

Monetary Policy Transmission and Its Implications for Islamic Banking: Challenges and Shariah-Compliant Alternatives

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Abstract

Monetary policy is one of the important factors of macroeconomic management, aiming to achieve monetary stability and promote economic growth by controlling the money supply and credit. It has undergone significant evolution throughout history, moving from traditional tools based on interest and discount rates to more complex modern instruments such as unconventional open market operations, quantitative and qualitative easing, and large-scale liquidity management. This evolution has led to fundamental challenges to Islamic banking, which is based on Sharia principles that reject interest (riba) and emphasize its connection to the real economy. This research analyzes the impact of conventional monetary policy on Islamic financial institutions. The research highlights the channels through which monetary policy is transmitted to Islamic banking. The research also discusses the liquidity management channel and the challenges it presents due to the scarcity of Sharia-compliant instruments, as well as the credit demand channel and its susceptibility to changes in overall monetary policy. The research also focuses on the impact of conventional interest rate adjustments on Islamic finance, despite Islamic banks not dealing directly with interest. It also examines the impact of money supply and its fluctuations on the performance of Islamic financial institutions, their susceptibility to conventional discount rates and exchange rates, and the implications of these factors for Islamic finance, particularly in open economies. In response to these challenges, the research discusses the concept of Sharia-compliant monetary policy instruments as a viable alternative capable of achieving monetary policy objectives without compromising Sharia principles. Furthermore, it underscores the importance of developing a diverse range of Islamic financial instruments to enhance the efficiency of Islamic monetary policy and support financial inclusion by expanding access to equitable and sustainable finance. The research concludes with a number of key findings, most notably that continued indirect reliance on conventional monetary policy tools limits the independence of Islamic banking, and that developing a comprehensive Sharia-compliant monetary policy framework is a strategic necessity for

enhancing financial stability and achieving inclusive economic development in economies that rely on Islamic finance.

Keywords: Islamic Banking, Shariah-Compliant Monetary Instruments, Liquidity Management in Islamic Finance, Islamic Financial Institutions, Financial Inclusion through Islamic Finance

Introduction

Monetary policy is the set of tools and measures used by a central bank to control the money supply and interest rates, with the aim of achieving economic stability, controlling inflation, and supporting sustainable growth.¹ The main tools of monetary policy are:

- Interest Rate: Raising interest rates to reduce spending (combating inflation) or lowering them to stimulate borrowing and investment.
- Open Market Operations: Buying or selling government bonds to control the amount of liquidity in the banking system.
- Reserve Ratio: Determining the percentage of funds that banks must hold as reserves with the central bank.

The research highlights the channels through which monetary policy is transmitted to Islamic banking, primarily the competitive pricing channel, which compels Islamic institutions to align their financing rates with prevailing market rates, and the benchmarking channel, where Islamic banks rely on traditional benchmarks to price their products. It highlights the role of financing structures based on Mudarabah and Musharakah agreements as effective tools for liquidity management, investment stimulation, and linking the financial sector to the real economy.

Overview of the Evolution of Monetary Policy

The Gold Standard (19th - early 20th centuries): The value of currencies was directly linked to the quantity of gold. During this period and because of the Gold Standard policy prices remained stable however, it has limited countries' ability to respond to crises because they could not print money without a required quantity of gold as reserves. Following the above period, the Bretton Woods Agreement (1944 - 1971) was signed and as result of this agreement Global currencies were pegged to the US dollar, which was itself pegged to gold. Central banks started to play a larger role in managing exchange rates.

With the passage of time, and due the American policies the Bretton Woods system collapsed. Now the currencies were no longer pegged to gold. The focus shifted to targeting inflation as a top priority, particularly in the 1980s to combat stagflation. after the 2008 crisis and as a result of unconventional policies new tools emerged, such as quantitative easing, where the central bank purchased massive amounts of financial assets to inject liquidity when interest rates reached zero.²

Modern monetary policy (2020-2026): Recent policies have focused on managing temporary shocks (such as the COVID-

19 pandemic) and digital transformation. In 2026, central banks are increasingly interested in integrating central bank digital currencies (CBDCs) into monetary policy to improve the speed and effectiveness of monetary transmission.

