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Bridging monetary policy and the real sector: A conceptual model in Islamic economics

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ABSTRACT

The disconnect between monetary policy and the real sector remains a key issue in modern economic systems, including Islamic finance, where decoupling between financial activities and productive sectors distorts the efficiency of monetary transmission channels. Previous studies have discussed Islamic monetary instruments and financial intermediation separately, with limited attention to an integrated framework linking Islamic monetary policy, Islamic financial institutions, and the real sector within a *Maqasid al-Shariah* perspective. This study aims to develop a conceptual model that bridges Islamic monetary policy and the real sector within an integrated framework. Using an integrative literature review and thematic content analysis, the study synthesizes theories and empirical findings on Islamic monetary transmission, financial intermediation, and *Maqasid al-Shariah*. The findings suggest an integrated model that links Islamic monetary instruments, Islamic financial institutions, and real sector activities through a dynamic feedback mechanism, with *Maqasid al-Shariah* as the normative foundation. In contrast to conventional monetary frameworks relying on interest-based transmission mechanisms, the proposed framework emphasizes profit-sharing, asset-backed financing, and ethical resource allocation linked to productive activities. This study highlights the importance of strengthening Sharia-compliant monetary instruments, institutional integration, and maqasid-based policy design to support inclusive, sustainable, and real-sector-oriented economic development.

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1. Introduction

The development of monetary economics from an Islamic perspective demonstrates increasingly complex dynamics, dual banking systems that integrate conventional and Islamic financial institutions, such as those implemented in Indonesia and Malaysia. Within this framework, monetary policy serves not only as an instrument of macroeconomic stabilization but also as a mechanism to foster linkages between the financial and real sectors (Shaheen et al., 2025). Islamic economics normatively emphasizes the importance of these linkages, where financial activities must be based on real economic activities and avoid interest-based practices (Ayub & Khan, 2021).

However, empirical evidence shows that Islamic financial intermediation in both countries still tends to be dominated by debt-based and low-risk financing structures. In Indonesia, murabahah financing accounts for more than 60% of Islamic banking financing portfolios (Djumadi, Syah et al., 2025). Similarly, in Malaysia, Bank Negara Malaysia reports that household financing constitutes around 64% of total Islamic financing, indicating a strong orientation toward household and consumption-based financing rather than productive investment. In addition, academic studies on Malaysian Islamic banks consistently find that debt-based contracts such as murabahah and tawarruq dominate financing portfolios, with profit-and-loss sharing instruments remaining very limited (Qureshi & Hussain, 2020). This pattern suggests that Islamic banking in dual systems still faces challenges in fully channeling financial resources toward productive sectors, thereby limiting the effectiveness of Islamic monetary policy in strengthening real-sector linkages. Therefore, strengthening the relationship between monetary policy and the real sector is a strategic issue in achieving sustainable and equitable economic stability (Choudhury, 2018).

In practice, the effectiveness of monetary policy transmission in the Islamic financial system still faces various challenges. Empirical studies indicate that Islamic banking plays a role in transmitting monetary policy through financing to the real sector; however, its contribution is relatively limited due to its smaller market share and the distinct characteristics of profit-sharing instruments, which differ from those in conventional systems (Audah & Kasri, 2020; Majid & Hasin, 2014). Furthermore, the monetary transmission mechanism in the Islamic system tends to be more complex because it does not rely on interest rates as the primary instrument, necessitating an alternative approach that is more in line with Islamic principles (Savon & Yousfi, 2025).

Based on these conditions, this study aims to develop a conceptual model that bridges monetary policy with the real sector from an Islamic economic perspective. This model is expected to provide a comprehensive analytical framework for understanding the interactions between Islamic monetary instruments, Islamic financial institutions, and real economic activity. Thus, this research not only contributes to strengthening the theoretical foundation of Islamic monetary economics but also provides relevant policy implications for monetary authorities in designing more effective and Sharia-compliant policies.

However, the existing literature reveals a significant gap in the study of Islamic monetary economics, particularly regarding the conceptual integration between monetary policy and the real sector. Most research focuses on empirical analysis of monetary policy transmission or partial Islamic banking performance, without developing a holistic and integrative theoretical framework (Choudhury & Ratnawaty, 2019; Shaheen et al., 2025). Bibliometric evidence also indicates that most studies on dual banking systems remain fragmented, focusing separately on interest rate channels, profit channels, or banking performance without integrating monetary policy objectives, Islamic financial intermediation, and real-sector outcomes into a unified framework (Pribadi et al., 2025; Ramadhini & Irfany, 2023). Consequently, the literature has not yet produced a comprehensive conceptual framework capable of explaining the interaction between Islamic monetary policy, financial intermediation, and equitable economic development in an integrated manner (Azzahro, 2025). This fragmentation represents a fundamental weakness of existing partial models, as they fail to capture the full transmission chain from Islamic monetary policy instruments to real-sector output. As a result, existing models have limited explanatory power and weak policy relevance, particularly in explaining how Islamic monetary policy can simultaneously achieve financial stability, productive investment allocation, and social welfare objectives (A. Z. Ali & Kishwar, 2022; Johari et al., 2022).

Therefore, the novelty of this research lies in the development of a conceptual model that integrates monetary policy, Islamic finance, and real-sector while embedding the *Maqasid al-Shariah* framework as the foundational objective of Islamic monetary transmission, particularly through the preservation of wealth (ḥifẓ al-māl), realization of public welfare (maṣlaḥah), and promotion of socio-economic justice (ʿadl). Mechanically, these principles influence monetary transmission through the prioritization of profit-sharing financing, asset-backed transactions, and productive investment allocation that directly support real economic activities. In contrast to conventional monetary transmission, which primarily depends on interest rate adjustments, the proposed framework emphasizes financial-real sector integration and socially oriented economic circulation. Accordingly, this research offers both theoretical and practical contributions, particularly for countries with dual banking systems such as Indonesia, in developing a more resilient and sustainable Islamic monetary system.

