THE SIGNIFICANCE OF ISLAMIC BANKING ON INDONESIA'S ECONOMIC GROWTH

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ABSTRACT

This paper study the significance of Islamic banking on Indonesia economic growth from the year of 2009 until 2015. Unit Root Test and Error Correction Model (ECM) have been used to analyse whether the financial system has an effect on economic growth in the long-run period. Variables used in this study are Gross Domestic Product (GDP), Total Investment (INV), Total Financing (TF) represents Islamic banking, Inflation (I), Export (EX) and Import (IM) as openness of economy. This study found that there is a long-run relationship between Islamic banking and economic growth. If there is a growth in the Islamic financial sector, it will somehow has a positive impact on economic growth. Likewise, the economic growth will affect positively on the development of Islamic banking. In Indonesia, the government has a policy that encourage investment, which in turn is able to develop the financial sector, both conventional and Islamic banking.

Keyword: *Gross Domestic Product, Total Investment, Total Financing, Inflation, Export, Import*

1. Introduction

Islamic banking or sharia compliant finance in general is defines as banking system based on sharia law. The main principle of sharia law is to ensure fairness in any kind of economy activities and therefore, any activities involved *riba* (interest), *maisir* (gambling) and *gharar* (speculative trading) are strictly prohibited. Perwataatmadja and Siamat Dahlam said the operation of Islamic banking is based on the provisions of the Quran and Hadith. Schaik on the other hand stated that Islamic banking is a form of modern bank based on Islamic law. In the time of Prophet Muhammad PBUH, banks are institutions that carry out three main functions; accept deposits, lend money and provide money transfer services.

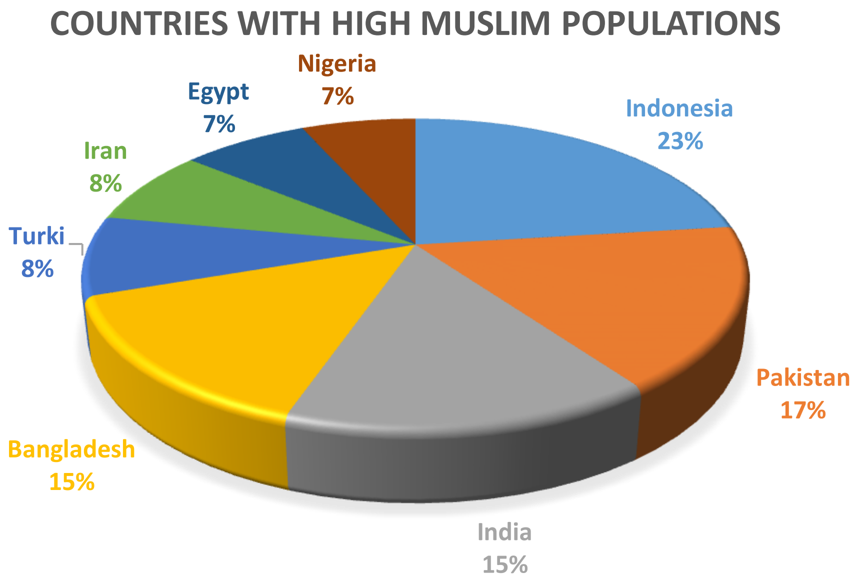

Diagram 1. Muslim Majority Countries
Source: The Pew Forum on Religion and Public Life

As for Indonesia stated from the diagram above, they holds the title as being the most majority of Muslim population compared to other countries. From this statement, the presence of Islamic banking in this country has become an obsession to many people long before Indonesia's independence. K.H Mansyur, board chairman of Muhammadiyah 1937- 1944 stated his opinion by saying Muslims of Indonesia were forced to use the services of conventional banks because there were no free interest financial institutions during that time. Thus, in 1990 Majelis Ulama Indonesia (MUI) formed a teamwork in order to establish an Islamic bank and a year after, Bank Muamalat Indonesia (BMI) is established and has been the first Islamic bank in Indonesia ever since then (*"Sejarah dan Perkembangan Bank Syariah di Indonesia,"* 2015).

