

## **CHAPTER II**

### **LITERATURE REVIEW**

#### **2.1 Theoretical Review**

##### **2.1.1 Islamic Banking Development**

The theory of Islamic banking is based on the concept that interest is strictly forbidden in Islam, and that Islamic teachings provide the required guidance on which to base the working of banks. The basic principle that has guided all theoretical work on Islamic banking is that although interest is forbidden in Islam, trade and profit is encouraged.

Islamic banking is a financial system whose key aim is to fulfill the teachings of Holy Quran. Islamic law reflects the commands of God and this law regulates all the aspects of a Muslim's life and hence Islamic finance is directly involved with spiritual values and social justice (Farahani, and Dastan, 2013).

The basic principle in Islamic law is that exploitative contracts or unfair contracts that involve risk or speculation are impermissible. Under Islamic banking, all partners involved in financial transactions share the risk and profit or loss of a venture and no one gets a predetermined return. This direct correlation between investment and profit is the key difference between Islamic and conventional banking which its main objective is maximizing shareholders wealth (Dar and Presley, 2000).

Islamic banking has introduced itself as an emerging alternative to conventional banking system and has grown rapidly over the last two decades both in Muslim and non-Muslim countries. Islamic banks have recorded high growth rates in both size and number and have operated in 60 countries worldwide and bankers predict that Islamic banking would control over 50% of savings in the Islamic countries within the next decade (Ahmad, 2004 and Abduh and Omar, 2012).

### **2.1.2 Economic Growth**

Economic growth means an increase in aggregate of output and real income. Economic growth is one of the indicators used to measure a country's achievements. All of these things are usually measured by the real revenue growth achieved of a country in a given period (Bastias, 2010)

The model developed by Rostow and Musgrave (Todaro, 2006) suggests the relationship of development expenditure from the government with the stages of economic development are distinguished to the initial stage, intermediate stage, and advanced stage. In the early stage, the percentage of government investment to total investment is high because at this stage the government should provide infrastructure, such as education, health, transport infrastructure, etc. At the intermediate stage, government investment still needed to boost economic growth, but at this stage, the role of

private investment is already growing. At the economic advance level, Rostow said that, government activity switched from infrastructure supply to expenditures for social activities.

There are three main factors in economic growth of every nation:

1. The accumulation of capital, which includes all forms or types of new investments embedded in the ground, physical equipment, and capital or human resource. For instance, the construction roads, electricity supply water supply, formal education, and job training.
2. Population growth, which in turn expanded the number of workforce. Population growth and force growth work is traditionally considered as a positive factor spur economic growth. The greater the number of workers means it will increase the number of productive labor, while greater population growth means increasing the size of its domestic market.
3. Advances technology, there are three classifications, namely:
  - 1) Advances in neutral technology
  - 2) Advances in labor-saving technology
  - 3) The capital-saving technological progress

### **2.1.3 The Link between Islamic Banking Development and Economic Growth**

The link between Islamic banking development and economic growth has long been a major subject in the field of economic development. The financial sector-one of it is Islamic banking- can support the economic growth if it is able being a good financial intermediaries which move the parties with financial excess to the parties with financial shortage. When the financial sector is more developed, more financial resources can be allocated into productive use, and more physical capital can be formed which can contribute positively to economic growth.

Farahani, and Dastan (2013) used empirical evidence to examine the role of Islamic banks' financing on economic performance of selected countries (Malaysia, Indonesia, Bahrain, UAE, Saudi Arabia, Egypt, Kuwait, Qatar and Yemen).The results generally signify that, in the long run, Islamic banks' financing is positive and significantly correlated with economic growth and capital accumulation in these countries. The results obtained from the Granger causality test reveal a positive and statistically significant relationship between economic growth and Islamic banks' financing in the short run and in the long run. It also found that the long run relationship is stronger than the short run relationship.

Abduh and Omar (2012) examined the short-run and the long-run relationships between Islamic banking development and economic growth in the case of Indonesia. The results demonstrate a significant relationship in short-run and long-run periods between Islamic financial development and economic growth. The relationship, however, is neither Schumpeter's supply-leading nor Robinson's demand-following. It appears to be bi-directional relationship.

Al-Oqool, Okab, and Bashayreh (2012) explore the relation between financial Islamic banking development (FIBD) and economic growth (EG) of Jordan over the periods of 1980–2012. The result shows that there is bi-directional long-run Granger causality between RGDP and FINC reflecting a positive contribution of Jordanian Islamic banks in financing the process of Jordanian social and economic development. The relation appears to show indirect relation between RGDP and DEPT running from RGDP to DEPT reflects the excess liquidity problem that all Jordanian Islamic banks suffer from it. With regarding to short-run causality there is not any significant relations between FIBD and EG.

