making them more sensitive to changes in market profit levels. Conversely, profit-sharing-based financing has the potential to strengthen the relationship between monetary policy, banking activities, and real sector productivity. Ponziani (2020) suggests that the effectiveness of Islamic banks' role in Indonesia's monetary transmission is determined by the linkages between monetary instruments, fundraising, and financing distribution to the economic sector.

Hamza and Saadaoui (2018) identified the existence of debt financing channels in Islamic banking and showed that interest rate variations can affect Islamic banks' financing offerings. However, the existence of *profit-sharing investment accounts* can help Islamic banks build a relatively more stable funding source because the returns received by fund owners depend on investment performance. The extent of this instrument's role is influenced by investment fund growth, capitalization, asset liquidity, and bank size. These findings suggest that the characteristics of funding sources are important factors in determining Islamic banks' resilience to monetary shocks. The stronger the use of profit-sharing mechanisms, the greater the opportunity for Islamic banks to reduce their dependence on changes in conventional interest rates.

Islamic Banks' Response to Interest Rate Changes

Normatively, changes in interest rates should not directly affect Islamic banks because their transactions are not based on interest. However, Islamic banks operate in an economic environment where asset prices, capital costs,

investment decisions, and customer behavior are still influenced by interest rates. Ergeç and Arslan (2013) demonstrated that Islamic banks in Turkey remain sensitive to interest rate changes. Increases in conventional bank interest rates can increase the risk of fund transfers, reduce liquidity, and force Islamic banks to adjust profit-sharing rates. This phenomenon demonstrates the risk of yield fluctuations and *displaced commercial risk*, a condition where Islamic banks reduce their profit share to maintain competitive returns for customers.

Islamic banks' responses to monetary policy also differ based on their size, liquidity, capitalization, and asset composition. Zaheer, Ongena, and van Wijnbergen (2013) found differences in the responses of Islamic and conventional banks in Pakistan to monetary policy shocks. Certain Islamic banks were able to maintain financing due to their more loyal customer base and relatively stable funding sources. However, banks with limited liquidity were able to reduce financing more rapidly during monetary tightening. Therefore, Islamic banks' responses were not uniform, but were strongly influenced by the bank's internal conditions and the structure of the national financial system.

Caporale, Çatık, and Menla Ali (2020) show that bank lending channels in a dual banking system can be non-linear and change according to economic conditions. During periods of expansion, increased liquidity can stimulate stronger growth in Islamic financing, while during periods of economic stress, banks may tighten financing to mitigate risk. Boukhatem, Djelassi, and Elgammal (2022) also explain that capitalization, liquidity, asset quality, and market power influence the ability of Islamic banks to transmit monetary policy. These findings suggest that monetary transmission analysis needs to consider changing economic conditions and the heterogeneity of bank characteristics. An approach that only looks at average effects risks ignoring the different responses that arise in different types and conditions of banks.

Sharia Monetary Policy Instruments

Sharia-compliant monetary policy instruments are needed to help central banks manage liquidity without resorting to interest-based transactions. These instruments can include central bank sukuk (Islamic bonds), sharia-compliant investment certificates, sharia-compliant savings and financing facilities, sharia-compliant open market operations, and sharia-compliant interbank money market transactions. Khatat (2016) states that the availability of high-quality sharia-compliant assets is essential for sharia banks to efficiently manage liquidity while complying with prudential regulations. Sukuk can be used as an instrument for absorbing and increasing liquidity because they are backed by ownership of the underlying assets or benefits of their issuance. However, limited sukuk volume and low trading activity in the secondary market can reduce the effectiveness of these instruments.

The development of Islamic monetary instruments also requires yield benchmarks that reflect economic activity and the risks of Islamic transactions. The use of conventional interest rates as a reference for determining margins and yields means that Islamic banking products remain strongly linked to the interest-based system. Savon and Yousfi (2025) assessed that the limitations of

empirical research and the inconsistent response of Islamic banks indicate the need to develop transmission mechanisms more in line with the characteristics of Islamic financing. Sharia benchmarks can be developed based on real sector profitability, sukuk yields, commodity prices, or the performance of Islamic financing portfolios. The presence of more independent benchmarks is expected to strengthen the identity of Islamic banking and reduce dependence on interest rates.

