

Research Article

Islamic Monetary Instruments and Central Bank Policy: A Systematic Literature Review on Effectiveness, Transmission Channels, and Macroeconomic Outcomes

Muslim Marpaung^{1*}, Irma Suryani Lubis²

¹ Politeknik Negeri Medan, Indonesia; e-mail : muslimmarpaung@polmed.ac.id

² Politeknik Negeri Medan, Indonesia; e-mail : irmasuryanilubis@polmed.ac.id

* Corresponding Author: muslimmarpaung@polmed.ac.id

Abstract: The rapid development of Islamic finance has encouraged central banks in dual banking systems to design monetary instruments that comply with Sharia principles while maintaining macroeconomic stability. However, the effectiveness of Islamic monetary instruments and their transmission mechanisms remain widely debated in the literature. This study aims to systematically review the empirical and conceptual literature on Islamic monetary instruments, focusing on their effectiveness, transmission channels, and macroeconomic outcomes. Using a Systematic Literature Review (SLR) approach guided by the PRISMA framework, this research synthesizes findings from major studies examining Islamic monetary policy operations, banking transmission mechanisms, and their impacts on inflation, output, and financial stability. The results reveal that the financing/credit channel and the interest–profit pass-through mechanism are the dominant transmission pathways in dual banking systems. Although Islamic banks often demonstrate relative stability during monetary shocks, policy transmission remains partly influenced by conventional interest rate benchmarks due to institutional and market structure factors. The effectiveness of Islamic monetary instruments is largely determined by the depth of Islamic money markets, the availability of liquid instruments such as central bank sukuk, and the strength of regulatory and institutional infrastructure. Furthermore, empirical evidence linking Islamic monetary instruments directly to macroeconomic outcomes such as inflation and growth remains limited. This study proposes an integrated conceptual framework linking Islamic monetary instruments, transmission channels, and macroeconomic outcomes, moderated by institutional quality, market share of Islamic banking, and market depth. The findings contribute to the literature by providing a comprehensive synthesis of existing research and offering policy insights for strengthening Islamic monetary policy frameworks in dual financial systems.

Keywords: Central Bank Policy; Financial Stability; Islamic Monetary Instruments; Macroeconomic Outcomes; Transmission Mechanism.

Received: January 17, 2026

Revised: February 25, 2026

Accepted: March 15, 2026

Published: March 18, 2026

Curr. Ver.: March 18, 2026



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1. Introduction

The development of the Islamic financial system over the past three decades has driven significant transformations in monetary policy practices in various countries with dual banking systems. The growing growth of Islamic banking assets requires central banks to design monetary instruments that comply with Sharia principles. The conventional interest-based monetary system is not fully compatible with the prohibition of usury in Islamic economics. Therefore, the need for alternative monetary instruments based on profit sharing, buying and selling, or other Sharia-compliant contracts has emerged. This challenge has given rise to extensive academic discourse on the effectiveness of Islamic monetary instruments in

achieving macroeconomic stability. Several early studies, such as Khan and Mirakhor (1994) and Chapra (1996), emphasized the importance of reformulating the monetary framework in Islamic economics.

Within the framework of Islamic economic theory, monetary policy is oriented not only toward price stability but also toward distributive justice and stability in the real sector. Chapra (1996) explains that an Islamic monetary system must avoid excessive speculation and ensure linkages between the financial and real sectors. This principle differs from conventional systems, which often focus on controlling inflation through interest rate instruments. Therefore, instruments such as Bank Indonesia Wadiah Certificates, Central Bank Sukuk, and Islamic repo instruments were developed as policy alternatives. The development of these instruments aims to maintain liquidity without violating Islamic principles. The literature shows that the design of these instruments significantly determines the effectiveness of monetary policy transmission (Ascarya, 2014).

In a dual banking system, monetary policy transmission becomes more complex due to the existence of two parallel mechanisms. Sukmana and Kassim (2010) show that Islamic banks respond to monetary policy differently than conventional banks. This response depends on the financing structure, the dominance of murabahah contracts, and sensitivity to changes in the benchmark interest rate. Although not explicitly using interest, many studies have found the phenomenon of interest rate pass-through in Islamic banking. This indicates that Islamic banks are still affected by conventional monetary policy through indirect channels. This complexity drives the need for a systematic evaluation of the effectiveness of Islamic monetary instruments.

Research by Zaheer, Ongena, and van Wijnbergen (2013) confirms that monetary policy transmission through Islamic banks tends to be more stable than conventional banks during crises. The study suggests that the asset-based and risk-sharing structures of Islamic banks can mitigate monetary shocks. However, this effectiveness is highly dependent on the market share of Islamic banking within the national financial system. When the market share is small, the aggregate impact on the economy is limited. Therefore, the literature emphasizes the importance of integrating macroprudential and monetary policies within the Islamic system. A comprehensive analysis is needed to understand the variation in research results across countries.

