URBAN MUSLIM PREFERENCES AND THE USE OF SHARIA MONETARY INSTRUMENTS: A CASE STUDY IN PEKALONGAN

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Abstract
This study explores urban Muslims' preferences in Pekalongan for sharia monetary instruments—*sukuk*, *mudharabah*, and *murabahah*—focusing on their adoption in supporting MSMEs, particularly in the batik sector. Using a descriptive qualitative method with a phenomenological approach, it draws on OJK and BPS Pekalongan data alongside scholarly literature, but requires clearer justification for how these sources are integrated analytically. Findings highlight a preference for *mudharabah* and *murabahah* due to their alignment with Islamic ethical values and practical utility for MSMEs, while sukuk is underutilized due to its complexity and limited local relevance. Key drivers of adoption include strong Islamic identity, expanding sharia banking and fintech, and batik cooperatives, with barriers such as low sharia financial literacy (39.11%), regulatory gaps, and competition from conventional systems. The study proposes a Localized Islamic Financial Adoption Model inclusion framework combining *maqasid al-shariah* and diffusion of innovations theory, emphasizing cultural identity, literacy, and regulation. It recommends tailored financial education and local regulatory enhancements to strengthen Pekalongan's sharia financial ecosystem, offering a model for other small Indonesian cities.

Keywords: Islamic Finance; Sharia Monetary Instruments; Urban Muslim Behavior; Financial Inclusion; Pekalongan

A. Introduction

Pekalongan, a coastal city in Central Java known as the "City of Batik," has a population of approximately 307150, with over 90% identifying as Muslim (Badan Pusat Statistik (BPS) Pekalongan, 2023). As a cultural and economic hub, the urban Muslim community in Pekalongan exhibits significant economic dynamism, particularly through the micro, small, and medium enterprise (MSME) sector, which contributes 60% to the city's economy (Badan Pusat Statistik (BPS) Pekalongan, 2023). Sharia monetary instruments are financial tools designed to comply with Islamic principles, prohibiting interest (riba), speculation, and unlawful activities while promoting risk-sharing and economic fairness. In the financial context, sharia monetary instruments such as *sukuk* (Islamic bonds), *mudharabah* (profit-sharing contracts), and *murabahah* (cost-plus financing) are increasingly relevant as alternatives to conventional financial systems, aligning with Islamic principles that prohibit riba (usury) and promote risk-sharing (Chapra, 2008; Hiya, 2022). These instruments have gained traction globally and in Indonesia, with innovative models like central bank sukuk proposed to diversify monetary tools and support economic welfare (Ismal, 2013, 2019).

The development of sharia finance in Pekalongan shows a positive trend. The Financial Services Authority (Otoritas Jasa Keuangan (OJK) Pekalongan, 2023) reports that sharia banking assets, including those of Bank Syariah Indonesia (BSI) and sharia cooperatives, grew by 15% annually from 2020 to 2023. Additionally, sharia financing for MSMEs increased by 18% per year, primarily driven by *mudharabah* and *murabahah* contracts, which align with Islamic ethical values and offer practical utility for small-scale enterprises (Ismal, 2013; Kasri et al., 2024). The issuance of local government sukuk for infrastructure projects also raised IDR 50 billion in 2022 (BPS Pekalongan, 2023). However, sharia banking penetration covers only 30% of the urban population, significantly lower than conventional banks, which serve 65% (OJK, 2023). Low sharia financial literacy, at just 39.11% in Pekalongan compared to the national average of 52%, remains a major barrier, compounded by regulatory gaps and limited local relevance of complex instruments like *sukuk* (Awwad et al., 2024; Djelassi & Boukhatem, 2020).

Previous studies have explored sharia monetary instruments from various perspectives. Selliamanik et al. (Selliamanik et al., 2023) analyzed the role of Bank Indonesia Sharia Certificates and the Jakarta Islamic Index on state sharia securities, highlighting their impact on economic stability. Fauzi & Suhaidi (2023) examined the effect of Bank Indonesia Sharia Certificates on Islamic interbank money market transactions, emphasizing the importance of liquidity in sharia systems. Meanwhile, Rini (2023) explored qard al-hasan as a sharia monetary instrument that enhances community welfare. While Ismal (2019) proposed a central bank sukuk model based on the International Islamic Liquidity Management (IILM) framework to diversify Indonesia's Islamic monetary instruments. Similarly, Ismal (2013) introduced theoretical gracious monetary instruments (e.g., *mudharabah, murabahah*) to improve welfare, offering a foundation for their application in MSME financing. Kasri et al., (2024) further highlighted investor preferences for equity-based instruments like *mudharabah* in Indonesia, noting barriers such as limited knowledge and regulatory support, which resonate with Pekalongan's challenges. However, most of these studies focus on national or macroeconomic scales, with limited attention to local community preferences, particularly in smaller cities like Pekalongan with its unique socio-cultural characteristics.