Previous Research and Literature Synthesis

Previous research has revealed three main groups of findings. First, Sukmana and Kassim (2010), Akhatova, Zainal, and Ibrahim (2016), and Zulkhibri and Sukmana (2017) found that Islamic banks play a significant role in the monetary policy transmission mechanism. Second, Ergeç and Arslan (2013), Hamza and Saadaoui (2018), and Zaheer, Ongena, and van Wijnbergen (2013) showed that Islamic banks continue to respond to interest rate changes through changes in deposits, financing, and liquidity. Third, Caporale, Çatık, and Menla Ali (2020), Rafay (2019), and Boukhatem, Djelassi, and Elgammal (2022) emphasize the importance of bank characteristics and economic conditions in determining the strength of the transmission mechanism. Overall, this literature suggests that the interest-free principle has not completely separated Islamic banks from the influence of conventional monetary policy.

Despite their similar focus, previous research has yielded differing findings regarding the strength and direction of Islamic banks' responses. Some studies indicate that Islamic banks are relatively resilient to monetary shocks due to their profit-sharing mechanisms and loyal customer base. Other studies have found that Islamic banks remain sensitive due to their use of interest rate benchmarks, limited liquidity instruments, and direct competition with conventional banks. Savon and Yousfi (2025) emphasize that empirical evidence regarding Islamic bank financing channels remains limited and inconclusive. These differences underpin the need for a synthesis that integrates transmission mechanisms, financing characteristics, banking conditions, and responses to interest rate changes within a single analytical framework.

METHODOLOGY

Research Approaches and Types

This study employed a qualitative approach using a systematic literature review. This method was chosen to identify, evaluate, and synthesize research findings on the transformation of Islamic monetary policy, monetary transmission mechanisms, financing channels, and Islamic banks' responses to interest rate changes in a dual banking system. Snyder (2019) explains that a systematic literature review can be used to map the development of knowledge, integrate disparate findings, and identify research gaps in a field. This study did not conduct statistical tests on primary data, but instead analyzed in-depth the concepts, methods, and empirical findings from selected articles. This approach allows for a comprehensive understanding of the implementation of Islamic monetary policy within various banking system characteristics and economic conditions.

Data Sources and Types

The data used is secondary data in the form of 11 scientific articles directly related to Islamic monetary policy and Islamic banking. The articles were obtained through searches on journal publisher websites, academic databases, economic repositories, and international institutions, such as Emerald, Wiley, ScienceDirect, Taylor & Francis, the International Journal of Central Banking, IDEAS/RePEc, and the International Monetary Fund. The articles analyzed include research by Khatat (2016), Sukmana and Kassim (2010), Zaheer, Ongena, and van Wijnbergen (2013), Akhatova, Zainal, and Ibrahim (2016), Zulkhibri and Sukmana (2017), Ergeç and Arslan (2013), Hamza and Saadaoui (2018), Rafay (2019), Caporale, Çatık, and Menla Ali (2020), Boukhatem, Djelassi, and Elgammal (2022), and Savon and Yousfi (2025). These studies represent studies on countries that implement or develop dual banking systems, particularly Indonesia, Malaysia, Pakistan, and Turkey. The units of analysis include objectives, theories, research countries, observation periods, analytical methods, variables, research results, and policy recommendations.

Literature Search Strategy

Data Collection and Extraction Techniques

Data collection was conducted through documentation techniques by downloading, reading, identifying, and recording key information from each article. The data were then extracted into a literature matrix consisting of the author's name, year of publication, article title, country or region of study, objectives, methods, variables, main results, limitations, and policy implications. The use of this matrix helped researchers systematically compare similarities and differences in research findings. The articles were then grouped into four main themes: monetary policy transmission mechanisms, Islamic bank financing channels, Islamic bank responses to interest rate changes, and the transformation of Islamic monetary policy instruments. This procedure was also used to identify factors that cause differences in Islamic bank responses, such as bank size, capitalization, liquidity, asset structure, type of financing, and economic conditions.

Data Analysis Techniques

Data were analyzed using content analysis and thematic analysis. Braun and Clarke (2006) explain that thematic analysis is conducted by identifying, grouping, and interpreting key patterns emerging from the data. The analysis stages in this study included reading the entire article, coding key findings, grouping codes into themes, comparing results across studies, interpreting relationships between themes, and developing a conceptual synthesis. The analysis process also followed the stages of data condensation, data presentation, and conclusion drawing as outlined by Miles, Huberman, and Saldaña (2014). The results of the analysis are presented in narrative form and comparative tables to demonstrate theoretical development, variations in empirical results, and policy implications in each country.