Farahani, Yazdan and Sadr, Hossein (2012) examined the short-run and the long-run relationships between Islamic banking development and economic growth in the case of Iran and Indonesia. The result shows a significant relationship in short-run and long-run

periods between Islamic financial development and economic growth. The relationship appears to be bi-directional relationship.

Furqani and Mulyany (2009) examined the dynamic interactions between explore the relation between financial Islamic banking development (FIBD) and economic growth (EG) of Jordan over the periods of 1980–2012. They found that in the short-run only fixed investment that Granger cause Islamic bank to develop for 1997:1-2005:4. Where as in the long-run, there is evidence of a bidirectional relationship between Islamic bank and fixed investment and there is evidence to support ‘demand following’ hypothesis of GDP and Islamic bank, where increase in GDP causes Islamic banking to develop and not vice versa.

Echchabi and Azouzi (2015) analyze the relationship between Islamic banking development and economic growth in the UAE. This study reveals that no relationship does exist between Islamic banking development and economic growth in the UAE. Such a result can be attributed to the small component of Islamic banking in the global banking sector and to its declining profitability in the period of study.

#### **2.1.4 Islamic Banking and Economic Growth in Indonesia**

The first Islamic Bank in Indonesia is Bank Muamalat Indonesia which was established in 1992 in Jakarta. It remained as

the only Islamic commercial bank until the financial crisis in 1997 which caused massive destruction on the financial system. As the impact of the crisis, four banks which are PT. Bank Dagang Negara, PT. Bank Bumi Daya, PT. Bank Exim, and PT. Bapindo has been merged into one bank, PT. Bank Mandiri. PT. Bank Susila Bakti which also affected by the financial crisis later begin to operate again under the name of PT. Bank Syariah Mandiri.

Until now, there are twelve Islamic commercial banks (i.e. Bank Muamalat Indonesia, Bank Rakyat Indonesia Syariah, Bank Syariah Mandiri, and Bank Panin Syariah), 22 Islamic Business Units, and 161 Islamic Rural Banks, with the total of 2881 Branches (Table 2.1). This rapid development of Islamic banks cannot be separated with the success of government strategies by released *The Blueprint of Islamic Banking Development in Indonesia* in 2002. It contains the vision, mission, and the target of Islamic banking development with some strategic initiation with a clear priority to respond the main challenge and reach the target in the next ten years. The target is the significant market targeting of Islamic banking through the advance role in the regional, national, and international financial activity by the integration with other Islamic financial sectors.

Besides that, the Islamic Banking Act No. 21 Year 2008 which released by Bank of Indonesia give more legal basis for the

Islamic banking industry. Since then many of commercial banks began to open the Islamic Business Unit (i.e. Bank Danamon, Bank Permata, Bank International Indonesia, Bank Cimb Niaga, and Bank OCBC NISP). On the other hand, Indonesia as a country with Muslim as the majority, it has high demand and opportunity for Islamic banking system which using Islamic basis as its principal. So that the government regulations and the high demand from people have encouraged Islamic banking to grow even faster.

Table 2.1

*Indonesian Islamic Banking Networks*

Islamic Banks	Years				
	1992	1999	2006	2010	2015 <sup>□</sup>
Islamic commercial banks	1	2	3	11	12
Islamic Business Units	0	1	20	23	22
Islamic rural banks	9	78	105	150	161
Number of Branches	1	40	637	1763	2881
<b>Note:</b> <sup>□</sup> Until June 2015					
<b>Source:</b> Sharia Banking Statistics					

Besides the development in terms of number of banks, it can be reflected by some selected Islamic banking indicators such as total assets, total financing, total deposits, financing to deposit



ratio (FDR), non performing financing (NPF), and the number of workers (Table 2.2). The total assets were IDR 272.389 billion in June 2015 while total financing and total deposits were IDR 203.895 billion and IDR 215.339 billion. All of these indicators were increasing about more than 35% during 2010 to 2015<sup>□</sup>. Meanwhile FDR and NPF were increasing though there was a decrease in between. In addition to this, the number of workers was also doubled through the year.