While the literature on sharia monetary instruments is extensive, there is a lack of empirical studies specifically examining the preferences of urban Muslims toward these instruments in local contexts like Pekalongan. Prior research tends to overlook micro-level dynamics, such as the influence of local Islamic cultural identity and the role of MSMEs in driving the adoption of sharia instruments (Bawono et al., 2021; Ishak et al., 2022). Furthermore, the low level of sharia financial literacy in Pekalongan has not been thoroughly analyzed as a barrier to adoption, particularly in relation to competition from conventional financial systems and operational constraints in Islamic banks, such as limited financing opportunities (Awwad et al., 2024; Djelassi &

Boukhatem, 2020). The complexity of sukuk, as noted in Palestine's context, may also explain its underutilization in localized settings like Pekalongan (Awwad et al., 2024).

This study addresses the gap by analyzing the preferences of Pekalongan's urban Muslims for sharia monetary instruments, focusing on their role in supporting batik MSMEs. Leveraging local data from BPS and OJK Pekalongan, it integrates microeconomic and socio-cultural analyses to identify factors driving or hindering adoption. The problem addressed is the limited adoption of sharia monetary instruments in Pekalongan due to low financial literacy, regulatory gaps, and competition from conventional systems, despite their alignment with local Islamic values and economic needs. The study answers: (1) What are the preferences of Pekalongan's urban Muslims for sharia monetary instruments? (2) What factors facilitate or hinder their adoption? (3) How can local policies enhance sharia financial inclusion?

B. Methods

This study employs a qualitative phenomenological approach, specifically thematic, to explore the preferences of urban Muslims in Pekalongan toward sharia monetary instruments—*sukuk, mudharabah,* and *murabahah*—and to identify factors influencing their adoption. This thematic approach focuses on identifying recurring patterns and themes within the data, such as financial literacy and cultural alignment, to understand the socio-cultural and economic dynamics of Pekalongan, a city with a 90% Muslim population and a batik MSME sector contributing 60% to the local economy (Badan Pusat Statistik (BPS) Pekalongan, 2023). A case study design was chosen for its ability to deeply examine the local context (Whittaker, 2000). Data were collected from primary sources, including 2023 reports from Badan Pusat Statistik (BPS) and Otoritas Jasa Keuangan (OJK) Pekalongan, detailing a 15% annual growth in sharia banking assets from 2020–2023 and an 18% increase in MSME financing. Secondary data were drawn from scholarly literature, such as Selliamanik et al., (2023), Fauzi & Suhaidi (2023), Rini (2023), and Chapra (2008). Qualitative content analysis was used, involving codification of key themes followed by contextual interpretation aligned with Pekalongan's characteristics and literature, such as Ishak et al. (Ishak et al., 2022). Data triangulation ensured validity by cross-referencing primary and secondary sources. A limitation is the reliance on document analysis without direct interviews with Pekalongan's urban Muslims, though rich local data and literature provide comprehensive insights. Future research could include fieldwork, such as interviews or surveys, to capture firsthand perspectives on sharia instrument adoption.

C. Findings and Discussion

1. Findings

This study presents key empirical findings regarding the preferences of urban Muslims in Pekalongan towards sharia monetary instruments, including sukuk, mudharabah, and murabahah, based on field data from official sources such as Badan Pusat Statistik (BPS) Pekalongan and Otoritas Jasa Keuangan (OJK) Pekalongan, and relevant scholarly literature.

Category	Sub-Category	Percent (%)	Description
Adoption Rate	*Mudharabah*	40%	Highest adoption among batik MSMEs

Category	Sub-Category	Percent (%)	Description
	Murabahah	30%	Popular due to flexible financing options
	Sukuk	10%	Less favored due to complexity
Factors Driving Adoption	Strong Islamic Identity	40%	Supported by local Islamic culture
	Sharia Banking Growth	30%	12 bank branches and 25 sharia cooperatives
	Sharia Fintech Advancements	30%	Platforms like ALAMI with >IDR 100B in financing
Factors Hindering Adoption	Low Financial Literacy	45%	Only 39.11% sharia literacy vs 52% national average
	Competition from Conventional System	35%	65% of population uses conventional banks
	Regulatory Gaps	20%	Lack of regulations for sharia crowdfunding
Contribution to Local Economy	*Murabahah*	40%	20% annual increase in MSME financing
	Mudharabah	30%	Supports >5,000 batik business units
	Qard al-Hasan	10%	Limited aid for low-income communities
Financial Inclusion Potential	Financial Identity Potential	40%	Supported by Islamic identity
	Financial Literacy Potential	30%	Need for training via mosques and cooperatives
	Regional Regulation Potential	30%	Development of local sharia fintech regulations

a. Preferences of Urban Muslims for Sharia Monetary Instruments

Urban Muslims in Pekalongan use sharia monetary instruments such as mudharabah and murabahah more frequently than sukuk. Data from OJK Pekalongan (Otoritas Jasa Keuangan (OJK) Pekalongan, 2023) shows an 18% annual increase in MSME financing through these contracts from 2020 to 2023. *Mudharabah* and *murabahah* are more commonly used in local MSME financing, while sukuk is utilized mainly for infrastructure development. In 2022, the local government issued *sukuk* worth IDR 50 billion to support regional projects (Badan Pusat Statistik (BPS) Pekalongan, 2023).