Ascarya (2014) developed the concept of interest-profit rate transmission channels in a dual financial system. The study showed that central bank interest rate policy continues to influence Islamic banks' profit margins. This suggests a structural link between the conventional and Islamic systems. This phenomenon raises questions about monetary independence within the Islamic system. If Islamic instruments remain dependent on conventional benchmarks, the objective of system differentiation is suboptimal. Therefore, a systematic study is needed to identify common patterns in the empirical literature.

A study by Šeho, Bacha, and Smolo (2020) found that changes in policy interest rates significantly impacted Islamic bank financing in various countries with dual banking systems. These results strengthen the argument that monetary policy transmission continues through the financing channel. However, the sensitivity is lower compared to conventional banks. This finding suggests differences in the elasticity of responses to monetary policy. These differences may be due to contract structure and customer preferences. The cross-country variation in results underscores the importance of a systematic literature review approach.

Rafay and Farid (2019) highlighted the role of Islamic banks in the monetary policy credit channel in developing countries. They found that Islamic banks play a complementary role in maintaining financing stability during monetary tightening. This suggests that the Islamic system has the potential to strengthen macroeconomic stability. However, its effectiveness is influenced by regulations and the depth of Islamic financial markets. Institutional factors are a crucial variable in determining the success of policy transmission. Therefore, a systematic literature review is needed to identify the key determinants of this effectiveness.

Drissi and Guerguer (2023) compared monetary policy transmission channels between Islamic and conventional banks in Europe and the MENA region. The study showed that differences in balance sheet structure influence responses to interest rate changes. Islamic banks tend to be more cautious in expanding financing. However, they also face challenges in liquidity management. Reliance on limited Islamic money market instruments poses a structural barrier. This reinforces the urgency of developing more effective Islamic monetary instruments.

Triwibowo et al. (2022) found that the business cycle influences the pass-through rate of monetary policy in Indonesia's dual system. During the expansionary phase, the response of Islamic financing is more elastic than during a recession. This finding suggests that the effectiveness of Islamic monetary instruments is dynamic. Variations in the economic cycle need to be taken into account in policy design. This suggests that literature analysis needs to consider the macroeconomic context. The SLR approach allows for pattern mapping based on economic conditions.

Fikri (2018) showed that financing channels play a significant role in the transmission of monetary policy in Indonesia. The study emphasized the importance of bank size and financing structure in determining policy responses. Larger Islamic banks exhibited higher sensitivity to monetary policy. This finding confirms the heterogeneity within the Islamic banking system. Therefore, the literature shows inconsistent results. Systematic analysis is needed to identify research gaps.

Sadeghi and Khadivy Rofougar (2018) examined the function of money demand in Islamic economics using the ARDL approach. The results demonstrated long-term stability in money demand based on Sharia principles. This stability serves as an important basis for formulating Islamic monetary policy. Stable money demand facilitates central banks' control of inflation. However, the context of developing countries presents different dynamics. This variation highlights the need for a comprehensive synthesis of the literature.

Several empirical studies highlight the significant role of sukuk in monetary policy transmission. For instance, Suriani et al. (2021) show that sukuk has a causal relationship with monetary policy variables such as interest rates and stock prices, particularly through asset price and exchange rate channels. However, it does not have a direct impact on inflation, emphasizing the importance of a deep secondary market for sukuk to enhance the effectiveness of Sharia-based monetary policy transmission. Furthermore, Hassan et al. (2025) provide panel evidence from multiple countries, demonstrating that sukuk issuance significantly improves liquidity and reduces credit risk in Islamic banking, thereby supporting the overall stability of the financial system and the long-term effectiveness of sukuk-based monetary instruments.

Although numerous studies have been conducted, results often show inconsistencies regarding the relative stability of Islamic banks compared to conventional banks. For example, empirical evidence from Indonesia indicates that factors such as impaired loans influence stability differently across bank types, with Islamic banks sometimes exhibiting relatively lower stability in certain quantiles of analysis (Khan et al., 2024). Similarly, broader evaluations of Islamic banking performance highlight that interactions between macroeconomic conditions, regulatory frameworks, and governance structures contribute to varied outcomes, underscoring the importance of systematic synthesis and contextual interpretation when comparing studies (Mubarok et al., 2024).

Overall, the development of Islamic monetary instruments shows significant potential in supporting financial system stability. However, the complexity of the dual system poses unique challenges in policy transmission. The empirical literature shows diverse and sometimes contradictory results. Therefore, a systematic literature review is needed to integrate existing findings. This research aims to fill this gap through a comprehensive synthesis. Thus, this article contributes to strengthening the Islamic monetary policy framework at the global level.

2. Preliminaries or Related Work or Literature Review

Theoretical Foundations of Monetary Policy in Islamic Economics

Monetary instruments must be free from usury, excessive gharar, and maysir (trading, financing, and financing), while maintaining price stability and a close link between the monetary and real sectors. Chapra (1996) and Khan and Mirakhor (1994) emphasize that the Islamic monetary framework must be able to manage liquidity while aligning with Islamic contracts. Unlike interest-rate-based systems, Islamic monetary policy emphasizes the allocation of funds to productive activities and asset-based financing and partnerships, so that policy transmission occurs through liquidity and financing structures, rather than through changes in the price of money.