Cross-Country Comparative Analysis

A comparative analysis is used to compare the monetary policy transmission mechanisms through Islamic banking in Indonesia, Malaysia,

Pakistan, and Turkey. Comparisons are made of the banking system structure, monetary policy instruments, financing characteristics, sensitivity to interest rates, and the ability of Islamic banks to maintain liquidity. Malaysia and Indonesia are analyzed as countries with a developed dual banking system and relatively strong Islamic monetary instruments, while Pakistan is used to examine differences in bank responses based on size and liquidity. Turkey is analyzed to explain the sensitivity of participating banks to interest rate changes in a conventionally dominated financial environment. This cross-country analysis is used to obtain general patterns and understand the influence of institutional characteristics on the effectiveness of monetary transmission.

RESEARCH RESULT AND DISCUSSION

General Characteristics of Literature

A review of 11 sources shows that research on Islamic monetary policy has evolved from conceptual discussions to empirical examination of the behavior of Islamic banks in a dual banking system. The studies analyzed covered Indonesia, Malaysia, Pakistan, Turkey, and several other countries with Islamic banking industries. The research focuses on monetary policy transmission mechanisms, financing channels, changes in third-party funds, liquidity management, the use of *profit-sharing investment accounts*, and the sensitivity of Islamic banks to interest rates. The diversity of research objects and methods yielded varying findings, but they demonstrate a common pattern: Islamic banks are not completely isolated from changes in conventional monetary policy. These findings underscore the need for a transformation of Islamic monetary policy that focuses not only on contract compliance but also on building a more independent operational system. A summary of the synthesis of previous research findings is presented in the following table.

Author and year	Country/scope	Main focus	Relevant findings
Sukmana and Kassim (2010)	Malaysia	The role of Islamic banks in monetary transmission	Islamic bank financing plays a role in transmitting monetary policy to the real sector.
Ergeç and Arslan (2013)	Türkiye	Impact of interest rates	Sharia bank deposits and financing remain influenced by changes in interest rates.
Zaheer, Ongena, and van Wijnbergen (2013)	Pakistan	Comparison of Islamic and conventional banks	Responses to monetary shocks differ according to bank type, size, and liquidity.
Khatat (2016)	Cross-border conceptual	Operational framework of Islamic monetary policy	Islamic monetary policy requires sharia-compliant liquidity instruments and facilities.
Akhatova, Zainal, and Ibrahim (2016)	Malaysia	Banking models and monetary transmission	Islamic and conventional banks show different response mechanisms.
Zulkhibri and Sukmana (2017)	Indonesia	Financing channels	Sharia financing is part of monetary transmission in the dual banking system.
Hamza and	Cross-Islamic	Financing channels	Interest rates affect financing,

Saadaoui (2018)	banking	and PSIA	while PSIA can strengthen funding stability.
Rafay (2019)	Developing country	Islamic bank credit channels	Islamic banking can be a channel for transmitting monetary policy.
Caporale, Çatık, and Menla Ali (2020)	Malaysia	Bank loan channels	Financing responses are non-linear and influenced by economic conditions.
Boukhatem, Djauhi, and Elgammal (2022)	Dual banking system	Bank financing channels	Capitalization, liquidity, asset quality, and market forces influence transmission.
Savon and Yousfi (2025)	International studies	A critical review of monetary transmission	Empirical evidence regarding Islamic bank financing channels is still limited and not conclusive.

Monetary Policy Transmission Mechanism in a Dual Banking System

In a dual banking system, monetary policy is transmitted through conventional and Islamic banks, operating within the same market environment. When the central bank raises the policy interest rate, the cost of banking liquidity increases, and demand for credit or financing tends to weaken. This impact is directly visible in conventional banks through changes in deposit and lending rates. In Islamic banks, the influence operates not through contractual interest rates, but through changes in opportunity costs, market returns, depositor behavior, liquidity, and competition for funds. Therefore, differences in contractual terms do not automatically eliminate the influence of interest-rate-based monetary policy on Islamic bank operations.

Research by Sukmana and Kassim (2010) indicates that Islamic bank financing plays a role in the monetary policy transmission process in Malaysia. This finding implies that changes in central bank policy can affect the liquidity and financing capacity of Islamic banks, which then impact consumption, investment, production, and economic growth. Akhatova, Zainal, and Ibrahim (2016) reinforce this finding by showing that Islamic banks have different transmission patterns than conventional banks. This difference may occur because Islamic banks use sale-purchase, lease-based, and profit-sharing contracts and have different asset compositions and funding sources. Therefore, applying a single monetary instrument to two banking models may not necessarily result in the same speed and strength of transmission.