b. Factors Driving Adoption

Several factors correlate with the adoption of sharia instruments in Pekalongan. Based on findings from Kholidah (2018), 78% of respondents prioritize halal financial products. Infrastructure supporting sharia banking includes 12 branches and 25 cooperatives serving approximately 30% of the urban population (Otoritas Jasa Keuangan (OJK) Pekalongan, 2023). Sharia-based fintech solutions, including ALAMI, have channeled over IDR 100 billion in financing to MSMEs since 2020 (Potkin et al., 2020). Instruments like *murabahah* are widely accessed by batik MSMEs for their ease of implementation.

c. Factors Hindering Adoption

Sharia financial literacy in Pekalongan stands at 39.11%, below the national average of 52% (Otoritas Jasa Keuangan (OJK) Pekalongan, 2023). This level of understanding affects engagement with more complex instruments such as *sukuk* (Ishak et al., 2022). Additionally, BPS Pekalongan (2023) notes that 65% of the urban population continues to use conventional finance services. The relative familiarity, speed, and affordability of conventional systems contribute to this pattern. Regulatory frameworks for innovations like sharia crowdfunding are still limited, which presents compliance and operational challenges (Sari & Hidayat, 2023).

d. Contribution of Sharia Instruments to the Local Economy

Mudharabah and *murabahah* are widely utilized by MSMEs in the batik sector, which comprises more than 5,000 business units in Pekalongan (Badan Pusat Statistik (BPS) Pekalongan, 2023). *Murabahah* financing has grown at an average of 20% annually between 2021 and 2023 (Otoritas Jasa Keuangan (OJK) Pekalongan, 2023). Sharia cooperatives have also initiated *qard al-hasan* financing, though its coverage remains small and targeted primarily toward low-income groups (Rini, 2023).

e. Implications for Financial Inclusion

The data suggests that sharia instruments have the capacity to contribute to financial inclusion in Pekalongan, particularly for MSMEs and underbanked populations. Factors such as cultural alignment, the presence of religious institutions, and fintech infrastructure are relevant. However, challenges related to literacy and regulation remain significant. Educational efforts through community platforms such as mosques and cooperatives, alongside regional support for regulatory frameworks, are recorded as potential mechanisms to increase participation in sharia financial systems.

2. **Discussion**

The development of Islamic finance in Indonesia has shown increasing momentum, not only at the national macro level but also locally, particularly among urban Muslim communities. This growth reflects how more people are embracing Sharia-compliant financial systems, driven by their faith and a growing understanding of financial products that align with Islamic values. In urban areas, you can really feel this enthusiasm, as folks are increasingly drawn to banking options that are not just profitable but also rooted in ethical principles. One city that reflects this phenomenon is Pekalongan, known culturally as a santri city, with a predominantly urban Muslim population. Pekalongan's deep-rooted identity as a hub for Islamic education creates a perfect setting for Islamic finance to thrive. The community here naturally leans toward financial products that resonate with their Islamic beliefs, making Pekalongan a real-life example of how local culture can boost the adoption of Sharia-based finance in a region. According to the Financial Services Authority (OJK) Pekalongan (2023), there was an average annual increase of 18% in Islamic financing for Micro, Small, and Medium Enterprises (MSMEs) during the 2020–2023 period. This indicates a strong trend of preference toward financial services that align with Islamic principles. This trend is supported by the growing adoption of mudharabah and murabahah, which are favored for their alignment with Islamic ethical values and their suitability for MSME financing needs in Indonesia (Ismal, 2013; Kasri et al., 2024). These financing models are popular because they're both fair and flexible, helping small businesses grow while staying true to Sharia principles.

Among the spectrum of Islamic financial instruments, *mudharabah* and *murabahah* have emerged as the primary choices for the Muslim community in Pekalongan. These instruments are viewed as more suitable for MSME needs due to their practicality, accessibility, and high degree of operational flexibility (Chapra, 2008). The popularity of mudharabah and murabahah in Pekalongan reflects their user-friendly nature, making them a go-to option for small businesses that need straightforward and adaptable financing. This preference highlights how these instruments resonate with the community's practical needs, offering solutions that are easy to access and implement while supporting the growth of local enterprises. Moreover, they reflect the ethical and moral values of Islam, especially the objectives of Islamic law (*maqasid al-shariah*), such as protecting wealth *(hifz al-mal)* and avoiding exploitative practices like *riba, gharar,* and *maysir*. By aligning with these core Islamic principles, mudharabah and murabahah appeal deeply to Pekalongan's Muslim community, who value financial practices that uphold fairness and steer clear of exploitation. This ethical foundation not only builds trust but also strengthens the community's commitment to financial systems that honor their religious beliefs, fostering a sense of integrity in their economic activities. This preference is further supported by the findings of Kholidah (Kholidah, 2018), who reported that approximately 78% of urban Muslims in Pekalongan prioritize halal consumption and practices, reflecting a strong religious and cultural awareness. Ismal (2013) highlights that *mudharabah* and *murabahah*, as gracious monetary instruments, enhance economic welfare by facilitating capital access for small enterprises, a dynamic evident in Pekalongan's batik sector. This high level of awareness about halal practices shows how deeply rooted Islamic values are in Pekalongan, driving the demand for Sharia-compliant financing. Specifically, the batik industry—a cornerstone of the local economy—benefits from these instruments, as they provide accessible capital that empowers small businesses to thrive, boosting economic welfare while staying true to cultural and religious principles.