2. Literature Review

Foundations of Monetary Policy in Conventional and Islamic Economics

Monetary policy is a key instrument for maintaining economic stability and growth, yet its conceptual foundations differ fundamentally between conventional and Islamic economics. In conventional economics, monetary policy relies on the use of interest rates as the primary instrument to control inflation, stimulate economic growth, and maintain macroeconomic stability through various approaches such as inflation targeting and controlling the money supply (Hossain, 2015). This approach generally focuses on macroeconomic indicators such as GDP growth, inflation, and unemployment, and is supported by a debt-based financial system that, in practice, can create a separation between the financial and real sectors (Othman, 2021). Several studies even show that the dominance of the financial sector in a debt-based system has the potential to weaken the effectiveness of monetary policy transmission to productive activities, as more liquidity expansion is absorbed into financial markets rather than real sector investment. This condition gives rise to the phenomenon of financialization, which causes financial sector growth not always to be followed by increases in real economic output, thus limiting the effectiveness of monetary policy in creating inclusive and sustainable growth (Abiola-Adams et al., 2025; Othman, 2021).

In contrast, from an Islamic economic perspective, monetary policy is based on sharia principles, which prohibit usury and emphasize profit-sharing mechanisms, distributive justice, and a close link between financial activities and the real sector (Ayub & Khan, 2021; Ibrahim &

Alam, 2018). Monetary instruments in the Islamic system do not rely on interest rates, but instead utilize schemes such as musharakah and partnership-based financing that encourage equitable risk sharing (Adela, 2018). Furthermore, Islamic economics integrates ethical, social, and sustainability dimensions into the formulation of monetary policy, thus orienting it not only toward economic stability but also toward the welfare of society at large (Awais et al., 2024). Historically, this thinking is rooted in the contributions of classical scholars such as Al-Ghazali and Ibn Khaldun, who emphasized the social function of money and the importance of economic balance (Figuera, 2018). However, there are points of intersection and contradiction between the two perspectives. On the one hand, both conventional and Islamic economics aim to maintain macroeconomic stability and promote growth. However, they differ fundamentally in their transmission mechanisms and ontological assumptions. Conventional economics emphasizes interest-based market efficiency, while Islamic economics emphasizes a direct link between financial activity and real productivity through risk-sharing mechanisms (Ayub & Khan, 2021). This theoretical synthesis reveals a conceptual gap regarding how monetary policy can effectively reach the real sector within a more equitable and stable framework. Therefore, this subsection provides an important theoretical foundation for the development of a conceptual research model, particularly in explaining the need for an integrative framework capable of bridging monetary policy, Islamic financial institutions, and real economic activity from an Islamic economic perspective.

Islamic Monetary Economics: Principles, Instruments, and Objectives

Islamic monetary economics is a discipline based on sharia principles that aims to integrate financial activities with Islamic ethical values and justice. One of the main principles in this system is the prohibition of usury, which encourages the use of profit-and-loss sharing mechanisms such as mudarabah and musharakah as fairer and more sustainable alternatives in the distribution of risks and profits (M. H. Uddin et al., 2022). Furthermore, Islamic monetary economics is oriented towards achieving *Maqasid al-Shariah*, namely the objectives of sharia that include the protection of religion, life, mind, property, and descendants, which implicitly emphasizes the importance of social welfare, economic justice, and financial system stability (Hayatudin & Adam, 2020; Suzuki et al., 2018; Uluyol, 2024). Unlike conventional monetary economics, which primarily relies on interest rates as the transmission mechanism of monetary policy, Islamic monetary economics seeks to align financial intermediation with productive economic activities through risk-sharing and asset-backed financing. This distinction reflects a fundamental theoretical divergence, where Islamic economics assumes that monetary stability should emerge from the direct linkage between financial flows and real-sector productivity rather than through debt-based expansion mechanisms. In its implementation, Islamic monetary instruments include various Sharia-based contracts such as *ijarah*, *murabahah*, and social instruments such as *qard al-hasan*, which function not only as financing tools but also as monetary policy instruments to promote price stability and employment opportunities (Abiola-Adams et al., 2025; Hamdouni & Khaldi, 2025; I. Uddin et al., 2024). Furthermore, monetary authorities can utilize instruments such as sukuk and various Sharia-based liquidity instruments to effectively manage the money supply without violating Sharia principles (Kalim, 2022; M. H. Uddin et al., 2022; Ulfah et al., 2024). Normatively, this system also emphasizes transparency, fairness, and the prohibition of speculative practices such as *gharar* and *maysir*, thus creating a more stable and real-sector-oriented financial system (Noviyanti et al., 2025; Widjaja, 2024). Nevertheless, the literature reveals both convergence and contradiction regarding the practical implementation of these instruments. While several studies argue that Sharia-compliant monetary instruments enhance financial resilience and economic inclusiveness, others suggest that Islamic financial institutions continue to depend on conventional benchmarks, particularly interest-rate references, thereby limiting the independence and effectiveness of Islamic monetary operations in practice (Audah & Kasri, 2020). This contradiction indicates that the normative superiority of Islamic instruments has not always been fully translated into an operationally integrated monetary system.

However, challenges such as the limited market share of Islamic banking and the need for innovation in modern financial instruments remain important issues that require further development, especially in the context of integration with the global financial system (Alhejaili, 2025; Audah & Kasri, 2020). Additionally, fragmented regulatory practices and the absence of globally standardized Sharia-compliant liquidity instruments create inconsistencies in monetary implementation across jurisdictions, weakening policy coordination and transmission effectiveness. Such limitations reinforce the argument that Islamic monetary instruments alone are insufficient unless embedded within a broader integrative framework that systematically connects monetary policy, Islamic financial institutions, and real economic activities. Thus, Islamic monetary economics offers an alternative framework that not only emphasizes economic efficiency, but also integrates ethical, social, and spiritual dimensions in achieving sustainable economic stability and prosperity. Therefore, this subsection contributes directly to the formation of the proposed conceptual model by identifying the foundational monetary instruments, ethical objectives, and institutional mechanisms necessary to bridge Islamic monetary policy with real-sector development in an integrated analytical framework.