Table 2.2  
*Selected Islamic Banking Indicators in Indonesia*

Banking Indicators	Years					
	2010	2011	2012	2013	2014	2015 <sup>□</sup>
Total Asset <sup>b</sup>	97.519	145.467	195.018	242.276	272.343	272.389
Total Financing <sup>b</sup>	68.181	102.655	147.505	184.122	199.330	203.894
Total Deposits <sup>b</sup>	76.036	115.415	147.512	183.534	217.858	215.339
FDR (%)	89.67%	88.94%	100%	100.32%	91.50%	96.52%
NPF (%)	3.02%	2.52%	2.22%	2.62%	4.33%	4.73%
Number of Workers	20,319	27,059	31,578	42,587	50,522	47,529
<b>Notes:</b> <sup>□</sup> Until June 2015; <sup>b</sup> in billion Rupiah						
<b>Source:</b> Sharia Banking Statistics						

Based on the data presented in table 2.3, Indonesia has a high gross domestic product (GDP) rate from year to year, which constantly increases. Unlike other countries, which have lower and unstable GDP, Indonesia's GDP is relatively high and stable. Indonesia is now different with what it was a decade ago after the crisis on 1998 and 2008. It showed the extensive transformation in many aspects, including the rapid development of Islamic banking, has provided a more resilience foundation into the Indonesian economic development today.

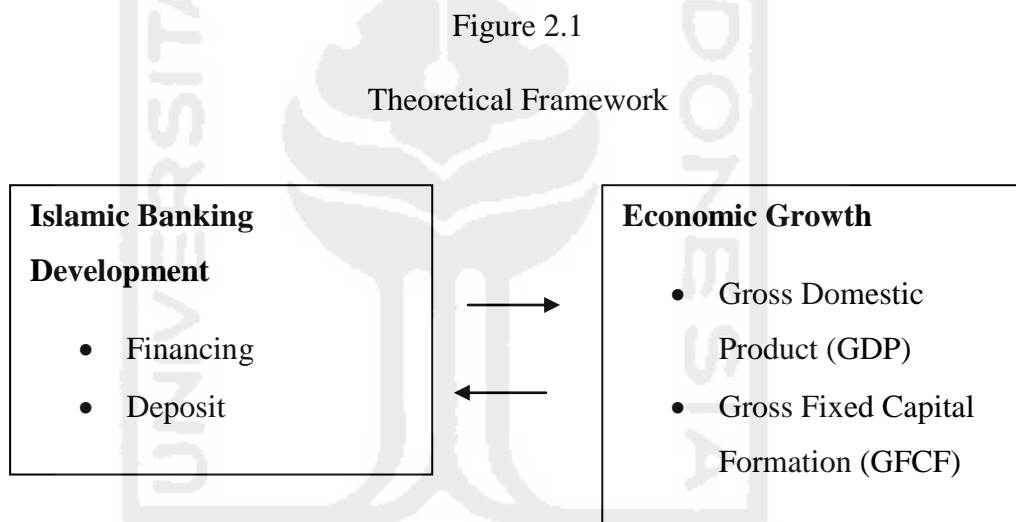
Table 2.3

*Annual GDP growth*

GDP growth (annual %)					
Country	2011	2012	2013	2014	2015
Indonesia	6.5	6.1	6.6	6.8	7
Malaysia	5.1	4.1	4.7	5	5
Thailand	0.1	5.4	7.5	4.5	4.6
Philippines	3.7	4.2	4.7	5	5
Singapore	4.9	2.7	3.9	4.1	4
USA	1.7	2.1	2.4	2.9	3.3
United Kingdom	0.7	0.8	2	2.5	2.6
Source: IMF					

## 1.1. Theoretical Framework

The theoretical framework of this research is as shown in figure 1. In this research, the causality between variables will be investigated which are Islamic banking development (financing and deposit) and economic growth (gross domestic product and gross fixed capital formation). For further investigation, the direction of causality between variables will also be analyzed.



### 1.1. Hypotheses Formulation

Based on the theoretical review, generally researchers found that there is causality between Islamic banking development and economic growth in the short-run and in the long-run. Specifically, the hypothesis will be formulated into short-run and long-run causality with two major hypothesis and eight minor hypothesis.

### **1.1.1. The Causality between Islamic Banking Development and Economic Growth in the short-run**

Some previous researches found that there is a short-run causality between Islamic banking development and economic growth. Farahani and Dastan (2013) revealed statistically significant relationship between economic growth and Islamic banks' financing in the short run. Another research, conducted by Abduh and Omar (2012), found a significant relationship in short-run periods between Islamic financial development and economic growth. In the same year, Farahani, Yazdan and Sadr, Hossein (2012) also found a significant relationship in short-run periods between Islamic financial development and economic growth. Based on the findings above, it is proved that there is Islamic banking development and economic growth in the short-run.

#### Major hypothesis

*H<sub>1</sub>: there is causality between Islamic banking development and economic growth in the short-run.*

Farahani, Yazdan, Sadr, and Hossein (2012) find that Islamic bank financing have significant impact on the changes in income. It is clear that in general that in short-run Islamic banks' financing is an important ingredient for economic development. Yusof and Usman (2013) found that GDP affects households' decision to borrow in the short-run. They found that when GDP increases, the demand for Islamic home financing

decreases and vice versa. These findings show that there is causality between financing and gross domestic product in the short-run.