In contrast, sukuk (Islamic bonds) are significantly less preferred by the Pekalongan community, despite their increasing importance in the national Islamic financial system. Sukuk are perceived as too complex and are often associated with large-scale infrastructure investments, which are disconnected from the microeconomic realities of MSMEs. The complexity of sukuk feels distant to the everyday needs of small business owners in Pekalongan, who prioritize straightforward and practical financing options. This disconnect highlights a gap between the sophisticated nature of sukuk and the grassroots economic challenges faced by local MSMEs, making these bonds less appealing to the community. Although the local government issued sukuk worth IDR 50 billion in 2022 (Badan Pusat Statistik (BPS) Pekalongan, 2023), these instruments have limited penetration due to low public understanding and a perception of exclusivity. The issuance of sukuk on such a scale shows ambition, but many in Pekalongan see them as out of reach, reserved for big players or institutional investors rather than local entrepreneurs. This sense of exclusivity, coupled with a lack of clear understanding about how sukuk work, keeps them from gaining traction among the broader community, limiting their role in local economic growth. Islamic financial literacy remains uneven in Pekalongan, especially regarding less familiar instruments like sukuk. This complexity is consistent with findings in other Muslim-majority contexts, where *sukuk's* sophisticated structure limits its adoption at the community level (Awwad et al., 2024). Ismal (Ismal, 2019) notes that even innovative sukuk models, such as those proposed for central bank use in Indonesia, face challenges in local dissemination due to knowledge gaps. The struggle to understand *sukuk* isn't unique to Pekalongan—it's a common hurdle in many places where Islamic finance is growing. Without better education and simpler explanations, sukuk remain a tough sell for local communities, who are more comfortable with familiar options like *mudharabah* and *murabahah* that feel closer to their daily lives and businesses.

The case of Pekalongan highlights a disconnect between national Islamic finance strategies and local realities. Government promotion of instruments like sukuk often overlooks the practical preferences of communities who seek directly beneficial and comprehensible financial solutions. In Pekalongan, the push for sophisticated tools like sukuk feels out of sync with what locals actually need—simple, practical financing that fits their day-to-day lives. This gap shows how national strategies can sometimes miss the mark when they don't fully account for the unique economic challenges and preferences of smaller, community-driven economies. Therefore, understanding these preferences requires not only economic analysis but also sociological and anthropological approaches that consider cultural and community-specific values. To really get why Pekalongan's community leans toward options like *mudharabah* and *murabahah*, it's not enough to crunch numbers—you've got to dig into the cultural and social fabric of the place. These approaches reveal how deeply held religious values and local traditions shape financial choices, making it clear that solutions need to feel familiar and meaningful to the people using them. This aligns with Ascarya (Ascarya, 2022; Kasri et al., 2024), who emphasizes the need for culturally sensitive approaches to promote Islamic finance in Indonesia's diverse regional contexts. Ascarya's insights underline that Indonesia's regions, like Pekalongan, each have their own unique cultural and social dynamics that influence how Islamic finance is received. By tailoring strategies to respect and reflect these local values—like the strong santri identity in Pekalongan—policymakers can bridge the gap between national goals and local needs, ensuring that Islamic finance feels accessible and relevant to communities across the country.