Monetary Policy Transmission Mechanism in Dual Financial Systems

The monetary policy transmission mechanism in a dual financial system integrating conventional and Islamic banking exhibits complex and different dynamics compared to a single system. In general, the credit channel is the primary channel for transmitting monetary policy, with both conventional and Islamic banks tending to reduce financing disbursement during monetary tightening, although Islamic banks are relatively less sensitive due to the use of profit-sharing instruments (Audah & Kasri, 2020; Shah & Rashid, 2019). Furthermore, the balance sheet channel also plays a role in the transmission process, although Islamic banks' response to monetary and price shocks tends to be weaker due to rigidity in yield adjustments and excess liquidity (Boukhatem & Djelassi, 2022). In a macroeconomic context, the inflation and exchange rate channels also influence real output growth, particularly when there are imperfections in nominal rate adjustments within the dual financial system (Hossain, 2016). Comparatively, Islamic banks generally have lower sensitivity to monetary policy changes than conventional banks, due to limited market share, the dominance of non-PLS financing, and non-interest-based operational characteristics (Asbeig & Kassim, 2015; Audah & Kasri, 2020). Furthermore, the phenomenon of excess liquidity in Islamic banks does not directly affect the transmission of policy interest rates, but can create price spillovers between Islamic and conventional banks through financial market linkages (Omer, 2019). However, there is an empirical contradiction because although the sharia system is theoretically seen as more resilient, the effectiveness of its transmission still often depends on conventional market structures and benchmarks, thereby reducing the independence of the Islamic monetary system. Empirical findings in various countries such as Indonesia, Malaysia, and Pakistan indicate that although Islamic banking contributes to the monetary transmission mechanism, its role is still limited and is heavily influenced by market structure and the design of the financial instruments used (Audah & Kasri, 2020; Shah et al., 2024). Therefore, the effectiveness of monetary policy in a dual financial system requires a more adaptive approach that takes into account the unique characteristics of Islamic banking, including strengthening profit-sharing-based instruments and better integration into the overall financial system. Thus, it contributes directly to the formation of the research conceptual model by emphasizing the importance of reconstructing the Islamic monetary transmission channel as a connecting mechanism between monetary policy, Islamic financial institutions, and the real sector more effectively.

Linkages Between Financial Sector and Real Sector in Islamic Economics

From an Islamic economic perspective, the link between the financial sector and the real sector is a fundamental principle that emphasizes that financial activities must be directly supported by productive economic activities based on real assets. This principle is reflected in the concept of asset-backed financing and risk-sharing mechanisms, which ensure that fund flows are not speculative but rather linked to real activities such as production, trade, and investment, thereby minimizing the potential for financial crises (Ahmed, 2010; Farooq & Selim, 2019). However, there is an empirical contradiction because even though the sharia system is theoretically seen as more resilient, the effectiveness of its transmission still often depends on conventional market structures and benchmarks, thus reducing the independence of the Islamic monetary system (Shaikh, 2025). Empirically, various studies have shown that Islamic finance has a positive contribution to economic growth and inclusive development, as seen in Indonesia and Malaysia, where Islamic financing has been able to stimulate the productive sector while reducing income inequality (Agustina et al., 2023; Kassim, 2016). Furthermore, the role of Islamic banks in supporting international trade is also evident in Turkey, where Sharia-compliant financing has contributed to increased exports and real economic activity (İçellioğlu & Engin Öztürk, 2019). However, there is an empirical contradiction because some Islamic financing practices still rely on conventional interest rate benchmarks and have not been fully standardized globally, so that the ideal integration between the financial sector and the real sector has not been fully achieved (Qadri & Bhatti, 2019). Nevertheless, the resilience of the Islamic financial system in the face of crises, such as the global financial crisis, demonstrates that strong integration between the financial and real sectors can be a more resilient alternative in maintaining economic stability (Ejaz & Khan, 2014). Thus, this literature strengthens the formation of a conceptual research model by placing the integration of the Islamic financial sector and the real sector as a core mechanism (bridging mechanism) that explains how Islamic monetary policy can be transmitted towards inclusive, stable, and equitable economic growth in accordance with the principles of *Maqasid al-Shariah*.

Macroeconomic Stability and the Role of Islamic Finance

Islamic finance is increasingly recognized for its strategic role in supporting macroeconomic stability through its unique characteristics that emphasize risk-sharing, linkages to real economic activity, and ethical and sustainable investment practices. Within this framework, the prohibition on speculative activity and the obligation to base real assets make the Islamic financial system relatively more stable and able to minimize the potential for economic bubbles compared to conventional systems (Shaheen et al., 2025; Zulkhibri & Abdul Manap, 2019). Empirical evidence shows that Islamic banking is more resilient to financial crises, as seen in the Gulf Cooperation Council (GCC) countries during the 2008 global crisis, where volatility was lower than conventional systems (Tabash et al., 2017). Furthermore, Islamic finance also contributes to price stability through non-interest-bearing mechanisms that have been able to dampen inflationary pressures in several countries such as Iran, Sudan, and Bahrain (Cham, 2019). In the long term, Islamic financing has been shown to have a positive relationship with economic growth and output stability, with increases in Islamic banking assets and financing correlated with increases in GDP in both the short and long term (Hassan et al., 2022). Furthermore, the integration of Islamic commercial and social finance, such as zakat and waqf, contributes to financial inclusion, poverty reduction, and improved social welfare, which overall strengthens the stability of the economic system (Ascarya & Suharto, 2021). However, there are different empirical views regarding the effectiveness of Islamic finance because macroeconomic stability remains influenced by inflation, exchange rates, and regulatory capacity, thus indicating that sharia instruments alone are not sufficient without strong governance support (Iqbal et al., 2025, 2026). The intersection of various theories shows that macro stability in Islamic economics depends not only on financial efficiency, but also on the integration between productive financing, social finance, and the real sector, which distinguishes it from conventional approaches that focus more on short-term monetary stabilization. Thus, this literature contributes directly to the development of a conceptual research model by positioning macroeconomic stability as an outcome of the interaction between Islamic monetary policy, Islamic financial institutions, and real sector activities within an integrated Islamic economic framework.

