

CHAPTER I

INTRODUCTION

1.1 Background

The word bank was inspired from the Italian word “*banco*” which means tables, desks or counters. It can also be defined as an institution that offer financial services such as being the custody of the money, foreign exchange, loan and receivable bills of exchange. According to Qamus al- Fi al- Lughah Munjid wa al- Ahlam, bank is best known as a place to put properties for the purposes of certain jobs under special maintenance. Not long after the establishment of conventional bank, a new term of bank has been introduces with a slightly different on how they operate, it is known as the 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. 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.

In short, we can conclude that conventional and Islamic banks have the same role as a financial institution. But there are some clear differences on how these two institutions operate, based on the systems they are using and other things as shown in the table below:

Table 1.1

COMPARISONS OF ISLAMIC AND CONVENTIONAL BANK

Conventional Bank (interest rate system)	Differences	Islamic Bank (profit-sharing system)
Agreements are made based on positive law.	Agreement/ Akad	Agreements are made based on sharia law.
The determination of interest rate is made at the beginning of the agreements with assumption, must always in a profitable state. Fixed interest payments regardless of profit or loss. Lastly, interest payments do not increase even if the amount of profits increased.	System	The estimation of risk of profit-sharing is made during <i>akad</i> are based on the possibilities of profit and loss. The amount of the profit sharing ratio based on the amount of profits earned and any losses will be shared by both parties. Lastly, distribution of profits increases with an increase in revenue.
There is no supervisory board.	Supervisory Board	There is a supervisory board that is responsible for overseeing and monitoring the bank's operations and all of its products in accordance with sharia law.
Customers are creditor-debtor	Relationship Between Bank and its Customers	Customers are partnerships.

A brief history of modern Islamic banking took part way back in the year of 1963 in Egypt during the reign of Ahlam el Najjar. There was a bank operated using sharia law system as an experiment to study the impact of the savings bank to the country. Even though they did not claim themselves as an Islamic bank, their activities show us something else in which way, the bank does not receive any kind of interest. Most of their investment concentrated on industrial and commercial sectors where they ended up forming a partnership with their customers and profit- sharing system has been their main system. This so called experiment lasted until 1967 and at the very same moment, nine banks with similar concept used in Egypt have been established (*“Sejarah Perbankan Syariah di Dunia dan Masuk ke Indonesia,”* 2016).

By 1970's, Islamic- based banks are widely known and many of them have been established across the globe. In the Middle East as example, there are several Islamic banks such as Dubai Islamic Bank (1975), Faisal Islamic Bank of Sudan and Faisal Islamic Bank of Egypt (1977) and Bahrain Islamic Bank (1979). As for Asia Pacific, Philippine Amanah Bank officially operated in the year of 1973 and was established under presidential decree. Malaysia in 1983, founded the Muslim Pilgrims Savings Corporation with an aim to help those in need to save up their money to perform Hajj and Umrah (Dermawan Budi, 2016).

COUNTRIES WITH HIGH MUSLIM POPULATIONS

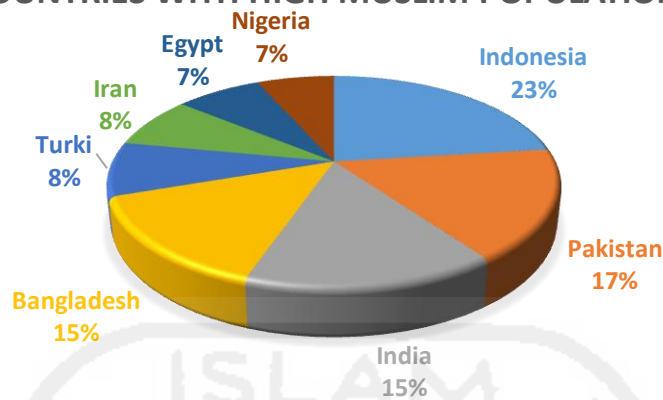


Diagram 1.1 Muslim Majority Countries
Source: The Pew Forum on Religion and Public Life

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).

