

## The Effects of Interest Rates on Islamic Banks in a Dual Banking System: Empirical Evidence from Saudi Arabia

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**Abstract :** Background: A relation has been established between Islamic banks' activities and interest rates. The aim of this study was to explore the impact of interest rates on the deposits and loans held by Islamic and conventional banks in Saudi Arabia. Methods: A time series data was performed over the period 2008Q1-2020Q2 on eight conventional banks and four Islamic banks. The impacts of interest rate shocks on deposits and loans were identified through panel vector autoregressive models. Results: Impulse response function analysis showed that increasing interest rates reduce loans and conventional deposits. For Islamic banks, deposits are more affected by interest rates than lending. Variance decomposition analysis revealed that deposits contribute to 61% of the Islamic financing variation and only 25% of the conventional loans. Conclusion: Interest rates impacted Islamic banks especially through deposits, which is inconsistent with the theoretical framework. Islamic deposits played an important role in Islamic financing variation and may provide to be a channel for the transmission of the monetary policy in a dual banking system. Monetary policy in Saudi Arabia works in part through "credits" (conventional bank credits) as well as through "money" (conventional and Islamic bank deposits).

**Keywords :** Islamic banking, interest rates, monetary policy transmission, panel VAR

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