Maqasid al-Shariah and Ethical Foundations of Monetary Policy

Maqasid al-Shariah, as the primary objective of sharia, provides a comprehensive ethical foundation for formulating monetary policy in Islamic economics, emphasizing the principles of justice, public welfare (*maslahah*), and protection of property (*hifz al-mal*) as the primary orientations of economic policy. Ontologically, the principle of tawhid is the basis for integration between economic, social and moral dimensions so that monetary policy not only functions as an instrument of economic stabilization, but also as a means of increasing social welfare (Choudhury, 2018; Nur et al., 2025). However, unlike the conventional monetary system which often faces transmission failures to the real sector due to the dominance of financial speculation and interest-based credit expansion, the maqasid perspective encourages the allocation of funds to productive activities through asset-based instruments and profit sharing, so that monetary transmission is more connected to investment, production, and the distribution of welfare (Ayub & Khan, 2021; Shaheen et al., 2025). In this context, *Maqasid al-Shariah* not only functions as normative justification, but also works as an economic mechanism that directs monetary policy towards priority sectors through the principles of distributive efficiency, reducing inequality, and limiting speculative activities (Al-Ayubi & Halawatuddu'a, 2021; Ismail & Baharuddin, 2025). The implementation of this framework is also reflected in the development of Islamic financial instruments, such as sukuk, zakat, waqf, and innovations such as Sharia-based central bank digital currencies aimed at increasing financial inclusion and economic system stability (Faizi, 2026). However, there are implementation contradictions due to the dominance of the conventional financial system and the limitations of standardized Islamic monetary instruments which still limit the operational effectiveness of maqasid in modern monetary policy (Mohd Zain et al., 2024; Rahim et al., 2024; Shaheen et al., 2025). Thus, this literature contributes directly to the formation of a conceptual research model by placing *Maqasid al-Shariah* as the foundation and guiding and transmission mechanism that bridges Islamic monetary policy, Islamic financial institutions, and the real sector towards inclusive and sustainable economic stability and prosperity.

3. Research Method

This study employed a qualitative approach based on a literature review (library research) with the aim of developing a conceptual model development (theory-building and conceptual synthesis type) that integrates monetary policy and the real sector from an Islamic economic perspective. This approach was chosen because it is relevant for exploring, synthesizing, and reconstructing various theoretical concepts scattered throughout the literature on Islamic monetary economics and Islamic finance. The data collection process was conducted through a systematic search of reputable international journal articles indexed by Scopus, academic books, and institutional reports relevant to the research topic. The literature search technique utilized databases such as Scopus, ScienceDirect, and Google Scholar with key keywords such as Islamic monetary policy, monetary transmission, real sector linkage, and *Maqasid al-Shariah*.

The literature reviewed was limited to publications from the last 10 years (2015–2025) to ensure relevance to contemporary economic dynamics. Literature inclusion criteria included topic relevance, journal quality (Q1–Q4), and contribution to the development of Islamic economic theory. This approach aligns with conceptual research methods that emphasize critical analysis and literature synthesis to build new theoretical frameworks (Snyder, 2019).

Next, data analysis was conducted using conceptual synthesis techniques, integrating various theoretical perspectives from the reviewed literature to construct a coherent and systematic conceptual model. The analysis stages included identifying key concepts, grouping themes, and developing relationships between variables representing the interactions between monetary policy, Islamic financial institutions, and the real sector. To ensure scientific rigor and reduce subjectivity, the conceptual model was validated through internal consistency checking and theoretical triangulation across selected literature sources, by comparing consistency of concepts and ensuring logical coherence between constructs. This approach enabled researchers not only to summarize the existing literature but also to generate theoretical contributions through the development of an innovative conceptual framework based on the values of *Maqasid al-Shariah*. This method is widely used in conceptual research in management and economics to produce theoretical models with strong policy implications (Jaakkola, 2020).

4. Result and Discussion

Integrating Islamic Monetary Policy and the Real Sector

Conceptualizing the relationship between Islamic monetary policy and the real sector demonstrates that Islamic economics normatively positions the financial sector as an integral part of productive economic activity. In the proposed conceptual model, this relationship is operationalized through two primary transmission channels, namely the *profit-sharing channel* and the *asset-backed financing channel*, which function as the main mechanisms linking monetary policy to real-sector performance. Basic principles such as asset-backed financing and risk-sharing emphasize that every financial activity must be directly linked to the real sector, thereby promoting sustainable economic growth and mitigating speculative risk. Through the profit-sharing channel, changes in Islamic monetary policy affect the volume and allocation of partnership-based financing (e.g., *musharakah* and *mudarabah*), which subsequently influence private investment, production capacity, and employment. Simultaneously, the asset-backed channel ensures that financial expansion remains tied to productive assets and real economic transactions, thereby reducing excessive financialization and speculative behavior often associated with monetary decoupling in conventional systems. However, the literature demonstrates a gap between these normative claims and empirical implementation, with integration between Islamic finance and the real sector not yet fully optimal (Farooq & Selim, 2019). Nevertheless, various empirical studies indicate a significant long-term relationship between Islamic banking financing and real economic performance, particularly in encouraging private sector investment and gross domestic product growth (Ben Mimoun, 2019; Kismawadi, 2024). This relationship reflects a two-way dynamic, namely supply-leading and demand-following, indicating that the financial and real sectors influence each other within the framework of the Islamic economic system (Chiad & Gherbi, 2024). In this model, the causal relationship is explicitly structured, where Islamic monetary instruments (independent variable) influence Islamic financial intermediation (mediating variable), which subsequently affects real-sector outcomes, including investment, employment, and output growth (dependent variables).

Furthermore, the link between the financial and real sectors in Islamic economics is not only economic but also contains strong ethical and social dimensions. The principle of *Maqasid al-Shariah* serves as the primary foundation for ensuring that financial activities contribute to societal welfare, distributive justice, and inclusive and sustainable economic development (Nouman et al., 2020). Rather than functioning solely as a normative justification, *Maqasid al-Shariah* is incorporated into the conceptual model as an evaluative policy objective that technically guides monetary transmission toward measurable outcomes, including price stability (*hifz al-mal*), equitable financing distribution (*al-‘adalah*), employment generation, and poverty reduction (*maslahah*). In this context, Islamic finance plays a role in stabilizing the economy by aligning financial flows with productive activities, thereby reducing economic volatility and maintaining price and output stability (Shaheen et al., 2025). This mechanism creates a dynamic feedback loop in which real-sector performance—measured through output growth, productive investment, inflation stability, and employment indicators provide signals for subsequent monetary policy adjustment, allowing Islamic monetary authorities to recalibrate liquidity instruments and financing incentives according to changing economic conditions. Thus, the conceptualization of the Islamic monetary–real sector nexus focuses not only on economic efficiency but also on achieving broader socio-economic goals. Compared to conventional monetary systems, where financial expansion may become disconnected from productive activities through debt-driven and speculative channels, the proposed Islamic model offers stronger resilience against the decoupling phenomenon because financial intermediation is structurally constrained to productive and asset-based transactions.