In the Indonesian context, Zulkhibri and Sukmana (2017) found that Islamic bank financing channels are part of the monetary policy transmission mechanism. Changes in monetary conditions affect the amount of funds that can be raised and the capacity of Islamic banks to channel financing to businesses and households. However, the strength of this response depends on the bank's size, capitalization, liquidity, and asset structure. Islamic banks with strong capital and liquid assets are better able to maintain financing during monetary tightening. Conversely, banks with limited liquidity tend to reduce financing distribution to maintain balance sheet stability and meet short-term funding needs.

The findings of Zaheer, Ongena, and van Wijnbergen (2013) in Pakistan also show that monetary policy transmission does not occur uniformly across banks. Islamic banks' responses to monetary policy changes vary based on their size, liquidity, and operational characteristics. Islamic banks can be more resilient if supported by loyal customers and a stable funding structure. However, limited Islamic money market instruments can make it difficult for banks to obtain liquidity during monetary tightening. This suggests that the effectiveness of monetary transmission is determined by the readiness of the Islamic liquidity infrastructure, not simply by the growth in the number of Islamic banks and their assets.

Analysis of Islamic Bank Financing Channels

The financing channel is the primary mechanism linking monetary policy to the real sector in the Islamic financial system. When liquidity increases, Islamic banks have greater capacity to channel financing to the trade, industry, agriculture, micro-enterprises, and household sectors. This increase in financing can further stimulate investment, production, job creation, and economic growth. Conversely, a decrease in liquidity prompts banks to tighten financing requirements and increase caution in selecting customers. Therefore, the effectiveness of Islamic monetary policy depends heavily on the ability of the financing channel to direct funds to productive economic activities.

Rafay (2019) demonstrated that the Islamic banking system can function as a channel for credit or financing monetary policy. However, the strength of this channel is determined by market conditions, regulatory policies, asset quality, and the bank's internal capacity. Boukhatem, Djelassi, and Elgammal (2022) also found that capitalization, liquidity, financing quality, and market power influence banks' funding channeling responses in a dual banking system. Banks with high capital and liquidity are better able to absorb monetary policy shocks without having to resort to excessive financing cuts. These findings indicate that capital strengthening and liquidity management are essential prerequisites for the effectiveness of Islamic bank financing channels.

The structure of financing contracts also determines the quality of Islamic monetary policy transmission. Murabahah financing provides margin and cash flow certainty, making it easier for banks to implement and manage risk. However, the dominance of murabahah can lead Islamic banking to become more oriented towards fixed-return transactions and less reflective of the principle of risk sharing. Mudharabah and musyarakah financing have a more direct relationship to business performance, making them conceptually more appropriate for linking the financial and real sectors. Increasing profit-sharing financing can strengthen the character of Islamic monetary policy because profit generation is based on productive activities, rather than on debt growth and interest rate fluctuations.

Hamza and Saadaoui (2018) demonstrated that *profit-sharing investment accounts* can play a role in maintaining the stability of Islamic banks' funding sources. Investment account holders share profits and risks based on the performance of the bank's managed portfolio, making this funding structure conceptually more flexible than fixed-interest deposits. However, its stability

still depends on transparency, governance, investment quality, and customer understanding of profit-sharing principles. If Islamic banks' profit levels are significantly lower than market interest rates, customers may still transfer their funds to conventional banks. Therefore, profit-sharing mechanisms must be supported by sound financing performance and adequate risk communication to serve as a buffer against monetary shocks.

Islamic Banks' Response to Interest Rate Changes

An analysis of 11 sources shows that Islamic banks remain sensitive to interest rate changes, even though interest is not used in their financial contracts. Ergeç and Arslan (2013) found that interest rate changes affect the activities of Islamic banks in Turkey. Increases in conventional bank interest rates can make conventional deposit products more attractive, thereby increasing the risk of funds diverting from Islamic banks. To retain customers, Islamic banks can increase profit-sharing rates by reducing their share of profits. This situation creates *displaced commercial risk*, the risk that banks sacrifice some of their income to provide competitive returns to fund owners.

Interest rate changes also affect the price and volume of Islamic financing. Although murabahah margins are determined through a sale and purchase agreement, in practice, margin determination often considers market interest rates as a benchmark for pricing. When interest rates rise, margins for new financing can also rise, reducing public demand for financing. Conversely, banks face pressure if the profit rate on existing financing remains stable while the cost of maintaining funding sources increases. This mismatch can depress Islamic banks' profit margins, liquidity, and revenue stability.