In the practice of a dual banking system, Islamic monetary policy often interacts with conventional interest-rate-based policy. Research indicates a link between changes in policy interest rates and Islamic banking profit indicators (the interest-profit channel), which can

arise through funding competition, portfolio substitution, and market expectations. Studies such as Ascarya (2014), Šeho et al. (2020), and Zaheer et al. (2013) indicate that Islamic banks continue to respond to monetary policy shocks, despite the different nature of their contracts. This suggests that the composition of the banking system influences the strength of the transmission channel, particularly through bank balance sheets and the credit channel.

Theoretically, central banks in Islamic systems are required to provide instruments that are not only Sharia-compliant but also liquid and effective in transmitting policy to inflation and output. The challenge is ensuring that Sharia instruments truly function as transmission devices, not merely as formal labels. Without adequate markets and robust liquidity management, Islamic banking's response to policy can weaken, thus reducing the aggregate effectiveness of monetary policy. Therefore, the theoretical foundation of Islamic monetary policy combines normative Sharia principles and modern macroeconomic stabilization functions, and requires a comprehensive mapping of instruments, transmission channels, and macroeconomic impacts.

Theory of Islamic Monetary Instruments and Central Bank Operations

Islamic monetary instruments are central banks' tools for managing liquidity without the use of interest, with two main criteria: sharia compliance and policy effectiveness. Compliance requires a clear contract, a lawful object, and freedom from excessive usury and *gharar*, while effectiveness requires instruments that are liquid, have a market, and are capable of reliably transmitting policy. Khan and Mirakhor (1994) and Chapra (1996) emphasize the importance of instruments that function equivalently to open market operations while simultaneously encouraging productive activity and discouraging speculation. Within this framework, central bank sukuk are a key instrument because they are asset-based and can be used to absorb or inject liquidity, although their effectiveness depends heavily on the depth of the secondary market and supporting infrastructure.

In addition to sukuk, various other instruments such as commodity *murabahah*, sharia-compliant standing facilities, sharia-compliant repos, and reserve requirements (GWM) are also used to support monetary operations. While buying and selling instruments like *tawarruq* provide cash flow certainty, their economic substance is often debated. Standing facilities and sharia-compliant repos play a crucial role in money market stabilization and short-term liquidity management, with their effectiveness dependent on contract design, collateral availability, and legal certainty. Meanwhile, reserve requirements are quantitative and relatively "rough," so their impact can vary across banks depending on their size, funding structure, and liquidity profile, as highlighted by Zaheer et al. (2013) and Šeho et al. (2020).

Another theoretical challenge is determining operational targets in a non-interest-rate-based system. In the practice of a dual banking system, sharia instruments often operate around conventional policy interest rates, creating an interest-profit channel, as explained by Ascarya (2014). This raises questions about the independence and distinctiveness of sharia monetary policy. Overall, theory emphasizes that the success of sharia instruments is determined by compliance, market depth, and the strength of transmission to the real sector.

Theory of Monetary Policy Transmission Mechanism in Dual Banking System

The monetary policy transmission mechanism explains how central bank decisions affect inflation, output, and other macroeconomic variables through channels such as interest rates, credit, exchange rates, asset prices, and expectations. In a dual banking system, these channels remain but become more complex due to differences in contracts, balance sheet structures, and customer behavior of Islamic banks. The literature suggests that Islamic bank financing and deposits can act as transmission channels to the real sector, with their strength dependent on market share and sensitivity to policy. Studies such as Zaheer et al. (2013) emphasize that Islamic banks' responses can resemble those of large banks in monetary contractions, thus influencing the strength of the credit channel and necessitating a theory that incorporates institutional heterogeneity.

The credit channel in the Islamic system operates through changes in liquidity and the cost of funds, which affect contract-based financing. When policy tightens, limited liquidity or increased costs of funds can put pressure on financing, especially if liquid Islamic instruments are limited. On the other hand, the fixed interest rate channel emerges indirectly through the interest-profit mechanism, where changes in policy interest rates affect Islamic banks' margins or profit levels due to competition and market benchmarks (Ascarya, 2014; Šeho et al., 2020). Furthermore, the heterogeneity of contracts—such as the differences

between murabahah and profit-sharing financing—leads to varying responses to policy changes, making contract composition a key variable in Islamic banking transmission theory.

Expectation channels, exchange rates, and market structure also influence the effectiveness of transmission within the dual system. Central bank credibility remains a key determinant of inflation expectations, while economic openness and exchange rate movements can influence the real sector financed by Islamic banks. The structure of the banking industry, including the level of competition and market power, also determines how quickly policies are transmitted to financing. Empirical evidence suggests transmission exists in the Islamic sector, but with varying patterns depending on the institutional context and depth of the Islamic money market.