However, the implementation of this relationship still faces various structural and institutional challenges. In a dual financial system, Islamic banking is still influenced by conventional monetary conditions, such as interest rates, which can diminish its unique characteristics as a Sharia-based system (Majid & Hasin, 2014). Furthermore, macroeconomic factors such as inflation and economic policy uncertainty can also weaken the contribution of Islamic finance to economic growth (Chiad & Gherbi, 2024). Another challenge is seen in the uneven distribution of financing between sectors, where some sectors have higher financing risks and thus require more effective portfolio management strategies (Mubarok et al., 2025). Therefore, strengthening the regulatory framework, standardizing Islamic financial instruments, and increasing integration with the real sector are crucial steps to optimize the role of Islamic finance in supporting stability and sustainable economic development (Kok et al., 2022). Accordingly, the proposed conceptual model not only explains the theoretical interaction between monetary policy and the real sector but also provides an operational analytical structure that can be empirically tested through measurable indicators of Islamic monetary instruments, financial intermediation, real-sector performance, and maqasid-based welfare outcomes.

Reconstruction of Islamic Monetary Policy Transmission Channels

Research findings indicate that the reconstruction of monetary policy transmission channels in the Islamic financial system confirms the existence of an effective transmission mechanism, despite its distinct characteristics compared to the conventional system. Islamic banking has been shown to be capable of transmitting monetary policy through financing and fundraising channels, particularly through the bank lending channel mechanism, which connects monetary policy changes with real economic activity (A. Z. Ali & Kishwar, 2022; Majid & Hasin, 2014; Rafay & Farid, 2019). However, this study argues that Islamic monetary transmission should not merely be understood as an adaptation of conventional bank lending channels, but rather as a reconstructed mechanism rooted in *profit-sharing* and *asset-backed financing*, where monetary expansion directly affects productive financing linked to tangible economic activities. In the context of a dual financial system, Islamic banking plays a complementary role to conventional banking in strengthening the effectiveness of monetary policy transmission (Shah et al., 2024). Nevertheless, positioning Islamic banking solely as a complementary system risks perpetuating dependence on conventional monetary benchmarks, thereby weakening the distinctiveness of Sharia-based intermediation. Therefore, this reconstruction emphasizes a more autonomous transmission structure in which Islamic financial institutions operate through Sharia-compliant liquidity and financing instruments rather than passively following conventional interest-rate signals. This demonstrates that, despite being non-interest-based, the Islamic financial system still has the capacity to influence economic output through a financial intermediation mechanism based on Sharia principles.

Furthermore, the unique characteristics of Islamic banking, such as the use of profit-sharing mechanisms and Sharia-compliant financial instruments, influence responses to monetary policy differently. Instruments like profit-sharing investment accounts (PSIA) can mitigate the impact of interest rate fluctuations on the financing structure, making Islamic banking relatively more stable against monetary shocks (Hamza & Saadaoui, 2018). More importantly, the reconstruction proposed in this study highlights the *Asset-Backed Transmission Mechanism*, in which any expansion of liquidity through Islamic monetary instruments must be supported by underlying assets or productive transactions. Technically, increases in financing automatically correspond to increases in inventories, trade activities, working capital, or investment in productive sectors, thereby creating a direct transmission pathway from monetary policy to real-sector expansion and reducing the decoupling tendency commonly observed in debt-based conventional systems. However, the effectiveness of this transmission still faces various structural constraints, such as excess liquidity due to limited Sharia investment instruments and rigidity in adjusting yield rates (Ali et al., 2019; Boukhatem & Djelassi, 2022). Another critical challenge is *displaced commercial risk*, where Islamic banks may face fund migration risks when returns offered by conventional banks are relatively higher. In response, the reconstruction model proposes strengthening profit-sharing benchmarks, expanding liquidity management instruments such as sukuk, and implementing targeted financing incentives to maintain competitiveness without compromising Sharia principles. In this context, the development of Islamic financial instruments such as sukuk is crucial, as they function not only as a liquidity management tool but also play a role in strengthening monetary policy transmission through asset prices and exchange rates (Suriani et al., 2021).

Further discussion confirmed that the reconstruction of Islamic monetary policy transmission channels requires a more innovative approach integrated with sharia principles. In operational terms, this innovation refers to the development of *Sharia-compliant Targeted Long-Term Refinancing Operations (TLTRO-like mechanisms)*, whereby central banks provide long-term liquidity to Islamic financial institutions conditional upon financing allocations to productive real sectors such as SMEs, agriculture, manufacturing, and halal industries. The development of Islamic money markets, the diversification of monetary instruments, and policy innovations such as the use of *istisna'*-based schemes are strategic steps to increase the effectiveness of monetary policy transmission while simultaneously promoting inclusive and sustainable economic growth (Can & Bocuoglu, 2022; Selim, 2020). In addition, selective financing schemes based on *istisna'* contracts can be utilized to channel monetary support toward infrastructure and industrial development projects, thereby ensuring that monetary stimulus produces measurable real-sector multipliers rather than remaining concentrated within the financial system. Furthermore, strengthening the regulatory framework and integration between monetary authorities and Islamic financial institutions are key to overcoming various existing structural barriers. Thus, this reconstruction not only improves the performance of the Islamic monetary system but also strengthens its role in optimally bridging the financial and real sectors within a just Islamic economic framework. Accordingly, the reconstruction proposed in this study positions Islamic monetary transmission not as a complementary extension of the conventional framework, but as a structurally distinct model capable of strengthening monetary–real sector integration through asset linkage, productive financing, and maqasid-oriented economic outcomes.