Monetary policy is the strategic management exercised by the central bank to achieve a delicate balance between economic growth and price stability.³ By 2026, this policy has moved from traditional tools to complex digital and technological horizons.⁴ Here are more details about its types, tools, and current developments:

Types of Monetary Policy and Their Objectives

Expansionary Policy: Used to stimulate the economy during recessions by lowering interest rates and increasing the money supply. This aims to reduce borrowing costs and encourage investment and consumer spending. **Contractionary policy:** This is implemented when inflation rates are high to "cool down" the economy. This is done by raising interest rates to reduce liquidity, making borrowing more expensive and limiting aggregate demand.

Modern Monetary Policy Tools

In addition to traditional tools (such as interest rates and reserve requirements), more sophisticated tools have emerged. Now the central bank take the following steps.

Forward Guidance: The central bank communicates with markets about the future path of interest rates to build confidence and reduce volatility.

Quantitative and Qualitative Easing: Purchasing long-term assets to inject liquidity directly into the financial system.

Inflation Targeting: Setting a target inflation rate (often around 2-3% in advanced economies) and adjusting policies to achieve it.

Central Bank Digital Currencies (CBDCs): In 2026, many countries will begin integrating digital currencies as a tool for direct liquidity control, allowing for faster implementation of monetary policy and reducing reliance on traditional banking systems.

Green Monetary Policy: Central banks will begin incorporating climate change risks into their decisions by directing lending toward sustainable investments.

Inflation Targeting in 2026: Reports predict that global inflation rates will stabilize around 2.7%, with major central banks (such as the US Federal Reserve) tending to maintain or slightly reduce interest rates to ensure a soft landing for the economy.

Keeping in view the importance of monetary policy in the modern economics systems. There is need to know and analyse its impact on Islamic banking system.

The impact of conventional monetary policy on Islamic banking

Islamic banking is a banking system for conducting financial activities and investment services in accordance with the principles of Islamic law (Sharia). It differs from conventional banking in three fundamental aspects:

Prohibition of Riba (interest): The prohibition of interest, whether given or received.

Profit and loss sharing: Instead of a relationship between creditor and debtor, the relationship is based on partnership or buying and selling.

Link to the real economy: Every financial transaction must have a tangible asset (goods, property, or services), which prevents financial bubbles.

Islamic banking is affected by conventional (interest-based) monetary policy through four main channels that lead to real changes in its financial performance, according to updated studies for 2026:

1. The Competitive Pricing Channel:

When the central bank raises the discount rate or interest rate, conventional banks raise the returns on their deposits. To avoid deposit disintermediation, the Islamic bank is forced to raise the profit distribution ratio for depositors. This leads to a decrease in the bank's net profit margin if it cannot raise the returns on its assets at the same pace.

2. The Benchmarking Channel:

Most Islamic banks use the conventional interest rate (such as the former LIBOR or currently the guaranteed funding rates) as a benchmark for pricing Murabaha and Ijarah contracts⁵. Consequently, any change in conventional monetary policy instruments is automatically followed by a change in the cost of funding paid by the Islamic bank's customers.

3. Liquidity Management Channel:

The value of Islamic bonds and financial instruments in the secondary market is negatively affected by rising conventional interest rates [3]. If interest rates rise, the market value of fixed-income bonds decreases, impacting the valuation of the Islamic bank's asset portfolio.

4. Credit Demand Channel:

Raising conventional interest rates leads to a general economic contraction. This contraction reduces investment opportunities in partnership and profit-sharing contracts and increases the risk of default for existing Islamic financing clients, potentially raising the ratio of non-performing loans on the bank's balance sheet⁶

Adjustments to Interest Rates and Islamic Financing

Interest rate changes is one of the important tool of monetary policy that influences the larger financial system. The implications of these changes are especially complicated in Islamic finance because in Islamic financial system interest or riba is not allowed. Thus, Islamic financial institutions face a unique challenge working in dual financial system. They have to survive with conventional monetary policy while adhering to Islamic principles. Understanding how interest rate changes affect Islamic financing practices necessitates a thorough analysis of the industry's theoretical underpinnings as well as practical applications.