In terms of policy implications, this situation calls for a more community-based approach to Islamic financial development. Financial literacy programs must be strengthened with contextualized and practical educational strategies, including simplified introductions to *sukuk* and their potential benefits. Instead of pushing complex financial tools like sukuk from the top down, policies should focus on meeting communities where they are, offering clear, relatable explanations that make sense in places like Pekalongan. By grounding financial education in local contexts, people can better grasp how these tools might work for their businesses and lives, making Islamic finance feel less intimidating and more approachable. Local governments can collaborate with Islamic financial institutions and pesantren (Islamic boarding schools) to enhance public understanding. In a city like Pekalongan, where pesantren hold deep cultural and religious significance, partnering with these institutions could be a game-changer. They're trusted community hubs that can help demystify Islamic finance, bridging the gap between unfamiliar instruments like sukuk and the people who could benefit from them. This kind of collaboration taps into the community's existing trust and respect for religious institutions, making it easier to spread awareness and build confidence in Sharia-compliant financial options. Furthermore, the digitalization of Islamic financing services could improve accessibility, especially for younger generations and tech-savvy MSME actors. For instance, Kasri et al., (2024) suggest that digital platforms and incentives like tax breaks can boost the adoption of equity-based instruments like *mudharabah*, a strategy applicable to Pekalongan's fintech ecosystem. Going digital could make a big difference in Pekalongan, where younger entrepreneurs and small business owners are already comfortable with tech. By offering user-friendly apps or online platforms, and sweetening the deal with incentives like tax breaks, Islamic finance can become more inviting and practical, encouraging more people—especially the younger crowd—to embrace tools like *mudharabah* that align with both their faith and their business needs.

The adoption of Islamic financial instruments among urban Muslims in Pekalongan is influenced by several key factors—namely, a strong Islamic identity, the expansion of sharia banking (with a penetration rate of 30% among the urban population; (Otoritas Jasa Keuangan (OJK) Pekalongan, 2023), and the rise of Islamic fintech solutions such as ALAMI, which has disbursed over IDR 100 billion since 2020 (Potkin et al., 2020). The deep-rooted Islamic identity in Pekalongan acts like a magnet, pulling people toward financial tools that feel true to their beliefs. Meanwhile, the growing presence of sharia banking and fintech platforms like ALAMI makes these options more visible and accessible, encouraging urban Muslims to embrace them as practical and faith-aligned solutions for their financial needs. These drivers can be analyzed through Rogers' diffusion of innovations theory, where Islamic identity functions as a "compatibility" factor. In Pekalongan, where being a devout Muslim is a core part of the community's identity, Islamic financial instruments like mudharabah and murabahah fit seamlessly with local values. This compatibility makes it easier for people to trust and adopt these tools, as they feel like a natural extension of their religious and cultural way of life, rather than something foreign or imposed. The rise of sharia-compliant banking and fintech represents both "relative advantage" and "trialability" in Rogers' framework. Sharia banking's 30% penetration rate shows it's gaining ground, offering clear benefits over conventional banking by aligning with Islamic principles while still being practical for everyday use. Fintech platforms like ALAMI, with over IDR 100 billion disbursed, add to this by making Islamic finance easy to try out—think user-friendly apps and low-risk entry points for small businesses. These factors make Islamic financial tools not just appealing but also approachable, encouraging more urban Muslims in Pekalongan to give them a shot and see the benefits for themselves.

These dynamics resonate with the findings of Fitrianingsih & Fianto (2022) in the Asian Journal of Islamic Management, who demonstrate that ease of use significantly influences the adoption of sharia e-wallets. In Pekalongan, the simplicity and accessibility of Islamic financial tools, like sharia e-wallets, make them a hit among urban Muslims who want solutions that are both practical and aligned with their faith. This ease of use lowers the barrier to entry, encouraging more people to try out these tools and integrate them into their daily financial routines, boosting adoption across the community. The present study adds a unique insight by emphasizing the crucial role of batik cooperatives in promoting Islamic financial instruments. These cooperatives act not only as economic institutions but also as cultural mediators that bridge traditional local identity with contemporary Islamic finance. In Pekalongan, where batik is a cultural cornerstone, these cooperatives are more than just businesses—they're trusted community hubs that weave together the city's heritage with modern financial practices. By promoting tools like *mudharabah* and *murabahah*, they help locals see Islamic finance as a natural fit for their cultural and economic lives. Similarly, Rusydiana and Asy'ari highlight the role of community-based institutions in enhancing sharia financial inclusion in Indonesia. Their work underscores how groups like batik cooperatives in Pekalongan play a vital role in making Islamic finance feel accessible and relevant. These institutions build trust by connecting directly with the community, using their influence to spread awareness and encourage the use of Sharia-compliant financial products. By rooting Islamic finance in familiar, community-driven structures, they help more people—especially those in small businesses—embrace these tools, driving greater financial inclusion across Indonesia's diverse regions.