As smooth as it might seemed for both conventional and Islamic banks, the year 1990’s has welcomed a nightmare for almost all nations in the world. There were many hectic things happened in the world of economy with negative impact on most of the countries across the globe. Especially in the year of 1998 where countries in Asia went through an economic crisis. Indonesia’s economy on the other hand, before facing the economic crisis, showed an excellent performance with growth rates ranging from 6% to 8% and seemed to be calmed with what will happen in the future. Logic reason behind of this is because Indonesia has a strong economic fundamentals to withstand external shock caused by the collapsed of South Korean and Thailand economy. On August 1997, everything changed after a policy of free- floating exchange rate has been issued by Indonesia’s government. Ever since the monetary policy is conducted, the banking crisis began to emerge and became a full- blown banking crisis affecting both financial and real sectors of Indonesia (I Putu Soebowo, 2003 as cited in Basyir Asyhar 2014).

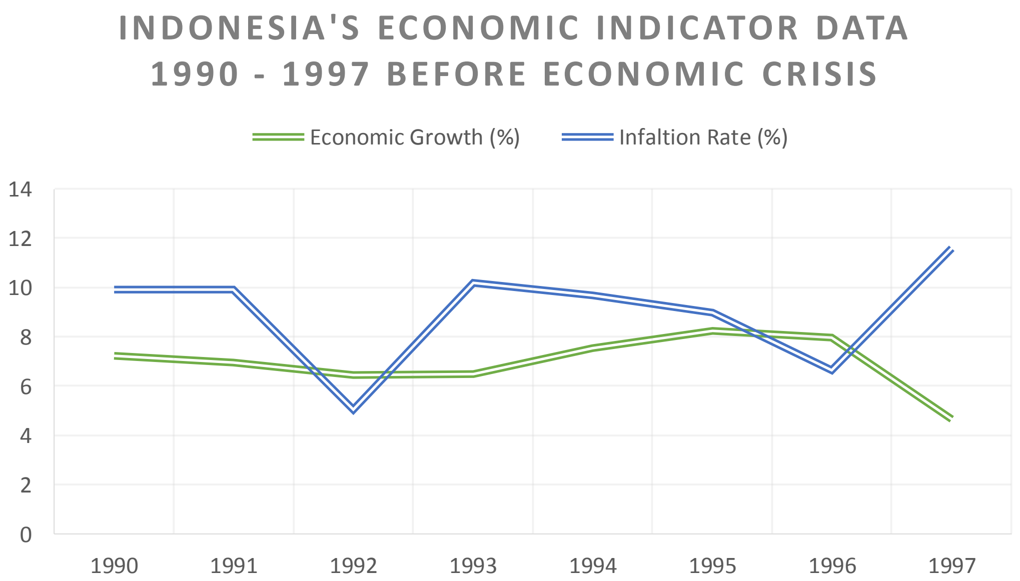

Diagram 1.1.

Source: BPS, Indikator Ekonomi: Bank Indonesia, Statistik Ekonomi Keuangan Indonesia; World Bank, Indonesia in Crisis, July 2nd, 1998 (Krisis Moneter Indonesia: Sebab, Dampak dan Peram IMF)

In 1997, Indonesia’s economic growth has decreased drastically with high inflation rate as shown in Diagram 1.1. Huge and short term of stock of private external is one of the reasons for Indonesia to hit economic crisis (Putra, 2008 as cited in Basyir Asyhar, 2014). Weak banking system used in Indonesia back then had caused the external private debt problems as domestic banking problems. Related to the previous issue on Indonesia’s banking system, there seemed to be some vulnerabilities and uncertainty in the banking systems they used that somehow does not suit with the country (*"Penyebab Krisis Ekonomi Tahun 1997- 1998,"* 2012).