Minor Hypothesis

*H<sub>1a</sub>: There is significant causality between financing and gross domestic product in the short-run.*

Furqany and Mulyani (2009) stated that as increase in Islamic bank financing stimulates an entrepreneurial response in the productive sectors and promotes more investments, at the same time, more investment in the country facilitates Islamic banking to develop further. This research confirm that there is causality between financing and gross fixed capital formation in the short-run.

Minor Hypothesis

*H<sub>1b</sub>: There is significant causality between financing and gross fixed capital formation in the short-run.*

Ogege and Shiro (2013) used least squares (OLS) two-stage approach and suggested by Engle and Granger (1987) was utilized in deriving the short run estimates. The structural analysis was done using the Impulse Response Analysis and Forecast Error Variance Decomposition to trace the one-time shock to one of the innovations in the current and future values of the exogenous variables. Empirical evidence emerges that money deposit banks in Nigeria was found to respond to economic growth. This imply that there is causality between deposit and economic growth in the

short-run which in this research gross domestic product was used as the measure of economic growth.

Minor Hypothesis

*H<sub>1c</sub>: There is significant causality between deposit and gross domestic product in the short-run.*

The research result of Omanklahen (2012) shows that commercial banks deposit liabilities only have immediate impact on capital formation. Furqani and Mulyany (2009) found that in the short-run only fixed investment that granger cause Islamic bank to develop. These findings show that in the short-run, there is causality between deposit and gross fixed capital formation.

Minor Hypothesis

*H<sub>1d</sub>: There is significant causality between deposit and gross fixed capital formation in the short-run.*

**1.1.2. The Causality between Islamic Banking Development and Economic Growth in the long-run**

Besides the causality between Islamic banking development and economic growth in the short-run, more researcher found that there is long-run causality too. Gudarzi Farahani and Dastan (2013) revealed statistically significant relationship between economic growth and Islamic banks' financing in the long run. It also found that the long run relationship is stronger than the short run relationship. Other researchs by

Abduh and Azmi Omar (2012), Ali Al-Oqool1, Okab, and Bashayreh (2012), also Farahani, Yazdan and Sadr, Mohammad Hossein (2012) found significant relationship in long-run periods between Islamic financial development and economic growth. So, it is proved that there is causality between Islamic banking development and economic growth in the long-run.

#### Major hypothesis

*H<sub>2</sub>: there is causality between Islamic banking development and economic growth in the long-run.*

Farahani, Yazdan, Sadr, and Hossein (2012) found that in the long-run, Islamic bank's financing is positive and significantly correlated with economic growth which measured by GDP. On the other hand, Yusof and Usman (2013) found that GDP being negatively significant to financing suggests that home financing provided by Islamic banks are more linked to movements in real economic activity which affect households decision to borrow. These findings show that in the long-run, there is causality between financing and gross domestic product.

#### Minor Hypothesis

*H<sub>2a</sub>: There is significant causality between financing and gross domestic product in the long-run.*

Farahani, Yazdan, Sadr, and Hossein (2012) The results generally show that in the long run, Islamic bank's financing is positive and significantly correlated with capital accumulation. These results reveal that

improvement of the Islamic financial system in these countries may benefit economic development and it is important in the long run for economic welfare. Farahani and Dastan (2013) Real gross capital formation has a positive and statistically significant impact on Islamic banks' financing, indicative of their complementarity. This finding prove that there is long-run causality between financing and gross fixed capital accumulation.

Minor Hypothesis

*H<sub>2b</sub>: There is significant causality between financing and gross fixed capital formation in the long-run.*

Al-Oqool, Okab, and Basyareh (2014) the relation appears to be unidirectional relation between gross domestic product and deposit. Ogege and Shiro (2012) investigate the long relationship between deposit money bank and economic growth in the Nigerian context from 1974 to 2010. The deposit money banks variables exert a modest influence on the GDP. Furqani and Mulyany (2009) found that in the long-run, there is evidence of a bidirectional relationship between Islamic bank which measured by financing and fixed investment. This shows that there is causality between These findings imply that there is long-run causality between deposit and gross domestic product.

Minor Hypothesis

*H<sub>2c</sub>: There is significant causality between deposit and gross domestic product in the long-run.*



Omankhanlen (2012) the role of deposit is reflected in capital formation through increased capital stock and the impact it makes on the capacity for an economy to generate more and higher incomes. In other word, in the long-run, there is causality between deposit and gross fixed capital formation.

Minor Hypothesis

*H<sub>2d</sub>: There is significant causality between deposit and gross fixed capital formation in the long-run.*