In contrast to traditional interest-based loans, Islamic finance emphasises on profit-sharing, risk-sharing, and asset-backed transactions. The central banks adjust interest rates to affect inflation, job levels, and economic growth. The impact of such steps by central bank can be significant on Islamic finance. For instance, a rise in interest rate will lead to increase in the costs of traditional financing which may make Islamic financing more alluring to borrowers looking for alternatives. It means that the requirement that the Islamic financial institutions follow Shariah rules may limit their operational flexibility in response to changes in monetary policy. Which may result in tempering its attractiveness.⁷

Moreover, when comparing Islamic finance to traditional finance, the means by which monetary policy is communicated can differ greatly. Islamic financial institutions commonly use interest-free frameworks such as Murabaha, Ijara, and Mudarabah. It means they generate income through leasing or profit-sharing arrangements. Therefore, as borrowers weigh the overall cost of financing options, changes in interest rates may have an indirect impact on interest in these services.⁸

The importance of liquidity management in Islamic finance is another crucial consideration. Islamic financial institutions must find other methods of managing liquidity outside of interest-based instruments since traditional monetary policy usually aims to regulate liquidity through interest rate adjustments. Innovative Islamic liquidity management tools, such as Sukuk and Shariah-compliant investment accounts, have been developed in response to this need. However, these instruments are limited or unable to fulfil the market demand for such instruments. In addition to providing necessary liquidity, these instruments also adhere to the moral and ethical standards of Islamic finance. The main obstacles is that these shariah compliant tools have play their role in market already dominated by interest based instruments. Adhering to shariah ruling may limit their performance. A better understanding of how these institutions may effectively respond to changing economic conditions while upholding Shariah principles can be gained by looking at how monetary policy affects Islamic financing practices. In addition to enhancing understanding of Islamic finance, this analytical viewpoint contributes to the larger discussion about the adaptability and resilience of financial systems in the face of shifting monetary policy.

Money Supply and Its Impact on Islamic Financial Institutions

A variety of financial organizations, including those operating under the Islamic finance model, are impacted by the money supply, which plays a crucial role in shaping the economic climate. Based on Shariah principles, the Islamic financial system emphasizes ethical investing, risk-sharing, and the prohibition of interest. Riba. To investigate how monetary policy affects Islamic financial products and services, it is essential to comprehend the complexities of the money supply. Changes in the money supply can have

an impact on funding costs, liquidity, and ultimately the profitability of Islamic financial institutions.

Interest rates are directly impacted by changes in the money supply, which, while not relevant to Islamic finance, nevertheless have an impact on the broader economy in which these institutions operate. For instance, when the money supply rises, interest rates often fall, increasing market liquidity. Because it may be easier for institutions to engage in profit-sharing arrangements or other Shariah-compliant financing choices, this increase in liquidity may encourage greater financing activities within Islamic finance. However, tighter liquidity circumstances brought on by a decline in the money supply may impede growth and limit Islamic financial institutions' capacity to offer credit or make investments in viable projects.⁹

Furthermore, changes in the money supply may have an impact on Islamic financial institutions' risk profiles. A more competitive environment brought about by increased liquidity may force financial institutions to lower their profit margins in an effort to attract customers. To maintain their market position, Islamic banks may create new products or enhance existing ones while abiding by Shariah regulations. On the other hand, Islamic financial institutions may face higher credit risk during periods of low liquidity as borrowers struggle to meet their obligations, which could compromise the viability of the institution as a whole.

The transmission of monetary policy also takes into account the distinctive characteristics of Islamic finance. For example, a variety of Islamic financial products built on asset-backed finance require a stable and enough money supply to function effectively. Changes in the money supply can therefore affect the price of these securities as well as the demand for Islamic financing generally. It is necessary to observe how these discussions show the relationship between monetary policy and Islamic finance and the importance of having a solid grasp of both areas. The money supply and Islamic financial institutions have a complicated and nuanced relationship.