In the bustle of economic crisis that affected the financial sector so badly, Indonesia's first Islamic bank, BMI, has proven its resistance despite decrease in profit. BMI implemented the principle of profit- sharing concept in their banking system and surprisingly survived from economic crisis due to varieties products offered by them. *Murabahah* for example, does not affected by the fluctuations of Bank Indonesia's (BI) rate and any real sectors that uses this kind of transaction will be secure from the negativity of BI's rate. As stated by Widodo Romi (2012), Islamic banks is known for its resistant to the crisis while conventional banks have become a parasite for the economy of a country. It is proved by the unsettled issues related to Bank Indonesia Liquidity Support, Recap Bonds and Indonesian Bank Restructuring Program that caused Indonesia a total loss of more than Rp. 650 trillion.

From the previous statement, we can see how Islamic banking played an important role on Indonesia's development when the country was hit by harsh financial crisis back in 1998. The contribution can be seen when Islamic banks are the ones who attracted Middle East investors because of the varieties Islamic investment offered by them that can be invest in Indonesia. Other than that, Islamic finance institutions contributed to the development of rill sector. From the prohibition of interest rate and speculation, funds managed by Islamic banks are required to be channelled to the real sector and halal sector, being the main reason for its contribution to rill sector. By doing so, some of the funds given to the rill sector will help the development of the nation's economy (Uzum Ramona, 2012).

The positive achievement gained by Islamic banking leaded to the formation of *UU No. 21 tahun 2008* that regulates Islamic bank in Indonesia. Under this law, Islamic financial institutions do not only accept deposits from the public but they also work as a distributor for public funds as well as social functions for: (1) receive zakat funds, (2) receive cash *waqf* and distribute it to *nadzhir*[1]. These social functions are entrusted to them because of the differences that lies in the intensity of practice between Islamic and conventional banks. However, there are several conventional banks that contribute to social activities but not in periodically way as the Islamic banks.

Since the performance of Indonesia's economy is getting better compared to the one they had during the rough year of 1998. The potential of Islamic finance market is still wide open and it will lead to a bright future for sharia industry in Indonesia. Islamic banking has become one of the nation's banking system and the growth of Islamic financial institutions have increased in number since economic crisis. The question is now, does it really contributes to the growth of Indonesia's economy in long-run period? This study will analyses the dynamic interactions between finance and growth, whether Islamic banking has an impact on economic growth or the other way round.

2. Literature Review and Hypothesis

Economic Growth from Islamic Perspective

Conventional economics defined economic growth as a largely devoted to prosperity and material which can only last in a short- term dimension, or in other words, we dedicated ourselves for the sake of unbalanced state between life and hereafter. When spiritual satisfaction is used in this study, any mathematical problems will not be included for it is intangible. Anyways, in an Islamic point of view, Islam has considers economic growth as a means of ensuring social justice which it output will somehow contribute to human welfare. What makes the differences of definition of economic growth from Islamic and conventional minds are in Islam we have the prohibition of *riba* and *zakat* whereas these two points are can nowhere be find in conventional concepts.

From the reading above, a conclusion can be made where the fundamental difference between Islamic and conventional point of view lies on its ultimate goal. Conventional economics background is oriented with high growth of economic activities without accompanying to the equitable distribution of output produced. With this, the output produced will ended up with a product of uneven distribution of human welfare. In contrast with the concept of conventional perception, Islamic economics sees economic growth as a means to improve the material well- being of mankind regardless of race, religion and race. In addition, Islamic perspective has a dual orientation in terms of economics, namely, the welfare of material (worldly) and inner satisfaction (hereafter).