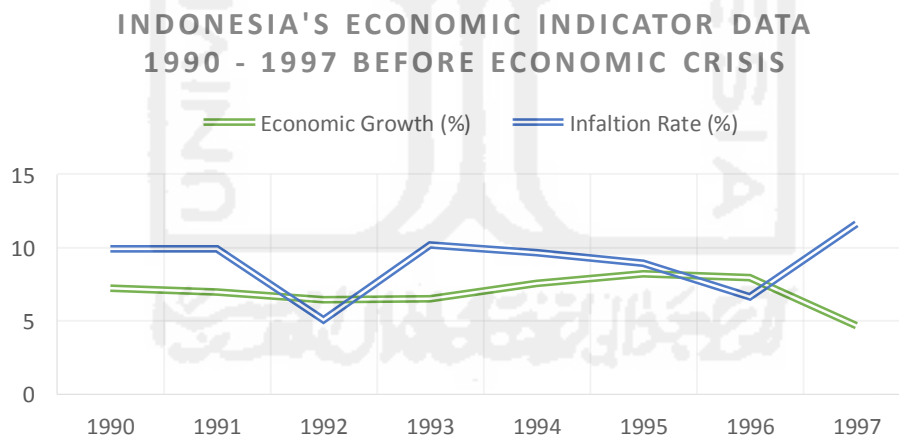


Diagram 1.2

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 led 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.

On the economic front, Islamic banking took part in taking care of the people's welfare and economic justice. Profits taken by conventional banks have discredited many parties especially those with weak economy background. A simple example for an instant, someone with low income has decided to open an account via conventional bank. He will have to be willing to cut a small amount of saving for the services that were not likely to be charge by Islamic banks for it does not go right with sharia law. By looking at this example, government has

made some progression by working on to develop Islamic banking because of its benefits bring justice to all levels of society.

Transactions based on sharia law has contributed to the stability of economy. From this, when the entire banking sectors switch side by implementing sharia law as the backbones of their systems, the amount of money and goods will be well balanced. This stability is significant enough to reduce the level of price when there is a shortage of goods happening in the market (Fuad, 2016). Lastly, all the facilities provided by Islamic banking has somehow give out some hope for those who wanted to start up a business. It means, to establish an enterprise and providing job opportunities and income at the same time. With so, the welfare of the people will be lifted.

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.

This study, **The Significance of Islamic Banking on Indonesia's Economic Growth** is inspired from a journal written by Ali Rama entitled *Analisis Kontribusi Perbankan Syariah Terhadap Pertumbuhan Ekonomi*.

1.2 Problem Formulation

Based on the reading above, the problem of this study can be listed as below:

- i) Does Islamic banking affects the economic growth of Indonesia?
- ii) Is there any long- run relationship between Islamic financial sector and Indonesia's economic growth?

1.3 Purpose of Research

Based on the problem formulation above, the goal of this study are listed as below:

- i) To analyses the contribution of Islamic banking on Indonesia's economic growth.
- ii) To test whether is there any long- run relationship between Islamic financial sectors and economic growth of Indonesia.

1.4 Benefits of Research

- i) For the author, this study has helped solving the question about the position of Islamic banking in Indonesia. Total Financing (TF) and Total Deposits (TD) as the main variables in this study have answered the main issue of this study, Indonesia's economic growth. From the

data collected by the author, the result of Islamic banking in Indonesia is quite surprise, especially on their performance throughout the years.

- ii) For readers, this study may be handy for those who wanted to know what Islamic banking is and what makes this financial institution strong when facing economic crisis.

1.5 Writing System

Chapter I Introduction. This very first chapter of a study will be explaining on the background, problem formulation, purposes and benefits of a study and last but not least, the writing system. **Chapter II Literature Review and Theoretical Framework.** Literature review describes previous studies that are related with current study which is Islamic banking on economic growth. As for theoretical framework of this study, it is divided into two, theories from conventional and Islamic point of view.

Chapter III Research Methodology. In this chapter, type and method of data collection, operational definition of variables and method of analysis will be elaborated.

Chapter IV Results and Analysis. In this chapter, the results of data research and the analysis if the data will be presented. **Chapter V Conclusion and Recommendation.** This study will be end with a conclusion that sums up what the study is all about and recommendation on this study will be written.