ANALYSIS OF THE ROLE OF ISLAMIC BANKING IN INDONESIA'S ECONOMIC GROWTH

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Abstract – *Banking is one sector that is important for the growth of a country, because the bank is the intermediary institutions which collect funds from people who have a surplus and distribute to the people who need funds. This study aimed to analyze the role of Islamic banking on economic growth due to the rapid development of Islamic banking in Indonesia. By using VAR/VECM to determine the influence of Islamic banking for economic growth is represented by the IPI. The results showed that the total assets of Islamic banking does not have a significant effect on economic growth, while the Islamic banking financing a significant effect on economic growth.*

***Keyword**: VAR/VECM, Economic Growth, Islamic Banking*

I. INTRODUCTION

One sector that plays an important role in a country's economic growth is the banking sector. The bank is principally an intermediary institution that collects funds from people who experience a surplus of funds and distributes them to people who need funds (Kasmir 2004: 23). Inggrid (2006) also explained that the financial sector plays a very significant role in triggering a country's economic growth, through *capital accumulation* and technological innovation, namely being able to mobilize savings.

Similar to the conventional financial sector, the Islamic financial sector in this case Islamic banking also plays an important role in economic growth. Many studies have been conducted that Islamic banking significantly influences economic growth. Hafaz and Mulyani (2009) in their research explained a significant relationship between economic growth and the Islamic banking sector. Meanwhile, Yusuf (2005) found that there is no empirical evidence showing the superiority of the non-usury bank system compared to banks that use usury.

Islamic banking first appeared in Egypt in 1963 under the name Mith Ghamr, the banking took the form of a deposit bank based on *profit sharing*. Due to the turmoil of the political crisis, the bank was only able to operate until 1967. At that time there were 9 banks with similar concepts in Egypt. The presence of Islamic banking in Indonesia began in 1992, and there is only one Islamic Bank that moves alone in the wilds of conventional banks in Indonesia. It was only after Islamic banks proved to be able to survive amid the shock of the crisis of 1997-1998, that most of the people who wanted to fight for Islamic law in the economic field, especially banking, began to meet from time to time. As a result, several conventional banks initiated the establishment of Islamic Banks. The establishment of Sharia Banks since the enactment of Law No. 10 of 1998 is divided into three forms, namely: 1) purely sharia banks, 2) banks converted from conventional banks, 3) conventional banks that open sharia units/doors (Abu Muhammad, 2014: 7).

After the global financial crisis in 2007/2008, the Islamic finance and banking industry experienced an increase in demand. So that finally the Islamic financial industry is no longer just an additional system or *peripheral* to the conventional system, but has played a complementary role that has the potential to be developed in the future as an alternative to the conventional system that has been operating for a long time (Ali, 2013). We can see this in the development of assets from year to year has increased.

As of August 2014, the Islamic banking industry has a network of 12 Sharia Commercial Banks (BUS), 22 Sharia Business Units (UUS), and 163 BPRS, with a total office network of 2,582 offices spread across almost all corners of the archipelago. Total Islamic banking assets reached Rp 261.96 trillion, financing disbursement 198.38 trillion, and deposit collection (specifically BUS and UUS) amounted to Rp 209.64 trillion. The Islamic financial industry continues to grow positively, although the market share of Islamic banking to the national financial industry until the third quarter of 2014 was around 4.9%. It is still far different from Malaysia, whose financial industry market share has reached 20% of its total national banking assets. But it is also undeniable that the development of the Islamic banking industry in Indonesia is growing quite rapidly.

Islamic banking has introduced itself as an emerging alternative to the conventional banking system and has grown rapidly over the past two decades, in both Muslim and non-Muslim countries. Islamic banks have recorded high growth rates in the size and number of banks already operating in more than 60 countries worldwide and bankers predict that Islamic banks will account for more than 50% of savings in Islamic countries in the next decade (Omar, 2012).

The paradigm in the concept of Islamic finance and banking is *risk sharing*, which encourages depositors and banks to share business risks. This concept will make depositors to be careful in choosing banks, and at the same time motivate bank management to be careful in channeling financing or in making investments (Chapra, 2000). Therefore, Islamic finance emphasizes more on the type of equity financing. This type of financing is prioritized because through this pattern fund owners will participate in risk so that they will be careful in managing risk and continue to supervise the activities of the borrower.

Another financing model is *sale-based modes of financing*. This Islamic banking financing model will greatly support the increase in real production of goods and services. Finally, the concept of profit sharing (*musharakah and mudharabah*) and buying and selling and renting will have an impact on the growth of the real economic sector and ultimately encourage national economic growth.

After being hit by the 1997 financial crisis, national economic growth fluctuated. In 2002 with a growth rate of 4.3% and continued to increase to 6.2% in 2007. Then in 2009 it had decreased to 4.5 percent due to the financial crisis that hit the US economy. However, it rose again in 2010 to 6.1% and continued to rise to 6.5% in 2011. But until 2014 it did not experience fluctuations and even experienced a decline in economic growth.

The Central Bureau of Statistics published the results of Indonesia's economic performance in the fourth quarter of 2014 which showed Indonesia's economic growth grew by 5.03 percent, smaller than the economic growth in the third quarter of 2013 of 5.63 percent. From the domestic side, the slowdown in growth was driven by limited government consumption in line with budget savings and limited investment activities. From the external side, weakening global demand, declining world commodity prices, and policies limiting mineral and coal exports have resulted in weakening export performance.