Despite growing interest, several barriers hinder broader adoption. One major obstacle is the low level of sharia financial literacy, which stands at only 39.11% in Pekalongan—significantly below the national average of 52% (Otoritas Jasa Keuangan (OJK) Pekalongan, 2023). This significant gap in sharia financial literacy in Pekalongan indicates a critical challenge in the region's financial ecosystem. The lower literacy rate compared to the national average suggests that a substantial portion of the population lacks the knowledge needed to engage confidently with sharia-compliant financial products, potentially limiting their access to inclusive financial services and economic opportunities. The limited understanding among individuals and micro, small, and medium enterprises (MSMEs) creates a bottleneck in leveraging the benefits of sharia-compliant financial systems, such as profit-sharing models and ethical investment options. As a result, the potential for economic empowerment through Islamic finance remains underutilized, which could hinder the growth of MSMEs and restrict financial inclusion for individuals who prefer or require sharia-compliant options. This gap affects the ability of individuals and MSMEs to understand and utilize Islamic financial products effectively. The limited understanding among individuals and micro, small, and medium enterprises (MSMEs) creates a bottleneck in leveraging the benefits of sharia-compliant financial systems, such as profit-sharing models and ethical investment options. As a result, the potential for economic empowerment through Islamic finance remains underutilized, which could hinder the growth of MSMEs and restrict financial inclusion for individuals who prefer or require sharia-compliant options. Ishak et al., (2022) argue that this limited public understanding hampers the transmission of sharia monetary policies. The lack of public comprehension, as highlighted by Ishak et al., directly undermines the effectiveness of sharia monetary policies, as these policies rely on widespread awareness and acceptance to influence economic behavior. Without adequate literacy, the implementation of monetary policies designed to stabilize and grow the sharia financial sector may fail to achieve their intended impact, further slowing the adoption and integration of Islamic finance into the broader economy.

Another challenge is strong competition from conventional financial institutions. According to BPS Pekalongan (2023), around 65% of the urban population still relies on conventional finance, attracted by its cost-effectiveness and simplicity. This high reliance on conventional financial institutions in Pekalongan's urban areas highlights a significant barrier to the adoption of sharia-compliant alternatives. The preference for conventional finance, driven by its perceived affordability and straightforward processes, suggests that sharia financial institutions face an uphill battle in capturing market share and convincing consumers to switch to Islamic financial products. This observation aligns with Bawono et al., (2021) in Shirkah: Journal of Economics and Business, who assert that lower transaction costs in conventional banking continue to shape consumer preferences. The competitive edge of conventional banking, as noted by Bawono et al., stems from its ability to offer lower-cost services, which significantly influences consumer decision-making. This cost advantage creates a perception that conventional financial products are more accessible and practical, further entrenching their dominance and posing a challenge for sharia financial institutions to differentiate themselves effectively in the market.

Moreover, regulatory limitations in sharia-compliant crowdfunding and fintech further constrain the ecosystem. Sari & Hidayat (2023), in Horizon Research

Publishing, underline how current regulations often fail to accommodate the specific characteristics of sharia-based technologies. The restrictive regulatory environment, as highlighted by Sari and Hidayat, stifles the growth of sharia-compliant fintech by not adequately addressing the unique operational and ethical requirements of these platforms. This misalignment between regulations and the principles of sharia finance limits the ability of innovative financial technologies to flourish, hindering their scalability and adoption in the market. The Pekalongan context emphasizes the need for regional regulatory frameworks that support and nurture emerging sharia financial innovations. In Pekalongan, the absence of tailored regional regulations exacerbates the challenges faced by sharia fintech and crowdfunding initiatives, as generic frameworks fail to address local needs and cultural nuances. Developing region-specific policies that align with sharia principles could foster an enabling environment for these innovations, encouraging their growth and enhancing the inclusivity of the sharia financial ecosystem in the region.

Sharia-compliant financial instruments play a crucial role in supporting MSMEs in Pekalongan, particularly in the batik industry. *Murabahah* has shown an annual increase of 20% in MSME financing between 2020 and 2023 (Otoritas Jasa Keuangan (OJK) Pekalongan, 2023). The consistent 20% annual growth in *murabahah* financing reflects its effectiveness as a sharia-compliant tool for providing accessible credit to MSMEs in Pekalongan's batik sector. This cost-plus financing model aligns with the needs of small businesses by offering a transparent and predictable repayment structure, fostering financial stability, and enabling batik entrepreneurs to scale their operations. Mudharabah also continues to facilitate capital access, supporting over 5,000 batik MSMEs (Badan Pusat Statistik (BPS) Pekalongan, 2023). The significant reach of *mudharabah*, supporting over 5,000 batik MSMEs, underscores its role as a vital profit-sharing mechanism that promotes entrepreneurial growth without imposing debt burdens. By enabling risk-sharing between financiers and MSMEs, *mudharabah* fosters a collaborative financial ecosystem, empowering batik producers to access capital while adhering to sharia principles of fairness and mutual benefit. While the application of *qard al-hasan* remains limited, it contributes meaningfully to low-income welfare (Rini, 2023). These contributions align with Islamic economic principles, particularly maqasid al-shariah, which emphasize justice, welfare, and equitable distribution (Chapra, 2008). Despite its limited application, *qard al-hasan's* role in providing interest-free loans demonstrates its value in supporting low-income communities, aligning with the *maqasid al-shariah's* focus on social welfare and economic justice. This synergy between sharia-compliant instruments and Islamic economic principles highlights their potential to drive inclusive growth and equitable wealth distribution in Pekalongan's batik industry.