The Theory of the Effectiveness of Islamic Monetary Instruments and Central Bank Policy Design

The effectiveness of Islamic monetary instruments refers to their ability to achieve operational objectives—such as liquidity management, yield stability, and smooth transmission to bank balance sheets—as well as the ultimate objectives of controlled inflation, stable output, and financial system stability. In the Islamic context, effectiveness also encompasses adherence to Islamic principles to maintain policy legitimacy. If instruments are illiquid or rarely used, policy signals are difficult to convey and transmission is weakened (Ascarya, 2014). Furthermore, credibility is a crucial factor: as emphasized by Chapra (1996) and Khan and Mirakhor (1994), policies inconsistent with Islamic principles can undermine public trust and influence fund and portfolio behavior, thereby reducing overall effectiveness.

Effectiveness also depends on the instrument's ability to bridge central bank policy and bank financing decisions. Bank responses to policy differ based on size, liquidity, and balance sheet structure (Zaheer et al., 2013), so an effective instrument must be broad-based and compatible with Islamic liquidity management requirements. In a dual system, coordination with conventional interest rate benchmarks through the interest-profit channel (Ascarya, 2014) can strengthen signal consistency but also raises issues of structural dependency. Therefore, effectiveness needs to be assessed within the context of the Islamic money market's development stage and institutional infrastructure, including contract standardization, legal certainty, and market depth, all of which impact transaction costs and liquidity.

From a financial stability perspective, effective instruments not only transmit policy but also minimize systemic risk. Asset-based and risk-sharing instruments have the potential to be more stable, but remain vulnerable if the secondary market is shallow or if a policy shock affects financing (Šeho et al., 2020). Theoretically, effectiveness evaluation should be conducted at three levels: the money market (operational), bank balance sheets (intermediate outcome), and macroeconomic variables such as inflation and output (final outcome). The literature shows mixed results depending on the market share of Islamic instruments, instrument design, and institutional quality. Therefore, a systematic synthesis through SLR is needed to identify conditions that strengthen transmission and bridge instrument analysis with macroeconomic outcomes.

The Theory of the Relationship between Islamic Monetary Instruments and Macroeconomic Outcomes

The main macroeconomic outcomes of monetary policy include inflation, real output, unemployment, and exchange rate stability. Within the monetarist and New Keynesian frameworks, these influences operate through interest rates, expectations, and credit conditions. In the Islamic system, these channels are complemented by liquidity mechanisms and asset-based financing that directly connect to the real sector. Chapra (1996) and Khan and Mirakhor (1994) emphasize that price stability and healthy growth are the common goals of Islamic monetary policy, with an emphasis on fairness and purchasing power protection. Thus, the theory of macro outcomes in Islamic monetary policy remains focused on inflation and growth, but through a unique intermediation structure and instruments.

Through financing channels, changes in liquidity influence the distribution of financing, investment, and consumption, which in turn impacts output. Studies such as Sukmana and Kassim (2010) and Zaheer et al. (2013) show that Islamic banking behavior can strengthen or modify the strength of the credit channel in a dual system. From an inflation perspective, stability in money demand and efficient intermediation are key to preventing liquidity expansion from driving unproductive price pressures. Instruments such as sukuk have the

potential to absorb liquidity while maintaining linkages to real assets. Furthermore, financial system stability—influenced by contract structure, risk management, and the depth of the Islamic money market—is an important outcome because disruptions to bank balance sheets can amplify macroeconomic fluctuations, as explained in the financial accelerator theory.

In an open economy, exchange rates and capital flows continue to influence inflation and growth, including in the Islamic system. The dominant financing structure in a particular sector can modify sensitivity to exchange rate fluctuations and external shocks. On the other hand, the principle of risk-sharing is theoretically expected to dampen business cycle volatility, although practices still dominated by sale and purchase contracts can make macroeconomic outcomes resemble conventional systems (Ascarya, 2014; Šeho et al., 2020). Overall, the relationship between Islamic monetary instruments and macroeconomic outcomes occurs through the liquidity-bank balance-financing-aggregate demand chain. Because empirical results are contextual and vary by market share and institutional quality, the SLR is an appropriate approach for mapping general patterns, dominant channels, and conditions that strengthen policy effectiveness on inflation, output, and stability.

3. Materials and Method

Research Design and Systematic Literature Review (SLR) Protocol

This study uses a Systematic Literature Review (SLR) approach to synthesize empirical and conceptual findings related to Islamic monetary instruments, central bank policy design, transmission channels, and their impact on macroeconomic outcomes. The SLR was chosen because the topic of Islamic monetary policy spans across disciplines, involving studies of Islamic banking, monetary policy, macroeconomics, and financial market institutions. A systematic approach is necessary to ensure transparent, replicable, and minimal selection bias in the evidence identification and synthesis process. The reporting framework follows PRISMA 2020, which provides a standardized checklist and study selection process (Page et al., 2021). Furthermore, the SLR principles in the policy and research management domains also refer to an evidence-based approach that emphasizes procedural rigor (Tranfield et al., 2003).