The Impact of Conventional Discount Rates on Islamic Banking Services

The commercial banks when face lack of liquidity in the short run they resort to the central bank to take loan to fulfill their financial obligations towards their customers. The central bank takes charges against such loan in the form of interest. The commercial banks some time present the commercial papers and treasury bills to central banks to rediscount them against the credit facility from the central bank to these commercial banks. Rediscounting of such commercial papers means that the Central Bank replaces the commercial bank to receive the loan payable against that commercial paper.¹⁰

Pricing of Financing Contracts: Islamic banks rely on the discount rate as a benchmark for pricing Murabaha and Ijarah contracts. When the discount

rate increases, banks are forced to raise their profit margins on new contracts to cover the opportunity cost.

Asset Refinancing: In conventional banks, the discount rate is the rate at which the central bank lends to banks. In Islamic banks, a higher discount rate makes Sharia-compliant repurchase agreements (repos) more expensive, which may reduce the bank's willingness to provide long-term financing.

Pressure on Investment Deposits: To avoid losing customers to conventional banks that are raising their interest rates, Islamic banks are forced to adjust profit distribution ratios in unrestricted investment accounts, which may affect the liquidity available for developing new digital services. Second: Alternatives to the Discount Rate Tool in the Islamic Financial System

Central banks managing Islamic financial systems (such as those in Sudan, Malaysia, or through Islamic banking windows in the Gulf countries) rely on Sharia-compliant alternatives to achieve the same monetary policy objectives. In this regard, Instead of an interest rate, the average profit rate in the Islamic banking sector or the yield on sovereign sukuk is used as a market guidance tool.

2026 Participation/Deposit Certificates: The central bank issues profit-sharing sukuk. If it wants to reduce liquidity, it raises the expected return on these sukuk to attract funds from Islamic banks.¹¹

Profit Sharing Ratio Adjustment: The central bank intervenes by adjusting the percentage that the bank takes as a "mudarib" (investment manager) in exchange for the depositors' share. This is a powerful tool for controlling the money supply without resorting to interest.¹²

International Interest-Free Loans (Qard Hasan): Some central banks use this to manage short-term liquidity with Islamic banks. Liquidity is exchanged without interest, with the bank obligated to return the liquidity by a specified date. You can explore more about Sharia-compliant liquidity management tools on the official website of the General Council for Islamic Banks and Financial Institutions (CIBAFI).

Currency Rates and Their Impact on Islamic Finance

The framework of Islamic finance is defined in large part by exchange rates, which have an impact on both the investment decisions made by individuals and the operations of financial institutions. In the context of Shariah-compliant Islamic finance, exchange rate fluctuations pose difficulties that require careful consideration. Currency exchange rate fluctuations can affect the price of goods and services, the appraisal of assets, and ultimately the returns on investments. The basic principles of the Islamic financial system emphasize ethical investing, promote risk-sharing and forbid interest. The risk characteristics of various financial products and services can be altered by fluctuations in currency prices. For instance, when a currency depreciates, the cost of imported goods increases, which may lead to inflationary pressures and may affect Islamic financial instruments like Ijara and Murabaha, whose pricing structures are closely related to the value of core assets.

Exchange rates have an effect outside of local markets as well. The fluctuation of exchange rates can pose significant challenges for Islamic financial institutions engaged in international commerce or investment. When creating Islamic financial products that may involve cross-border transactions, currency risk is a crucial consideration. The profit under the agreements of Islamic financial institutions for letter of credit may also alter.

Another important aspect that has an impact on Islamic finance is the role that central banks and monetary authorities play in monitoring exchange rates. Monetary policy decisions, such as interest rate adjustments, can directly impact currency rates and, consequently, the efficacy of Islamic financial products.

In conclusion, the relationship between exchange rates and Islamic finance is important for the Islamic banking system. People may better grasp the complexities of Islamic finance and its ability to adjust to global economic conditions by encouraging a deep comprehension of these concepts, which will ultimately connect theory and practice in this ever-evolving field.