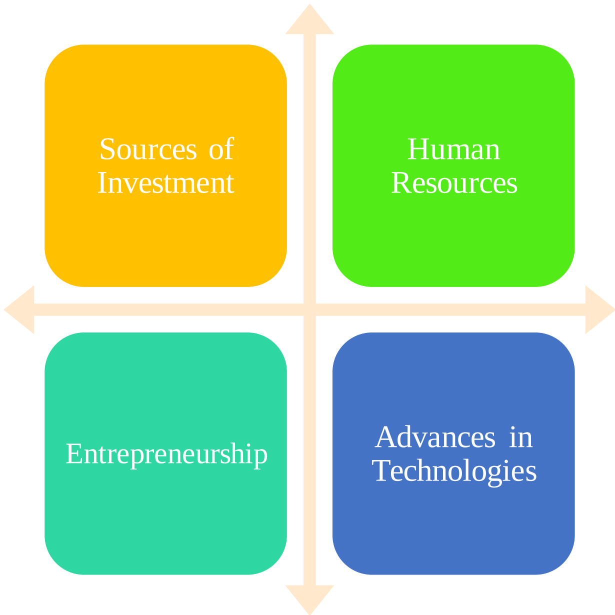

Diagram 2. Factors of Economic Growth According to Islam

As shown in Diagram 2., sources of investment, human resources, entrepreneurship and advances in technologies are four main factors of economic growth according to Islamic perspective. First point explains that growth requires investment resources (domestic and foreign investor) in order to increase the production of physical assets that generate future revenue streams. Physical assets mentioned before including factories and industrial machines that assist the growth of production. In connection with sources from external capital, it is important to cooperate with other Islamic countries, especially countries which took the prohibition of *riba* seriously in their financial management and freeing themselves from the influence of social, cultural and political slavery of Western's mind-set.

By doing so, the potential significance of Islamic economics on how to mobilize domestic resources for economic growth can be seen (Abidin Zainal, 2012).

The second factor of economic growth according to Islam, human resources, played as one of the important roles for economic growth. We, humans, are the only living things who are active on economic activity, the one who exploit natural resources and the one who is taking care of capital accumulation, social development, economic and political institutions. We are best known as the one who contribute the most to the growth process. This is due to the special qualities inside us where no other living things have, professionalism and moral attitude. These two qualities are very important to achieve maximum contribution to the growth of economy. Example, professional workers without honesty might not be contribute anything to the process of growth and vice versa with workers who are honest. Same goes with having sincerity but no skills, it does not contribute much for economic growth. Abidin Zainal (2012) said this situation as two sides of a coin that cannot be separated from one another.

Moving on to the third point, entrepreneurship, some economist asserted their opinion by saying entrepreneurship as one of the most important factors in economic growth. It is so important until it has been mentioned in the Holy Quran and Prophet Muhammad PBUH. He said, "nine out of ten (or 90%) of sustenance is derived from commercial business". In the Holy Quran, verse 275 of chapter two surah al- Baqarah stated "but Allah has permitted trade and has forbidden interest". From these two statements, we can see how supportive Islam is on the growth- development of entrepreneurship. Islam provides positive motivation to obtain halal livelihood by encouraging Muslims to work hard (working for other or it can be done independently) as long it does not breaks the sharia law. Allah has ordered us to find *rezk* that He has prepared for everyone (Abidin Zainal, 2012).

Last but not least, advancement of technology. It is something so undeniable that technological progress has contributed so much on our daily life and of course, to the growth of economic. Islam is not opposed to the concept of technological progress. As a reality, these technologies must be accepted and utilized as it provides significant contribution to growths. Verses from Quran guide people to find and earned new things or by experiences they had to benefit many people. New discoveries can be used to explore natural resources that Allah has provided for man's welfare. Other than the four factors mentioned before, economic growth can be measure by Gross National Product (GNP). GNP measures the flow of national income during a certain period of time. Generally, to calculate the growth, we use the same model as the conventional economics but adding the letter "Z" at the back of the model to differentiate Islamic and conventional economics. The letter Z represents *zakat* and the model can be expressed as $GNP = C + I + G(E - M) + Z$.