This study defines the review type as a structured thematic synthesis (SLR) with a structured thematic synthesis and evidence mapping options when the number of studies is large. Thematic synthesis was chosen because methodological variations and country contexts can make rigorous quantitative meta-analysis difficult. In SLR, researchers can still group results based on study design, policy variables, and outcome indicators without having to aggregate single numerical effects. This approach is common in policy studies that span contexts and methods (Tranfield et al., 2003).

Inclusion–Exclusion Criteria and Study Selection Process (PRISMA)

Inclusion criteria were established to ensure that selected studies fully addressed the SLR's focus on Islamic monetary instruments and central bank policies. Studies were included if they addressed at least one of three elements: (i) Islamic monetary instruments/Islamic monetary operations, (ii) the transmission mechanism of monetary policy within Islamic banks or dual systems, or (iii) the impact of policies on relevant macroeconomic outcomes. Articles should be peer-reviewed publications or reputable policy journal articles with clear methodologies. Conceptual studies were included if they provided a broadly influential framework for instruments/policies, such as Khan & Mirakhor (1994) and Chapra (1996). Empirical studies such as Sukmana & Kassim (2010), Zaheer et al. (2013), Ascarya (2014), and Šeho et al. (2020) were included because they examined the transmission and/or response of Islamic banks to policies. The explicit criteria align with the SLR's principle of reducing selection bias (Petticrew & Roberts, 2006).

Exclusion criteria included articles that only discussed Islamic banking from a micro perspective without any link to monetary policy or liquidity instruments. Studies that only assessed Islamic bank performance (profitability, efficiency) without monetary policy variables were excluded because they did not answer the RQ. Non-scientific articles such as opinion pieces, magazine articles, or policy news without research methods were also excluded. Furthermore, articles lacking full-text access and not providing minimal methodological information were excluded because their quality could not be evaluated. In the SLR, the reasons for exclusion must be consistently recorded to allow for auditability of decisions (Page et al., 2021).

Synthesis Techniques, SLR Data Analysis, and Results Reporting

This study employed a structured thematic synthesis because the heterogeneity of study designs, variables, and contexts makes aggregating a single quantitative effect less appropriate. Thematic synthesis allows for grouping findings based on the type of Islamic monetary instrument, transmission channel, and macroeconomic outcome, allowing conceptual and empirical studies to be integrated without imposing a single effect size. The process begins with an evidence map to identify the types of instruments studied, the country context, and gaps between practice and academic studies. This map serves as the basis for assessing the operational effectiveness of the instruments and connecting normative literature with empirical evidence, in line with the SLR policy approach that emphasizes understanding mechanisms and conditions (Tranfield et al., 2003; Petticrew & Roberts, 2006).

The next stage is the synthesis of transmission channels by grouping studies into categories such as the financing/credit channel, interest-profit pass-through, liquidity channel, and other channels. Each study is mapped according to its analytical focus and then compared to examine the consistency of findings and contextual factors that moderate the results. Next, a synthesis of macroeconomic outcomes—inflation, output/growth, financing stability, and financial system stability—is carried out, noting the direction of effects and their accompanying conditions. Results are presented in a matrix to systematically highlight patterns of consensus and variation, while avoiding overgeneralization by emphasizing the contextual nature of the findings (Kitchenham & Charters, 2007; Petticrew & Roberts, 2006).

To ensure transparency and robustness of inferences, a quality-based sensitivity analysis was conducted comparing conclusions when only high-quality studies were considered versus all studies, to prevent overconfidence in policy recommendations. Where relevant, descriptive bibliometric analysis was added to map publication trends, country distribution, and research focus, without replacing substantive synthesis. Methodologically, the combination of PRISMA with the evidence-based approaches of Tranfield et al. (2003) and Petticrew & Roberts (2006) strengthens the contextual orientation, transparency, and policy relevance of the SLR results.

4. Results and Discussion

Mapping of SLR Key Findings and General Patterns of the Literature

The SLR mapping results reveal two major streams in the Islamic monetary literature: the conceptual-normative stream and the empirical-transmission stream. The conceptual stream, represented by Khan and Mirakhor (1994) and Chapra (1996), emphasizes the prohibition of usury, strengthening the real sector, and monetary stability as the foundations of policy. Meanwhile, the empirical stream—such as Sukmana and Kassim (2010) and Zaheer et al. (2013)—focuses more on Islamic banks' responses to central bank policies in a dual banking system. The general finding is that many studies do not directly evaluate Islamic monetary instruments, but instead assess policy transmission, which still relies on conventional signals. As a result, a gap emerges between conceptual ideals and operational practice, where Islamic instruments often serve as a complement to liquidity management, rather than a primary policy anchor, and remain influenced by interest rate benchmarks (Ascarya, 2014; Seho et al., 2020).