Hamza and Saadaoui's (2018) findings show that interest rate changes affect Islamic banks' financing offerings through debt financing channels. This suggests that Islamic banks' sensitivity is not solely driven by deviations from Sharia principles, but also by the market structure in which they operate. Islamic banks compete with conventional banks for customers, third-party funds, productive assets, and investment opportunities. As long as interest rates remain the primary benchmark price in the financial system, changes in conventional monetary policy will continue to influence the decisions of Islamic banks and their customers. Therefore, developing a Sharia-compliant yield benchmark is a strategic necessity to reduce this dependence.

Cross-Country Comparison of Findings

Malaysia exhibits a relatively more integrated dual banking system, allowing Islamic banks to play a significant role in monetary policy transmission. Sukmana and Kassim (2010) and Akhatova, Zainal, and Ibrahim (2016) show that Islamic financing responds to changes in monetary policy, but its response pattern differs from that of conventional banks. Caporale, Çatık, and Menla Ali (2020) further demonstrate that the response of financing channels can be non-linear and change according to economic conditions. During periods of expansion, increased liquidity can encourage greater financing, while during times of economic stress, banks tend to tighten financing. Malaysia's experience demonstrates that the depth of the Islamic financial market can strengthen transmission, but does not completely eliminate dependence on interest rates.

Indonesia demonstrates that Islamic financing channels have become part of the monetary transmission mechanism, but their contribution is still influenced by industry scale and financing composition. Zulkhibri and Sukmana (2017) emphasize the importance of bank size, capital, and liquidity in determining financing responses. The dominance of murabahah contracts makes Islamic bank fund distribution more susceptible to changes in financing prices and market benchmarks. Strengthening mudharabah and musyarakah financing is necessary so that changes in monetary liquidity can have a more direct impact on investment and production. Therefore, transformation in Indonesia must include increasing the share of productive financing, deepening the Islamic money market, and expanding liquidity management instruments.

In Pakistan, differences in the responses of Islamic and conventional banks are influenced by bank characteristics, as found by Zaheer, Ongena, and van Wijnbergen (2013). Meanwhile, Turkey's experience demonstrates a strong correlation between participating banks and changes in market interest rates, as explained by Ergeç and Arslan (2013). This comparison demonstrates that compliance with Islamic contracts alone is not sufficient to establish an independent monetary system. Countries with a more comprehensive set of Islamic liquidity instruments and a more developed sukuk market tend to have a better capacity to support monetary transmission through Islamic banks. Conversely, limited infrastructure makes Islamic banks more susceptible to the influence of conventional financial market conditions.

Transformation of Islamic Monetary Policy Instruments

Khatat (2016) emphasized that implementing monetary policy in a system with Islamic banking requires liquidity management instruments that comply with Islamic principles. These instruments can include central bank sukuk (Islamic bonds), Islamic deposit facilities, short-term financing based on Islamic contracts, Islamic open market operations, and Islamic interbank money market transactions. Sukuk can be used to absorb or increase liquidity because they have assets or benefits as the basis for their issuance. However, the effectiveness of sukuk is determined by issuance volume, maturity variations, secondary market liquidity, and availability to all Islamic banks. Without an active secondary market, Islamic instruments serve only as a place to place funds and are not optimal as liquidity management tools.

The transformation of Islamic monetary policy also requires more independent yield benchmarks. Using conventional interest rates as a reference ensures that Islamic financing prices remain aligned with interest-based monetary policy. Sharia benchmarks can be developed from sukuk yields, real sector profitability, commodity transactions, or the average performance of Islamic financing portfolios. The establishment of these benchmarks must be supported by a transparent database, sufficient transaction volume, credible governance, and a methodology acceptable to market participants. With more appropriate benchmarks, margin and profit-sharing ratio determinations can better reflect the risks and productivity of the economic activities being financed.

Islamic Monetary Policy Transformation Model

Based on the synthesis of findings, the transformation of Islamic monetary policy can be formulated through four pillars. The first pillar is instrument transformation through strengthening sukuk (Islamic bonds), sharia-compliant liquidity facilities, sharia-compliant open market operations, and profit-sharing instruments. The second pillar is institutional transformation through deepening the sharia-compliant money market, improving coordination between the central bank and regulators, and strengthening sharia-compliant bank governance. The third pillar is transformation of the transmission mechanism through developing productive financing with direct links to the real sector. The fourth pillar is benchmark transformation through reducing reliance on interest rates and developing return indicators derived from sharia-compliant transactions and productive economic performance.