Islamic Bank

Islamic banking or sharia compliant finance in general is defines as banking system based on sharia law. The main principle of sharia law is to ensure fairness in any kind of economy activities and therefore, any activities involved *riba* (interest), *maisir* (gambling) and *gharar* (speculative trading) are strictly prohibited. Islamic banking has a significant influence on other Islamic financial practices such as *takaful* (Islamic insurance), Islamic bonds, Islamic mutual funds, sharia finance companies and Islamic capital market. In 2011, the global growth of Islamic banking decreased by 25%. Islamic banking in Indonesia on the other hand increased by $\pm$49%. Other than that, total deposits of Indonesian Islamic banking was also at the highest number back in 2011 with an increase of $\pm$51% (Bank Indonesia, "*Outlook Perbankan Syariah 2014*").

Gross Domestic Product

The gross domestic product (GDP) is one of the primary indicators used to gauge the health of a country's economy. It represents the total dollar value of all goods and services produced over a specific time period. Usually, GDP is expressed as a comparison to the previous quarter or year ("What is GDP and Why is it So Important to Economist and Investors?," 2016).

$$GDP = C + I + G + (X - M)$$

Diagram 2.1. Equation Used to Calculate GDP

Diagram 2.1., shows the equation used to calculate GDP where C is knows as private consumption, I is gross investments, G represents government spending and (X-M) is exports and imports. Real GDP accounts for inflation and deflation. It transforms the money-value measure, nominal GDP, into an index for quantity of total output ("Calculating Real GDP," 2016).

Hypothesis

The hypothesis of this study can be formulated based on what has been described above:

1. H_1 : Total Financing (TF) has a negative and significant effect on GDP.

3. Data and Methodology

Data Set

There are two types of data, primary and secondary. Both data has the same function in which they collected information to make a basic conclusion of a study. Primary data is obtained directly from its original source such as form an interview, polls of individuals or groups of people as well as the results of observations of an object, even or test results. Secondary data is obtained through an intermediary or indirectly from books, records, evidence, anything that are available and require researches to visit the library, research center, archives or read lots of book related to his or her research in order to obtain the data needed.

Based on the reading above, this study is using time series data which falls under secondary data from the year of 2009.Q1 until 2015.Q2. The time series data are obtained through the website monthly report from World Bank, *Bank Indonesia*, *Pusat Badan Statistik* and Trading Economics.

Operational Definition of Variables

Variables that are used in this study are inspired from a journal written by Ali Rama entitled *Analisis Kontribusi Perbankan Syariah Terhadap Pertumbuhan Ekonomi.* The variables are Gross Domestic Product (GDP), Total Investment (INV), Total Financing (TF), Inflation (I), Export (EX) and Import (IM).

$$GDP_t = \beta_0 + \beta_1 INV_t + \beta_2 TF_t + \beta_3 I_t + \beta_4 EX_t + \beta_5 IM_t + \varepsilon$$

- Gross Domestic Product (GDP) as economic growth.
- Total Investment (INV) represents Indonesia’s investment.
- Total Financing (TF) represents Islamic Banking.
- Inflation (I) as inflation rate.
- Export (EX) and Import (IM) as openness of economy.

Unit Root Test

In statistics and econometrics, the unit root test is used to test whether the time series data used in a study is stationary or not. Augmented Dickey- Fuller test is commonly used in unit root test. Another similar test with same function is known as Phillips- Perron test where both indicate the presence of a unit root null hypothesis (Ariyoso, 2009).

Error Correction Model (ECM)

ECM is an analysis of time series data with variables that have a dependency or often referred as cointegration. ECM method used to balance short run economic relationship variables that have a balance/ long run economic relationship (Marwadi Muhammad Chalik, 2014).

4. Findings and Discussions

Unit Root Test

In statistics and econometrics, the unit root test is used to test whether the time series data used in a study is stationary or not. Augmented Dickey- Fuller test is commonly used in unit root test. The result of each variable will be shown below:

Table 4.