Geographically and thematically, the dominant literature comes from countries with relatively mature Islamic financial infrastructure, such as Malaysia, Indonesia, and parts of the MENA region. The depth of Islamic money markets, the availability of sukuk, and central bank policies have been shown to significantly influence instrument effectiveness and transmission patterns. Thematically, studies have concentrated on three areas: instrument design, transmission mechanisms, and macroeconomic outcomes, but transmission studies are more numerous than evaluations of specific instruments. Furthermore, bank characteristics—size, liquidity, and funding structure—often differentiate outcomes (Zaheer et al., 2013; Rafay & Farid, 2019). While some studies find relative stability among Islamic banks, evidence also suggests a strong correlation with policy interest rates, thus ensuring their full independence from conventional benchmarks has not been consistently confirmed.

In terms of outcomes, most studies still assess intermediate outcomes such as financing, deposits, and margins, while direct testing of inflation and growth is relatively limited. The variety of methods—time series, cross-bank panels, and even cross-country—adds to the heterogeneity of findings, so differences in results often reflect differences in research design and institutional context. Overall, the literature indicates that policy transmission continues

to occur within Islamic banks, but direct evaluation of the effectiveness of central bank Islamic instruments remains limited. This situation reflects more the consequences of a dual system and an immature market depth than a conceptual failure. Therefore, the policy agenda is directed at deepening Islamic money markets and strengthening liquid instruments, while the research agenda needs to strengthen direct measurements of instrument effectiveness and their linkages to macroeconomic outcomes.

Effectiveness of Islamic Monetary Instruments and Implementation Barriers

The effectiveness of Islamic monetary instruments is generally measured by their ability to influence Islamic banking liquidity and money market stability. Instruments such as central bank sukuk, Islamic open market operations, liquidity facilities, and Islamic repos are frequently discussed but rarely analyzed in detail due to data limitations and differences in frameworks across countries. Consequently, many studies measure effectiveness indirectly through the response of Islamic bank financing to policy interest rates. Ascarya (2014) emphasizes that Islamic transmission mechanisms still require institutional strengthening, while Khan and Mirakhor (1994) emphasize the importance of Islamic monetary instruments that are functionally equivalent to conventional open market operations. This suggests that the challenges to effectiveness are not only technical but also structural.

The main barriers to effectiveness lie in secondary market depth, contract standardization, and collateral legal certainty. Without an active market, instruments are difficult to trade efficiently, limiting the central bank's flexibility in fine-tuning liquidity. This infrastructure weakness can create liquidity segmentation between Islamic and conventional banks and weaken policy transmission (Ascarya, 2014; Zaheer et al., 2013). This situation also encourages reliance on conventional benchmarks, reflected in findings of pass-through between policy rates and profit rates (Ascarya, 2014; Šeho et al., 2020). However, some literature views this reliance as a transitional phase in the development of Islamic money markets, rather than a conceptual failure.

Contextually, instrument effectiveness is strongly influenced by the share of the Islamic banking industry and the quality of market institutions. In countries with more mature infrastructure, such as Malaysia, transmission through Islamic banking is more identifiable (Sukmana & Kassim, 2010), while in other contexts the results are weaker due to instrument limitations. Although some studies find relative stability of Islamic banks during monetary contractions (Zaheer et al., 2013; Rafay & Farid, 2019), such stability does not necessarily translate into high effectiveness—it may reflect rigidity or limitations in expansion. In synthesis, the effectiveness of Islamic monetary instruments is endogenous to market depth, standardization, and regulatory support. Therefore, the policy agenda emphasizes deepening Islamic money markets and strengthening central bank toolkits, while the research agenda encourages direct evaluation of Islamic instruments and their linkages to macroeconomic outcomes and transmission channels.

Transmission Channels: Financing/Credit Channel and the Role of Islamic Bank Balance Sheets

The financing/credit channel is the most dominant transmission channel in the monetary policy literature on Islamic banking. This channel operates through changes in bank liquidity and the cost of funds, which then influence the capacity to channel financing to the real sector. Studies such as Sukmana and Kassim (2010) show that Islamic bank financing and deposits are important transmission channels in Malaysia, while Zaheer et al. (2013) emphasize that the strength of transmission is strongly influenced by bank balance sheet characteristics, such as size and liquidity levels. Heterogeneity in funding composition, financing structure, and limited availability of Islamic liquid instruments make Islamic banks' responses to monetary tightening or easing inconsistent. Furthermore, these responses can be asymmetric across the business cycle (Triwibowo et al., 2022) and influenced by competition for third-party funds through the interest-profit mechanism (Ascarya, 2014). Thus, bank balance sheets serve as the interface between monetary policy and real activity, and the effectiveness of this channel is highly dependent on the "Islamic liquidity architecture."