Shariah-Compliant Monetary Policy Tools Concept

Creating monetary policy tools that adhere to Shariah is essential to incorporating Islamic finance into contemporary economic frameworks. Interest rates and other traditional monetary policy instruments are in direct opposition to Shariah laws, which prohibit riba (usury). Therefore, it is essential to create substitute systems that uphold Islamic moral principles while effectively managing liquidity and financial stability. In order for policymakers to come up with innovative solutions that support the economy and Shariah principles, they must have a thorough understanding of both Islamic finance principles and conventional monetary policy techniques.

The adoption of profit-sharing plans, which might replace interest-based systems, is one potential remedy. Central banks can use profit-sharing agreements, such as mudarabah and musharakah, to communicate with financial institutions. For instance, mudarabah agreements, in which banks participate in profitable initiatives and tie returns to actual economic performance, are one way that central banks might supply liquidity. In addition to upholding Shariah conformity, this approach encourages banks to make more profitable investments, hence promoting economic growth.

Adopting profit-sharing schemes is a key solution to address the imbalances of interest-based systems. In this model, the central bank's role shifts from "lender of last resort" charging interest to "strategic partner" aimed at stimulating real growth.

1. Mudarabah Agreements:

Central banks use Mudarabah to provide liquidity to Islamic banks. In this case, the central bank acts as the "capital provider" (Rab al-Mal) and the commercial bank as the "Mudarib." The central bank injects funds into specific investment portfolios held by the bank. Instead of a fixed discount rate, the central bank's returns are linked to the actual economic performance of those investments.

This approach encourages banks to direct liquidity towards more profitable and productive projects, thus reducing unproductive financing activities.¹³

2. Musharakah Agreements:

This instrument relies on equity financing between the central bank and commercial banks. The two parties jointly finance major national projects (such as infrastructure or renewable energy). Profits are distributed according to the agreement, while losses are distributed precisely according to each party's capital contribution.¹⁴

This instrument contributes to regulating the money supply through "participation certificates" that the central bank can issue to absorb liquidity or repurchase to inject it.

Promoting Economic Growth and Stability: Unlike interest, which represents a fixed burden regardless of the project's status, profit sharing makes the financial system more flexible. Financial costs for banks decrease during recessions and increase during booms, creating a natural balance that prevents financial crises resulting from the accumulation of usurious debt.

The use of Islamic bonds, or sukuk, is another way to develop monetary policy tools that adhere to Shariah. Sukuk can serve as a crucial instrument for carrying out monetary policy and managing state debt. Central banks can provide liquidity into the financial system without depending on interest-based loans by issuing sukuk. Additionally, sukuk can be created to finance specific initiatives, enhancing the financial and social returns on investments. Additionally, this tool can attract both foreign and domestic investors who are increasingly searching for morally sound investment opportunities that follow Islamic law.

Moreover, the establishment of shariah compliant reserve requirements could improve the stability of the financial sector. In accordance with Islamic finance regulations, central banks can ensure that banks have adequate liquidity by establishing reserve ratios that are not influenced by interest calculations. This strategy may require banks to hold onto some of their assets in Shariah-compliant investments, which would support the growth of the Islamic finance sector and guarantee that banks remain strong in times of economic uncertainty.

In conclusion, integrating Islamic finance into the larger economic system requires the creation of monetary policy instruments that follow Shariah principles. Through innovative adaptation of conventional monetary policy instruments to conform to Shariah principles, industry can foster a financial environment that is both morally upright and economically robust.

Enhancing Financial Inclusion via Islamic Finance

Advancing financial inclusion via Islamic finance presents a valuable opportunity to tackle economic inequalities while complying with Shariah guidelines. Financial inclusion denotes the availability and utilization of formal financial services for individuals and enterprises, especially in underserved

areas. Islamic finance, based on ethical and fair practices, provides a structure that corresponds with the goals of financial inclusion. The tenets of risk-sharing, profit-sharing, and the ban on interest give rise to distinctive financial offerings that can meet the varied needs of the community, encouraging a setting where all individuals can engage in economic endeavors.