THE VALUE OF PROBABILITY OF UNIT ROOT TEST

Variable	Level	1^{st} difference
GDP	0.6362	0.0008
INV	0.0712	0.0327
TF	0.0000	0.0000
I	0.1039	0.0000
EX	0.1888	0.0000
IM	0.0582	0.0001

From the table above, most of the variables used in this study are not stationer at level since the probability of each variable is greater than α 5%, except for independent variable, total financing (TF). TF is stationer at level as shown in the table where the value of probability is smaller than α 5% ($0.0000 < 0.05$). Then, a second stationarity test has been made by testing each variable on first difference. As for the result, all variables are stationer at first difference.

Error Correction Model (ECM)

Table 4.1.

THE RESULT OF LONG TERM EQUATION

Variable	Probability
INV	0.3323
TF	0.0001
I	0.9382
EX	0.8418
IM	0.0247
Prob (F-statistic) 0.0000	

The value of Prob (F-statistic) is smaller than 0.05 ($0.0000 < 0.05$), it means the independent variables are simultaneously significance to dependent variable. The significance of each variable does not need to be below 0.05 because it depends on the theoretical of a study. In this case, this study will focus on total financing (TF) for it is a variable which represents Islamic banking. Based on the probability values as shown in Table 4.10 that have been compared with α 5%, we can conclude that independent variables TF and IM have a significance effect on GDP.

Both variables contribute to the growth of Indonesia's economic and mutually influence between each other. Focusing on Islamic banking (TF), if there is a growth in the Islamic financial sector, it will somehow has a positive impact on economic growth. Likewise, the economic growth will affect positively on the development of Islamic banking. In Indonesia, the government has a policy that encourage investment, which in turn is able to develop the financial sector, both conventional and Islamic banking.

Table 4.2.

THE PROBABILITY VALUE OF RES

Phillips-Perron Unit Root Test on RES	
Prob.	0.0217

The result above showed res variable is stationer at level or in other words, stating that variable GDP, INV, TF, I, EX and IM are cointegrated with each other.

Table 4.3.

THE RESULT OF SHORT TERM EQUATION

Variable	Probability
D(INV)	0.2496
D(TF)	0.3020
D(I)	0.2375
D(EX)	0.4801
D(IM)	0.3124
RES(-1)	0.0055
Prob (F-statistic) 0.1308	

The value of Prob (F-statistic) is greater than 0.05 (0.1308 > 0.05), it means the independent variables are not simultaneously significance to dependent variable. Based on the probability values as shown in Table 4.12 that have been compared with α 5%, we can conclude that none of the variables used in this study are significance to dependent variable on a short- run economic growth. In a nutshell, there is a 65% of imbalance on a short- term effect on INV, TF, I, EX and IM on GDP that have been corrected every period.

5. Conclusions and Recommendations

The test results of the regression model turned out significance for main independent variable (TF) and insignificant for the other independent variables except IM. Variable total financing of Islamic bank and other variables are able to explain the effect of 88.54% on GDP variable. This means that the role of Islamic banking for economic growth is doing well even though it is not fully participate on the growth of economic. Probably because of the market share of Islamic banking is still low compared with conventional banks even though the number of Islamic banking assets continued to increase is one of the reasons on why it still can't fully compete in financial sector. Focusing on Islamic banking (TF), if there is a growth in the Islamic financial sector, it will somehow has a positive impact on economic growth. Likewise, the economic growth will affect positively on the development of Islamic banking. In Indonesia, the government has a policy that encourage investment, which in turn is able to develop the financial sector, both conventional and Islamic banking.

There are various strategies that can be done by Islamic banking in order to boost up their market shares among other. One of it is by improving the quality and quantity of human resources. Next, Islamic banking need to consider to increase financing scheme of *mudharabah* for it is proven reduce poverty, unemployment, and inflation. This journal is far from perfect and there are still a lot of errors. Any corrections, constructive criticism and good suggestions are welcomed for the perfection of this journal.

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