Integration of Islamic Financial Institutions in Monetary And Real Sector Linkage

Research findings indicate that the integration of Islamic financial institutions into the linkages between the monetary and real sectors plays a strategic role in strengthening the effectiveness of monetary policy transmission. Islamic banking has proven capable of bridging monetary policy and real economic activity through its financial intermediation function based on financing and fundraising. Empirical studies in Malaysia and Pakistan indicate that Islamic banking financing and deposits significantly influence real output, particularly through the bank lending channel mechanism, which serves as the primary channel for monetary policy transmission in a dual financial system (A. Z. Ali & Kishwar, 2022; Sukmana & Kassim, 2010). However, this study argues that Islamic financial institutions should not merely be conceptualized as complementary intermediaries but as core transmission agents within an integrated monetary–real sector model, where financing decisions are directly linked to productive economic activities through Sharia-based contracts. This confirms that Islamic financial institutions function not only as a complement but also as a crucial component of a real-sector-oriented monetary system. In the proposed model, Islamic financial institutions act as mediating institutions that translate monetary policy signals into productive financing while simultaneously transmitting real-sector performance indicators back to monetary authorities.

Furthermore, the fundamental characteristics of Islamic finance, based on asset-backed transactions and the profit-sharing principle, strengthen the direct link between the financial and real sectors. This relationship operates through a *Double Tie Mechanism*, in which every Islamic financial transaction contains two inseparable dimensions: (1) a legal and contractual relationship between Islamic financial institutions and customers through Sharia contracts such as *musharakah*, *murabahah*, or *ijarah*, and (2) a real economic relationship where financing must correspond to underlying assets, inventories, services, or productive investments. This approach ensures that financial activities are always supported by productive economic activities, thereby reducing the disintegration between the two sectors that often occurs in conventional systems (Choudhury & Hoque, 2017; Farooq & Selim, 2019). Consequently, monetary expansion in Islamic finance automatically generates real-sector expansion because increases in financing are structurally tied to productive assets rather than speculative debt accumulation, thereby mitigating the financial decoupling phenomenon commonly found in conventional monetary systems. Furthermore, the Islamic financial system emphasizes ethical and productive resource mobilization by eliminating interest-based mechanisms, ultimately promoting economic stability and social welfare (Ascarya & Suharto, 2021; Shaheen et al., 2025). However, in practice, this integration still faces challenges, particularly in a dual financial system where Islamic banking remains influenced by conventional interest rate dynamics, thereby reducing the independence of the Islamic system (Majid & Hasin, 2014). A major challenge in this context is *Displaced Commercial Risk (DCR)*, where depositors may shift funds to conventional institutions offering higher benchmark returns. To mitigate this, the proposed conceptual model emphasizes profit-sharing–based competitiveness, strengthened Sharia liquidity instruments (e.g., sukuk), and performance-linked returns tied to real-sector productivity, allowing Islamic financial institutions to maintain transmission independence without excessive reliance on conventional interest-rate benchmarks.

Further discussion emphasized that strengthening the integration of Islamic financial institutions into monetary relations and the real sector requires comprehensive policy support and a regulatory framework. Monetary authorities need to accommodate the role of Islamic financial institutions in policy formulation by developing Islamic money markets, appropriate liquidity instruments, and adaptive Sharia-based regulatory standards (Dolgun et al., 2020). In addition, the proposed model positions Islamic social finance instruments, particularly *zakat* and *waqf*, as complementary stabilizing mechanisms within monetary transmission. During periods of monetary contraction, zakat and waqf can function as a *real-sector liquidity buffer* by sustaining household consumption, supporting micro-enterprises, and financing productive social investments, thereby reducing the contractionary effects of restricted liquidity. Furthermore, the integration of Islamic social finance, such as zakat and waqf, with commercial finance also has the potential to expand financial inclusion and improve *allocative efficiency*, where capital allocation is determined by the productivity prospects and economic viability of real-sector activities rather than solely by collateral capacity or interest-based repayment ability (Maulina et al., 2023). This mechanism systematically increases economic efficiency because financing is directed toward sectors with stronger productive potential, strengthening investment quality, employment creation, and sustainable output growth. Thus, the integration of Islamic financial institutions not only strengthens the effectiveness of monetary policy transmission but also contributes to achieving the goals of inclusive, sustainable, and equitable economic development. Accordingly, the proposed conceptual model reconstructs Islamic financial institutions as independent transmission actors capable of connecting monetary policy and real-sector development through asset-backed financing, profit-sharing mechanisms, and maqasid-oriented allocative efficiency.

Embedding *Maqasid al-Shariah* in Monetary Policy Framework

Research findings indicate that the integration of *Maqasid al-Shariah* into the monetary policy framework provides not only a normative foundation but also an operational benchmark for evaluating monetary effectiveness in Islamic economics. Monetary policies designed based on the principles of *hifz al-mal* (protection of wealth), *al-ʿadālah* (justice), and *maṣlaḥah* (public welfare) can be translated into measurable policy targets or maqasid-based Key Performance Indicators (KPIs). For example, *hifz al-mal* may be operationalized through maintaining purchasing power stability, especially for lower-income groups, limiting excessive inflation, and preventing severe currency depreciation; *al-ʿadālah* may be reflected in equitable financing distribution and reduced financial exclusion; while *maṣlahah* may be assessed through real-sector productivity growth, employment expansion, and MSME financing accessibility (Nur et al., 2025). This reconstruction shifts maqasid from merely ethical justification into a policy evaluation instrument embedded within the monetary transmission process, thereby confirming that Islamic monetary policy is oriented not only toward macroeconomic stabilization but also toward socially inclusive economic outcomes.

On the other hand, the literature also criticizes the conventional monetary system based on fiat money and interest rates, which are deemed not fully aligned with the principles of *Maqasid al-Shariah*. Kameel Mydin Meera & Larbani (2006), critically argue that fiat-money systems encourage excessive monetary expansion detached from real productive activity, contributing to the phenomenon of financialization, where the growth of financial claims significantly exceeds real GDP growth. This decoupling weakens the transmission of monetary policy to the productive sector and increases systemic instability. From a maqasid perspective, monetary expansion should therefore be constrained by the principle of maslahah, meaning liquidity creation must be proportionate to real-sector growth and tangible social benefits rather than speculative financial accumulation. In this context, *Maqasid al-Shariah* serves as an analytical framework for controlling monetary expansion and ensuring stronger linkages between financial intermediation and productive economic activity (Ahmad et al., 2025; Billah et al., 2024).