On the other hand, the literature also shows that the relative stability of Islamic banks does not always equate to high transmission effectiveness. Several studies (Zaheer et al., 2013; Rafay & Farid, 2019) found that under certain conditions Islamic banks can exhibit lower volatility. However, this stability may stem from contract rigidity, particularly the dominance

of murabahah contracts—which limit short-term adjustments. Financing sensitivity also differs by contract type, as demonstrated by Šeho et al. (2020), making contract composition an important variable that is often not analyzed in granular detail. Cross-country findings confirm that the financing channel is stronger when Islamic money markets and liquidity instruments are mature (Drissi & Guerguer, 2023). Therefore, strengthening Islamic monetary instruments and deepening Islamic money markets are seen as prerequisites for fostering a healthy and responsive financing channel, while also serving as a bridge to the discussion of the next channel, namely interest-profit pass-through and reliance on conventional benchmarks.

Transmission Channels: Interest–Profit Pass-Through, Benchmark Dependence, and System Convergence

Interest-profit pass-through is a central theme in the literature explaining how fixed interest rate policies affect Islamic banking variables in a dual banking system. Although Islamic banks do not use interest, numerous studies have found a correlation between policy interest rates and Islamic margins or returns. Ascarya (2014) introduced the concept of the interest-profit channel to explain this mechanism, while Šeho et al. (2020) demonstrated the sensitivity of Islamic financing to cross-border interest rate changes. Pass-through occurs through competition for third-party funds, adjustments to financing margins based on the cost of funds and risk, and inflation expectations and opportunity costs that follow policy signals. Thus, this phenomenon reflects market integration in the dual banking system rather than a deviation from principles, and serves as an indicator of the limitations of independent Islamic benchmarks.

However, the literature also confirms that the level of pass-through is highly contextual and influenced by the depth of the Islamic money market, balance sheet structure, and business cycle phase (Triwibowo et al., 2022; Drissi & Guerguer, 2023). On the one hand, response convergence facilitates policy coordination and monetary stability; on the other hand, reliance on conventional benchmarks can hinder the differentiation of risk-sharing systems, as envisioned by Chapra (1996) and Khan and Mirakhor (1994). Several studies have found lower sensitivity of Islamic banks compared to conventional banks, which could imply a stability cushion but also weaker responsiveness to stimulus. The SLR emphasizes the importance of separating the impact on the deposit and financing sides and enhancing granular analysis by contract type. Overall, pass-through is a consistent empirical finding, but its implications should be read within the framework of the trade-off between policy coordination and strengthening the independence of Islamic instruments toward a more real-sector-oriented system.

Macroeconomic Outcomes: Inflation, Output, and Financial System Stability

The synthesized literature shows that macroeconomic outcomes—such as inflation and growth—are often discussed indirectly through intermediary variables in banking, such as financing, deposits, and margins. However, normatively, Chapra (1996) and Khan and Mirakhor (1994) place price stability and healthy growth as the primary objectives of Islamic monetary policy. The most frequently described mechanisms are the liquidity and financing channels: policy easing increases financing and aggregate demand, while tightening suppresses it. However, empirical evidence directly linking Islamic monetary instruments to inflation remains limited. Studies such as Šeho et al. (2020) and Sukmana and Kassim (2010) more strongly demonstrate transmission at the financing and real sector levels, while the link to inflation and aggregate output is often inferential. Therefore, the literature is considered still at the stage of strengthening the transmission mechanism, not yet reaching firm conclusions about final macroeconomic outcomes.

In terms of financial system growth and stability, research results indicate contextual patterns influenced by financing structure, contract composition, and the quality of market infrastructure. Zaheer et al. (2013) and Rafay and Farid (2019) found that Islamic banks can act as relatively stable credit channels under certain conditions, but this stability does not necessarily translate into high policy effectiveness; it may reflect contract rigidity or liquidity constraints. External factors such as exchange rates and capital flows also influence outcomes, particularly in developing countries (Drissi & Guerguer, 2023). Furthermore, the challenges of causal identification in time-series studies require macroeconomic conclusions to be interpreted in a manner commensurate with the research design. Overall, a relationship exists between Islamic monetary instruments and inflation, output, and stability, but direct evidence

remains patchy. This SLR concludes that deepening instrument analysis and integrating micro-macro approaches is an important agenda to clarify the impact of Islamic monetary policy on macroeconomic outcomes.

Moderating Factors: Institutions, Sharia Market Share, and Depth of the Sharia Money Market

The effectiveness of Islamic monetary policy instruments and the strength of its transmission are significantly moderated by institutional factors. Liquidity regulations, contract standardization, sukuk market readiness, and the operational capacity of the central bank determine whether Islamic instruments can function liquidly and effectively. Strong institutions and market infrastructure make it easier for policies to "land" in the Islamic sector; conversely, shallow markets and limited instruments weaken transmission (Ascarya, 2014; Drissi & Guerguer, 2023). Islamic banking market share is also a key moderator: the larger the share, the more important the Islamic bank's response is in achieving macroeconomic targets (Zaheer et al., 2013; Sukmana & Kassim, 2010). Furthermore, the depth of the Islamic money market and the availability of short-term instruments determine the speed of liquidity adjustment and the quality of cross-border transmission (Šeho et al., 2020). Thus, institutions and market structure are not merely additional variables but prerequisites for policy effectiveness.