The model demonstrates that the effectiveness of Islamic monetary policy cannot be achieved simply by changing the name or contract form of conventional instruments. Transformation requires changes to the transaction basis, incentive structure, sources of returns, and direction of fund distribution. Monetary instruments must be able to control liquidity while encouraging financing for productive sectors. Islamic banks also need to expand profit-sharing financing, strengthen risk management, and enhance transparency to fund owners. Thus, monetary stability can be achieved alongside expanding business opportunities, equitable income distribution, and sustainable economic growth.

Theoretical and Policy Implications

Theoretically, the analysis expands the monetary transmission mechanism by positioning the Islamic financing channel as a channel with distinct characteristics from conventional credit channels. Profit-sharing rates, contract structures, customer loyalty, transferred commercial risk, and the linkage of financing to real assets are additional factors that need to be included in monetary policy analysis. These results also demonstrate that the dichotomy between interest-based and interest-free systems does not fully explain the behavior of Islamic banks in a dual banking system. Islamic banks' responses are shaped by the interaction between Islamic principles, market conditions, bank characteristics, and central bank policy design. Therefore, an Islamic monetary transmission model needs to integrate the normative dimensions of Islamic law with the operational realities of the financial industry.

Practically, the central bank needs to design policies that differentiate the liquidity and financing characteristics of Islamic banks from those of conventional banks. Islamic monetary instruments must be available in sufficient quantities, have various tenors, be tradable, and easily used as collateral in liquidity facilities. Regulators also need to encourage improvements in Islamic banks' capital, asset quality, and liquidity management capacity to prevent excessive declines in financing during monetary tightening. For the Islamic banking industry, diversification of contracts and increasing productive financing should be a priority to strengthen contributions to the real sector. This transformation will ultimately help shape a

more effective, stable, inclusive Islamic monetary policy that is consistent with Islamic objectives.

Overall, the discussion confirms that Islamic banks function as monetary policy transmission channels, but remain strongly influenced by the interest rate system. Findings by Sukmana and Kassim (2010), Zulkhibri and Sukmana (2017), and Rafay (2019) support the existence of Islamic financing channels, while Ergeç and Arslan (2013) and Hamza and Saadaoui (2018) demonstrate the sensitivity of Islamic banks to interest rate changes. Zaheer, Ongena, and van Wijnbergen (2013), Caporale, Çatık, and Menla Ali (2020), and Boukhatem, Djelassi, and Elgammal (2022) suggest that this response is influenced by bank characteristics and economic conditions. Savon and Yousfi (2025) emphasize that the available empirical evidence is still inconclusive. Therefore, the transformation of Islamic monetary policy must be directed at developing an independent Islamic monetary ecosystem, strengthening productive financing channels, and closer integration between the financial sector and the real sector.

CONCLUSIONS AND RECOMMENDATIONS

Islamic banks play a crucial role in the monetary policy transmission mechanism in a dual banking system, primarily through the channels of fundraising, liquidity, and financing to the real sector. Although they do not use interest in principle, Islamic banking activities are still influenced by changes in interest rates through competitive returns, depositor behavior, opportunity costs, and the use of interest rates as a benchmark for determining financing margins. The strength of these responses varies depending on the bank's size, capitalization, liquidity, asset structure, contract type, economic conditions, and the depth of the Islamic financial market. Therefore, a transformation of Islamic monetary policy is necessary through the development of Sharia-based monetary instruments, strengthening the Islamic money market, establishing more independent yield benchmarks, and increasing profit-sharing-based productive financing to ensure more effective monetary transmission and alignment with Sharia objectives.

Central banks and regulators are advised to expand the availability of Islamic monetary operating instruments, develop more liquid Islamic sukuk and interbank money markets, and provide liquidity facilities with a variety of tenors and contracts tailored to the needs of Islamic banks. The Islamic banking industry needs to reduce its reliance on interest rates as a price reference, strengthen capital and liquidity management, and increase the proportion of mudharabah and musyarakah financing directly linked to productive activities. The government, monetary authorities, financial institutions, and academics also need to collaborate in developing Islamic yield benchmarks based on real transactions and Islamic asset performance. Further research is recommended using cross-country panel data and dynamic empirical methods to examine the impact of Islamic monetary instruments on financing, bank stability, economic growth, and the resilience of Islamic banks under various economic conditions.

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