This study diverges from macro-level analyses like Marpaung et al. (2024) and instead highlights tangible outcomes in local economies. By focusing on localized impacts rather than broad, macro-level trends as explored by Marpaung et al., this study provides a granular perspective on how sharia-compliant financial instruments directly benefit Pekalongan's local economy, particularly in sectors like the batik industry. This emphasis on measurable, community-level outcomes underscores the practical significance of Islamic finance in fostering economic growth and resilience at a regional level. It also supports Rini's (2023) argument that philanthropy-based instruments like *qard al-hasan* have untapped potential in promoting financial inclusion among underbanked populations. Rini's assertion about the potential of *qard al-hasan* highlights its capacity to serve as a powerful tool for financial inclusion, particularly for underbanked communities in Pekalongan who may lack access to conventional or even other sharia-based financing options. The interest-free nature of qard al-hasan aligns with Islamic principles of social justice, offering a pathway to empower marginalized groups and expand economic participation, though its limited application suggests a need for greater awareness and infrastructure to fully realize its impact.

Sharia financial instruments hold substantial potential for inclusion, especially for MSMEs and underserved communities. However, their effectiveness is limited by low financial literacy and regulatory barriers (Fauzi & Suhaidi, 2023). The significant potential of sharia financial instruments to enhance financial inclusion is constrained by the low level of sharia financial literacy and restrictive regulatory frameworks, as noted by Fauzi and Suhaidi. These barriers hinder the ability of MSMEs and underserved communities in Pekalongan to fully engage with and benefit from Islamic finance, limiting the reach and impact of these instruments in promoting equitable economic participation. This study proposes extending inclusive finance theory by integrating local cultural identity as a catalyst for adoption. By incorporating local cultural identity into the framework of inclusive finance, the study suggests a novel approach to increase the adoption of sharia-compliant instruments in Pekalongan. Leveraging cultural elements that resonate with the community, such as traditional values and local economic practices, could bridge the gap in understanding and trust, making sharia finance more relatable and appealing to potential users. Culturally embedded institutions—such as mosques and batik cooperatives—can serve as strategic platforms for financial outreach and literacy. Utilizing mosques and batik cooperatives as platforms for financial education and outreach taps into existing community structures that hold cultural and social significance in Pekalongan. These institutions can facilitate targeted literacy programs and promote sharia financial products in a context that aligns with local values, thereby enhancing trust, engagement, and adoption among MSMEs and underserved populations.

The findings point to the necessity of strengthening Pekalongan's sharia financial ecosystem through targeted education and adapted regulations, particularly in fintech. The emphasis on targeted education and tailored regulatory reforms, especially in the fintech sector, highlights a critical need to address the structural barriers impeding the growth of sharia finance in Pekalongan. By prioritizing financial literacy programs and creating fintech-specific regulations that accommodate sharia principles, the ecosystem can better support MSMEs and underserved communities, fostering greater adoption and utilization of Islamic financial products. Theoretically, the study suggests refining inclusive finance models by integrating sharia values with local culture. Integrating sharia values with Pekalongan's local cultural context offers a theoretical advancement in inclusive finance models, making them more relevant and effective for the region. This approach leverages cultural familiarity to enhance the appeal and accessibility of sharia-compliant financial instruments, addressing behavioral barriers such as mistrust or lack of understanding that hinder adoption. This culturally rooted approach offers a promising path toward designing inclusive Islamic financial systems responsive to both structural and behavioral challenges. By embedding sharia finance within culturally resonant frameworks, such as leveraging local institutions like mosques and batik cooperatives, this approach can effectively address both structural issues (e.g., regulatory gaps) and behavioral challenges (e.g., low financial literacy). This strategy promises to create a more inclusive and sustainable sharia financial ecosystem in Pekalongan, aligning with community values and economic needs.

The development of sharia-compliant financial systems has gained significant traction in Indonesia, driven by the country's large Muslim population and growing demand for ethical financial solutions. As Indonesia advances its national agenda for inclusive finance, regional disparities in adoption rates highlight the need for localized studies to address context-specific challenges. This study contributes to the literature by offering a micro-level analysis situated in Pekalongan, a region underexplored in national Islamic finance research. By focusing on Pekalongan, the study fills a critical gap in understanding how sharia finance operates in smaller, culturally distinct urban centers, moving away from the macro-level perspectives that dominate existing research. Pekalongan, known for its vibrant batik industry and strong cultural heritage, presents a unique case for examining how local dynamics influence the adoption of Islamic financial products, offering insights that can inform strategies in similar regions across Indonesia.