Moreover, contemporary monetary innovation such as a Sharia-compliant Central Bank Digital Currency (CBDC) may strengthen this framework if designed based on maqasid principles. Unlike speculative digital assets, a maqasid-based CBDC can be linked to productive assets or targeted financing programs for the real sector, ensuring that digital liquidity circulates within economically productive activities. In this mechanism, digital monetary instruments are not merely transaction facilitators but become part of an asset-backed transmission system that supports financial inclusion, transparency, and real-sector productivity while minimizing gharar and maysir elements (Balarabe et al., 2025). This perspective reconnects digital finance to central bank monetary objectives and strengthens the proposed bridging model between Islamic monetary policy and the real sector.

However, the integration of *Maqasid al-Shariah* into monetary policy still faces several challenges, both conceptually and in implementation. Several studies have shown misunderstandings in the application of the *maqasid* concept in financial practice, as well as limitations in the operational framework that can connect normative principles with practical policies (Al-Nahari et al., 2022; Monawer et al., 2022). To address this limitation, this study proposes a Maqasid-Based Monetary Policy Matrix, in which monetary authorities classify instruments according to maqasid priorities: *Dharuriyyat* (essential needs), such as targeted financing and inflation control for food and basic sectors; *Hajiyyat* (transactional ease), including liquidity facilities and payment system efficiency; and *Tahsiniyyat* (financial enhancement), such as digital innovation and financial inclusion programs. This matrix enables maqasid to function not merely as a moral reference but as an operational mechanism for selecting and evaluating monetary instruments. Therefore, the development of a more comprehensive Islamic monetary system requires strengthening contextual ijtihad, maqasid-based policy instruments, and empirical testing of transmission effectiveness, ensuring that *Maqasid al-Shariah* becomes a measurable analytical component within a just, inclusive, and sustainable monetary system rather than remaining purely normative discourse (Ismail & Baharuddin, 2025; Laksana et al., 2025).

Development of an Integrated Islamic Monetary Framework

The development of an integrated Islamic monetary framework demonstrates that the Islamic monetary system emphasizes not only the replacement of interest-based instruments but also the reconstruction of policy mechanisms based on profit-sharing principles, such as *musharakah*, as the primary instrument of monetary control. At the central bank level, musharakah may be operationalized through equity-based monetary schemes, whereby monetary authorities channel liquidity into strategic productive sectors or national infrastructure projects through profit-sharing arrangements with Islamic financial institutions (IFIs). Under this mechanism, monetary expansion becomes directly linked to productive investment rather than speculative financial circulation, enabling the central bank to regulate money supply through real-sector performance and expected returns rather than interest-rate adjustments. This approach allows the central bank to directly influence economic activity through asset-backed and equity-based mechanisms, thereby strengthening the link between monetary policy and productive activity (Adela, 2018). Furthermore, this framework emphasizes that the Islamic monetary system must eliminate distortions caused by interest rates and replace them with a fairer, partnership-based financing structure, thus aligning with the principles of justice and balance in Islamic economics (Kuforiji, 2019). Unlike conventional monetary systems that frequently experience decoupling between financial and productive sectors, this reconstruction ensures that monetary expansion is systematically tied to investment, employment creation, and productive asset formation.

Furthermore, the integration of Islamic social finance, such as zakat, waqf, and *al-qard al-hasan*, is a crucial component of a comprehensive monetary framework, as it plays a role in expanding financial inclusion and reducing social inequality (Maulina et al., 2023). In this proposed framework, *al-qard al-hasan* functions not merely as a charitable instrument but as a countercyclical monetary buffer during liquidity contractions in the real sector. During economic downturns or credit tightening, zakat and waqf funds may support consumption smoothing and micro-enterprise financing, thereby maintaining purchasing power and productive activity without imposing debt or interest burdens. This mechanism strengthens social justice while simultaneously reducing the transmission lag often observed in conventional countercyclical policies. The synergy between social and commercial finance creates a system that is not only economically efficient but also oriented towards the welfare of society at large (Hasbulah et al., 2026). Furthermore, the development of financial technology (fintech) and digitalization, including the use of blockchain, provides opportunities to increase transparency, efficiency, and standardization in the Islamic financial system. In particular, digital monitoring systems may improve transparency in profit-sharing contracts, reduce information asymmetry, and facilitate real-time supervision of productive financing allocation, strengthen accountability in the implementation of Islamic monetary policy (Aziz et al., 2024; Wahab & Mahdiya, 2025).

However, the implementation of an integrated Islamic monetary framework still faces various structural challenges, such as the lack of global standardization in Islamic financial practices, limited institutional capacity, and operational obstacles in the transition from conventional to Islamic systems (Mukhlisin & Fadzly, 2020). Furthermore, from the perspective of institutional economics, the transition toward an Islamic monetary system requires more than merely replacing financial instruments; it also necessitates institutional transformation, governance reform, and public trust-building in profit-sharing arrangements, which inherently involve higher uncertainty compared to fixed-interest systems. Weak governance structures, asymmetric information, and low trust in risk-sharing institutions may reduce the effectiveness of Islamic monetary transmission. Therefore, policy harmonization, regulatory strengthening, and the development of a standardized global framework are needed to enhance the credibility and effectiveness of the Islamic monetary system (Khan & Tabet, 2023). Thus, an integrated Islamic monetary framework has the potential to become an alternative model that not only promotes economic stability but also supports sustainable development based on the values of justice and social welfare (Khandakar et al., 2024).

Based on the synthesis of theoretical and empirical findings that have been described, this study proposes an integrated conceptual framework that describes the dynamic relationship between Islamic monetary policy, Islamic financial institutions, and the real sector in achieving economic stability and prosperity based on the principles of *Maqasid al-Shariah*, as presented in Figure 1.