Monetary policy plays a critical role in shaping the structure of Islamic finance and its ability to promote financial inclusion. By implementing policies that encourage the expansion of Islamic financial institutions, central banks and regulatory agencies can increase the reach of these institutions into underprivileged areas. Monetary policy can help provide Shariah-compliant financial services by creating an atmosphere that is favorable to Islamic banks and microfinance organizations. These products usually include microloans, leases, and cooperative finance plans, which can help low-income people and small businesses get the money they need without compromising their moral values.

Financial inclusion can be significantly enhanced by integrating technology into Islamic finance. Online platforms and mobile banking are examples of digital financial services that could link underserved communities with established banking systems. Islamic financial institutions can offer innovative solutions that are more affordable and accessible by leveraging technology. This change not only complies with the principles of Islamic banking but also responds to the growing demand for efficient and accessible financial services. These efforts can be strengthened by training programs aimed at increasing potential users' digital literacy, which will guarantee that people are equipped to use these services effectively.

Enhancing financial inclusion through Islamic finance requires not only technical advancement and product innovation, but also financial literacy. In addition to general financial management, training programs that highlight the principles of Islamic finance can help people make informed decisions regarding their financial needs. By making the ideas and practices of Islamic finance more understandable, these initiatives can help the general public better understand them. Students and aspiring teachers can raise a generation that understands the value of moral financial behavior and how it contributes to the betterment of society by encouraging an awareness of how Islamic finance operates.

In the end, the effective execution of financial inclusion programs utilizing Islamic finance depends on the collaboration of various stakeholders. To create regulations and initiatives that increase public knowledge and accessibility to Islamic financial products, governments, academic institutions, and financial institutions must work together. Working together can help identify barriers to participation, provide solutions, and share best practices in a variety of fields. The concepts of Islamic finance can be effectively integrated into broader financial inclusion plans by fostering a collaborative environment. This would support social welfare and sustainable economic growth that is in line with Shariah.

Key Findings

The examination of how monetary policy affects Islamic finance reveals a number of important findings that link theoretical frameworks with practical applications. First of all, it is evident that incorporating conventional monetary policy tools, such as shifts in interest rates and reserve ratios, into Islamic banking presents challenges. It takes innovative thinking to replace traditional monetary policy tools because Islamic finance is based on the idea that interest (riba) is forbidden. This necessitates a thorough understanding of how Shariah-compliant Islamic financial organizations can adapt to current monetary policy.

Second, the study shows that the regulatory framework imposed by monetary policy has a significant impact on the liquidity management strategies employed by Islamic banks. Shariah-compliant tools, such as sukuk or mudarabah agreements, are commonly used by Islamic financial organizations to manage liquidity. However, fluctuations in interest rates and shifts in the money supply could jeopardize the effectiveness of these instruments. This realization emphasizes how important it is to develop Shariah-compliant liquidity management systems that respect Islamic law and can effectively adapt to changes in monetary policy.

The study also highlights how crucial central banks are to fostering an environment that is conducive to the growth of Islamic financing. The power to implement policies that support the integration of Islamic financial concepts into the broader monetary system rests with central banks. Central banks can create rules that allow Islamic and conventional financial systems to live peacefully by recognizing the distinctive operational features of Islamic finance. In a dual banking environment, this collaboration is essential to achieving financial stability and promoting economic growth.

The study also emphasizes the significance of financial literacy and awareness among those involved in the Islamic finance sector.

In conclusion, the findings emphasize the need for ongoing dialogue between academics, financial institutions, and policymakers in order to bridge the gap between theory and practice in the area of Islamic banking. The Islamic financial sector must adapt to changing monetary restrictions while maintaining its fundamental values as the global economy develops. In addition to strengthening Islamic finance, this collaborative effort will support the broader objective of fostering Shariah-compliant, sustainable economic growth.

The relationship between monetary policy and Islamic finance is a crucial area of research. Promoting a comprehensive grasp of contemporary financial systems requires an understanding of how monetary policy impacts Islamic financing practices.

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