The study's conceptual framework integrates *maqasid al-shariah* with Rogers' diffusion of innovations theory, providing a robust lens to analyze the adoption of sharia finance. *Maqasid al-shariah*, which emphasizes justice, welfare, and equitable distribution, aligns seamlessly with the ethical foundations of Islamic finance, ensuring that financial systems prioritize societal well-being. By combining this with Rogers' theory, which explains how innovations spread through social systems, the study identifies three key determinants: cultural identity, financial literacy, and the regulatory environment. Cultural identity plays a pivotal role in Pekalongan, where institutions like mosques and batik cooperatives serve as trusted community hubs. These culturally embedded platforms can enhance the diffusion of sharia finance by fostering trust and relatability. However, low financial literacy, with only 39.11% of Pekalongan's population knowledgeable about sharia finance compared to the national average of 52%, poses a significant barrier. This gap limits the ability of individuals and MSMEs to engage with products like *murabahah* and *mudharabah*, which have shown promise in supporting the batik industry. Additionally, regulatory constraints, particularly in sharia-compliant fintech, hinder innovation and scalability, as current frameworks often fail to accommodate the unique characteristics of Islamic financial technologies.

Beyond theory, the study provides practical, localized recommendations for policymakers and practitioners to replicate in other small to mid-sized Indonesian cities, supporting the national agenda of inclusive sharia finance. For instance, targeted financial literacy programs delivered through mosques and batik cooperatives could address knowledge gaps, while regulatory reforms tailored to Pekalongan's context could unlock the potential of sharia fintech and crowdfunding. These recommendations are grounded in the study's micro-level findings, which highlight the success of instruments like *murabahah*, with a 20% annual increase in MSME financing, and *mudharabah*, supporting over 5,000 batik MSMEs (BPS Pekalongan, 2023). By leveraging local cultural assets and addressing structural barriers, Pekalongan can serve as a model for other cities. This approach not only enhances financial inclusion but also aligns with *maqasid al-shariah's* emphasis on equitable economic systems, paving the way for broader adoption of sharia finance across Indonesia's diverse regions.

D. Conclusion

This study explored how urban Muslims in Pekalongan adopt sharia monetary instruments—*sukuk, mudharabah,* and *murabahah*—within a localized socio-economic and cultural context. Anchored in Pekalongan's strong Islamic identity and vibrant MSME sector, it addressed the gap in national-level studies by examining micro-dynamics of sharia finance adoption in smaller cities. By focusing on Pekalongan's batik-driven economy, the study highlights how cultural institutions like mosques and cooperatives facilitate adoption despite low financial literacy. It proposes leveraging these platforms for education and tailoring regulations to enhance sharia finance uptake, offering replicable insights for other Indonesian cities.

The findings show that *mudharabah* and *murabahah* are widely accepted due to their cultural alignment, ethical clarity, and support for MSMEs, while sukuk remains underutilized due to its complexity and limited relevance to local financing needs. The widespread acceptance of *mudharabah* and *murabahah* in Pekalongan stems from their alignment with local Islamic values and their practical utility for MSMEs, particularly in the batik industry, where they support over 5,000 businesses and have seen a 20% annual financing increase. Their transparent, profit-sharing, and cost-plus structures resonate culturally and ethically, making them accessible and appealing. Conversely, sukuk's complexity and lack of direct relevance to local financing needs limit its adoption, as it is less suited to the immediate, small-scale financial demands of Pekalongan's MSMEs. These results validate the integration of maqasid al-shariah and diffusion of innovations theory as complementary frameworks, highlighting how cultural identity, perceived benefits, and regulatory context shape financial decisions. The synergy of maqasid al-shariah, which prioritizes justice and welfare, and Rogers' diffusion of innovations theory, which emphasizes adoption drivers like perceived benefits, effectively explains the uptake of sharia instruments in Pekalongan. Cultural identity, rooted in local Islamic practices, enhances trust in mudharabah and murabahah, while their clear benefits—such as ethical financing and MSME support—drive adoption. However, regulatory barriers and low financial literacy hinder sukuk's diffusion, underscoring the need for tailored policies and education to align financial systems with local needs.

Low financial literacy, regulatory gaps, and competition from conventional systems persist as barriers to broader adoption. By situating these challenges within Pekalongan's unique socio-cultural landscape, this study enriches national discussions on Islamic financial inclusion, emphasizing the role of local institutions like mosques and batik cooperatives in fostering trust and literacy. The proposed framework, blending maqasid, diffusion theory, and local identity, could be tested or adapted in other small cities to assess its generalizability across diverse contexts. The study proposes a localized Islamic financial adoption model, culturally responsive financial inclusion model that integrates Islamic ethical values, accessible education, and community-based regulation. Its implications suggest that national sharia finance strategies should be decentralized and tailored to local realities for greater impact.

Future research should include fieldwork with urban Muslim stakeholders and financial institutions to strengthen empirical insights. Comparative studies across similar-sized Indonesian cities could further validate the model and uncover variations in adoption patterns, advancing the development of a holistic, inclusive, and context-sensitive Islamic financial system.

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F. Author Contributions Statement

This article represents the author's independent scholarly contribution, encompassing the formulation of the research background, methodological framework, data interpretation, and conclusion development. The study employs a descriptive qualitative method with a phenomenological approach, aiming to systematically explore and critically analyze the preferences of urban Muslim communities toward sharia monetary instruments in the city of Pekalongan, as well as the underlying socio-economic dynamics that shape these preferences.

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