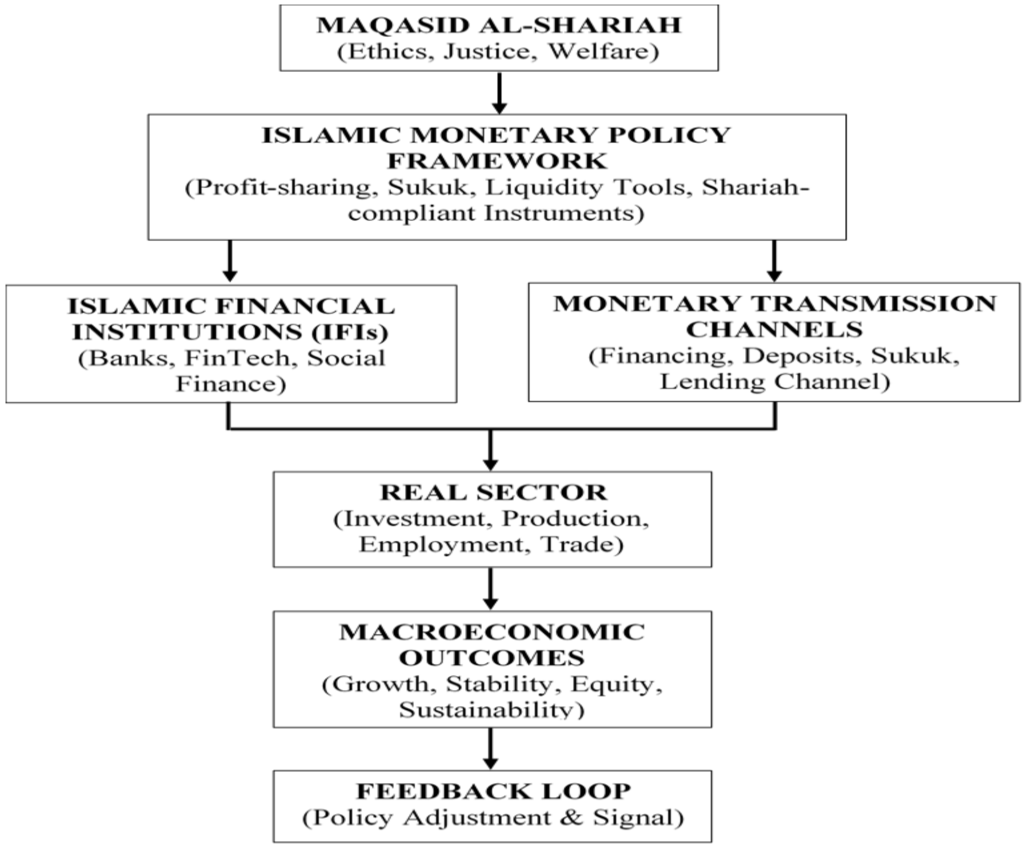

Figure 1. Conceptual Framework of Islamic Monetary–Real Sector Nexus.

Source: Authors' elaboration based on the literature (Ascarya & Suharto, 2021; Farooq & Selim, 2019; Khandakar et al., 2024; Majid & Hasin, 2014; Maulina et al., 2023; Shaheen et al., 2025)

Figure 1 above illustrates an integrated conceptual model that bridges Islamic monetary policy with the real sector within an Islamic economic framework. This model positions *Maqasid al-Shariah* as the normative foundation guiding monetary policy formulation, ensuring that economic objectives align with ethical principles, social justice, and the general welfare. Islamic monetary policy instruments, including profit-sharing mechanisms, sukuk, and sharia-compliant liquidity instruments, influence Islamic financial institutions (IFIs) and monetary transmission channels, which together mediate the flow of funds into real sector activities such as investment, production, and employment. This interaction generates macroeconomic outcomes in terms of economic growth, stability, equity, and sustainability. Importantly, the feedback loop in this framework operates dynamically through measurable real-sector indicators, including rates of return on productive investment, employment ratios, MSME productivity, inflation in essential goods, and purchasing power stability. Improvements or deteriorations in these indicators provide signals for monetary authorities to recalibrate liquidity allocation, profit-sharing financing intensity, and targeted monetary interventions. In this sense, monetary policy becomes adaptive and evidence-based, reducing the disconnection between financial indicators and real-sector conditions that often characterizes conventional monetary systems.

Theoretically, these findings contribute to the development of Islamic monetary economics by offering a more holistic and integrative analytical framework than previous, more partial approaches. Unlike prior studies that mainly discuss Islamic monetary instruments separately, this model operationalizes causal linkages between maqasid-based objectives, Islamic financial institutions, monetary transmission channels, and measurable real-sector outcomes, making the framework more empirically testable. This model also fills a gap in the literature by linking monetary, financial, and real sector aspects into a single, coherent conceptual construct. From a policy perspective, these findings imply that monetary authorities need to develop profit-sharing-based instruments, strengthen regulations on Islamic financial institutions, and integrate the objectives of *Maqasid al-Shariah* into policy design. Thus, the Islamic monetary system serves not only as a stabilization tool but also as an instrument for equitable and sustainable economic transformation.

5. Conclusions

The conclusion of this study confirms that the proposed Islamic Monetary–Real Sector Nexus model offers a conceptual solution to the persistent disconnect between the financial and real sectors that characterizes conventional monetary systems. The model demonstrates that Islamic monetary policy can strengthen the linkage between finance and productive economic activity through asset-backed financing, profit-sharing mechanisms (musharakah), and risk-sharing transmission channels that systematically connect liquidity expansion with investment, production, and employment creation in the real sector. Furthermore, the integration of *Maqasid al-Shariah* transforms monetary policy from a solely stabilization-oriented framework into an inclusive system with measurable objectives related to distributive justice, purchasing power stability, and social welfare. The primary novelty of this study lies in operationalizing the interaction between Islamic monetary instruments, Islamic financial institutions, and real-sector performance within a dynamic feedback mechanism, thereby providing a more coherent and empirically testable framework for Islamic monetary economics.

Based on these findings, this study recommends more operational policy directions for monetary authorities, particularly through the use of musharakah-based instruments in open market operations, such as equity-based liquidity facilities to finance productive sectors and national strategic projects via Islamic financial institutions. In addition, zakat, waqf, and al-qard al-hasan may function as countercyclical liquidity buffers to sustain purchasing power and MSME financing during economic contractions without increasing debt burdens. Regulatory harmonization, expansion of Islamic money markets, and digital monitoring systems are also needed to improve efficiency and transparency. However, this study is limited by its conceptual nature and reliance on theoretical synthesis without direct empirical testing. Therefore, future research is encouraged to validate this framework using quantitative or mixed-method approaches, particularly by examining the causal relationships between profit-sharing instruments, real-sector indicators, and maqasid-based monetary outcomes in different economic contexts.

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