Other moderators include prudential regulations, bank characteristics, and the phase of the business cycle and external shocks. Liquidity provisions or financing restrictions can strengthen or weaken the impact of policies, depending on the bank's balance sheet structure and access to liquid instruments (Zaheer et al., 2013; Triwibowo et al., 2022). Heterogeneity in bank size, funding structure, and risk profile also influences responses, making aggregate analysis without disaggregating bank characteristics potentially misleading. On the macro level, policy effectiveness is asymmetric across the business cycle and varies by institutional context (Drissi & Guerguer, 2023). Therefore, the SLR emphasizes the importance of a context-mechanism-outcome approach: transmission outcomes can only be understood through the interaction between instruments, institutions, and economic conditions. Policy implications focus on strengthening market infrastructure and standardization, while research implications emphasize study designs that explicitly capture heterogeneity and moderators.

Central Bank Policy Implications, Research Agenda, and Integrated Conceptual Framework

The final synthesis of the SLR indicates that Islamic monetary instruments have significant potential to support macroeconomic stability, but their effectiveness is not yet uniform due to the influence of institutional factors and market maturity. Normatively, Khan and Mirakhor (1994) and Chapra (1996) emphasized the need for Sharia-compliant monetary management, strengthening the real sector, and maintaining price stability without usury. However, empirical evidence in dual systems shows that policy transmission remains influenced by policy interest rates through a pass-through mechanism (Ascarya, 2014; Šeho et al., 2020). Therefore, a realistic policy implication is to strengthen Islamic instruments—such as central bank sukuk, Islamic repos, and liquidity facilities—while maintaining coordination with the conventional system. Deepening the liquidity toolkit, strengthening the secondary market, and developing a representative Islamic benchmark are seen as gradual steps to reduce benchmark dependence without disrupting stability. Furthermore, integration of monetary and macroprudential policies is necessary to ensure that strengthening the Islamic segment aligns with the overall system stability objective.

From a research perspective, the SLR identified three priority agendas: (1) increasing the number of studies evaluating Islamic monetary instruments directly based on monetary and money market operations data; (2) increasing the granularity of analysis at the contract, sector, and maturity levels to capture transmission heterogeneity; and (3) strengthening the empirical bridge between banking transmission and macro outcomes such as inflation and output through an integrated micro-macro design. The integrated conceptual framework formulated is: Islamic Instruments (liquidity) → Transmission Channels (financing and interest-profit) → Macro Outcomes (inflation, output, stability), with institutions, market share, and market depth as the main moderators. This framework is consistent with the normative foundations of Islamic monetary and is compatible with cross-country empirical evidence (Sukmana & Kassim, 2010; Zaheer et al., 2013; Triwibowo et al., 2022; Drissi & Guerguer, 2023). Thus, this SLR article not only summarizes the literature, but also offers a strategic map for

policymakers and researchers to strengthen the effectiveness of Islamic monetary instruments in a dual financial system.

5. Conclusion

Islamic monetary instruments have strong potential to support central bank objectives, particularly monetary stability and strengthening the linkages between the monetary sector and the real sector. However, their effectiveness depends heavily on the maturity of market infrastructure and operational policy capacity. Conceptual literature emphasizes the importance of usury-free and functional instruments for managing liquidity (Khan & Mirakhor, 1994; Chapra, 1996), while empirical evidence suggests that transmission within the Islamic segment continues to occur in a dual system through financing/credit channels and interest-profit pass-through (Sukmana & Kassim, 2010; Zaheer et al., 2013; Ascarya, 2014; Šeho et al., 2020). Therefore, benchmark dependence is better understood as a consequence of market structure and the need for policy coordination rather than simply a normative deviation. The effectiveness of Islamic instruments should therefore be interpreted as a function of the depth of the Islamic money market, the availability of collateral, and standardization and legal certainty.

From a policy perspective, the SLR recommends strengthening the toolkit of Islamic liquidity instruments, including tradable and repo instruments, as a prerequisite for improving transmission quality and gradually reducing reliance on conventional anchors (Ascarya, 2014; Drissi & Guerguer, 2023). Developing credible Islamic benchmarks through deepening the sukuk and Islamic money markets is considered more effective than abrupt severance of coordination (Chapra, 1996; Šeho et al., 2020). From a research perspective, key agendas include direct evaluation of Islamic monetary instruments, granular analysis based on contract/product types, and integrating micro-banking findings with macro-outcomes such as inflation and output (Zaheer et al., 2013; Triwibowo et al., 2022). Overall, this article offers a conceptual model of “instrument–transmission–outcome” moderated by institutional factors and market context, while emphasizing that Islamic monetary progress is measured not only by its Sharia compliance, but also by its contribution to sustainable macroeconomic stability and well-being.

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