The significant growth of Islamic financial institutions and declining economic growth attract interest to study whether the banking sector has increased both in terms of assets and financing as well as the increase in BUS and UUS, whether there is a mutually influencing relationship between the Islamic financial sector and economic growth. Does economic growth affect Islamic banking or will the development of Islamic banking affect economic growth?

II. METHODS

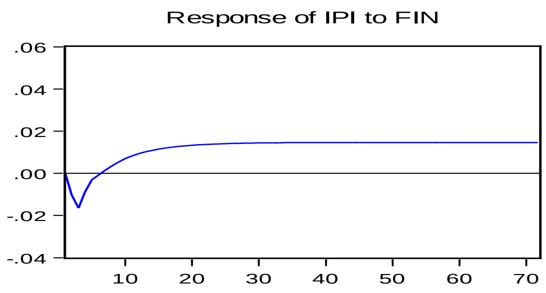
This study used secondary data types obtained from various official sources such as Bank Indonesia (BI), Financial Services Authority (OJK), Central Statistics Agency (BPS) and other sources related to this study. In addition, the author also conducts literature studies to justify theory and data accuracy. In this case, the data used monthly data as the database, with a vulnerable time of six years.

III. RESULTS AND DISCUSSION

IPI's Response to Sharia Banking Financing Shocks

In Figure 1 below, the IRF test results show the effect of variable financing shocks on IPI. At the beginning of the period, namely in the 2nd *period, the Financing shock had a negative influence with a standard deviation of -0.010336, but the negative influence did not last long and then* the remaining Financing shocks had a positive influence on the IPI and began to stabilize in period 48 with a *standard deviation of* 0.014610. Then also the shock of variable *financing* to *financing* was responded positively, and began to stabilize in the 50th period with a standard deviation of 0.043940.

This shows that the financing provided by the Islamic banking industry is responded positively by economic growth, which means that increased funding by the Islamic banking industry will further increase economic growth. This result is in accordance with the theory proposed by Sulhan and Siswanto (2008) which states that banking has a role as a driver of the national economy through good fund distribution, so economic actors can be helped in allocating funds and managing funds. In line with the theory presented by Perwataatmadja and Tandjung (2011) that the Islamic banking industry provides equal income for all elements of society to strive through musharakah and mudharabah financing based on profit sharing contracts, so that it will accelerate economic growth, the same thing also happens in research conducted by Hafaz & Mulyani (2009) in Malaysia which states that credit or financing will increase economic growth both in short-term or long-term.



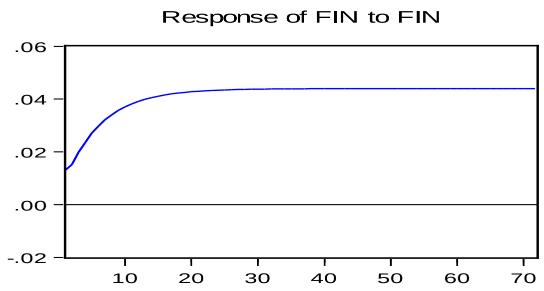
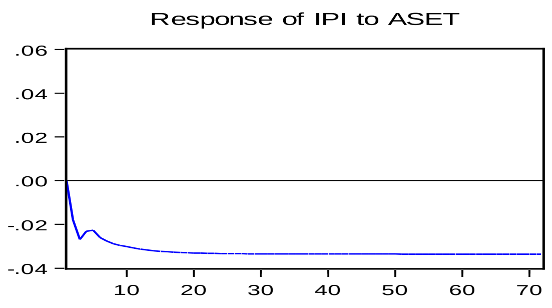


Figure 1 IPI's Response to Financing

IPI's Response to Asset Shocks

In Figure 2 IPI's response to Assets below shows the effect of Asset variable shocks on IPI. Asset variable shocks were responded negatively by IPI with a standard deviation at the beginning of the period of -0.017934 and began to stabilize in the 47th period with a standard deviation of -0.033555. Meanwhile, asset variable shocks to assets were responded positively at the beginning of the period with a standard deviation of 0.020127 and began to stabilize in the 32nd period with a standard deviation of -0.0055708. In period 8, asset variable shocks to assets responded negatively with a standard deviation of -0.001082. Variable assets are responded negatively by economic growth, this means that when there is a shock to the increase in Islamic banking assets, in the long run economic growth will decrease. This is because the total amount of assets of Islamic banks is relatively small when compared to the total assets of conventional banks. This result is in accordance with research conducted by Johnson aimed to see the factors that are determinants of GDP per capita, taking into account the role of Islamic banking. Using *the Two Stage Least Square Panel Estimation* (2SLS), the author analyzes the influence of variables such as initial GDP, population, level of physical capital deposits and *IB* variables representing two different types of Islamic banks on economic growth. The results show that Islamic banks do not have a significant influence on economic growth, both measured in terms of assets and the number of banks and instruments (Jhonson, 2013).



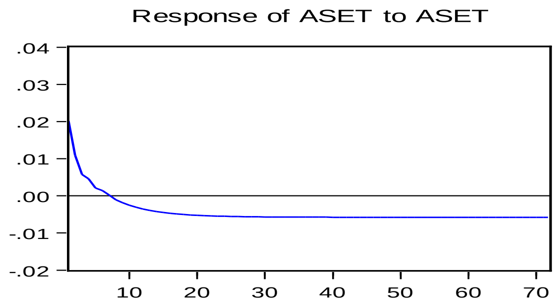
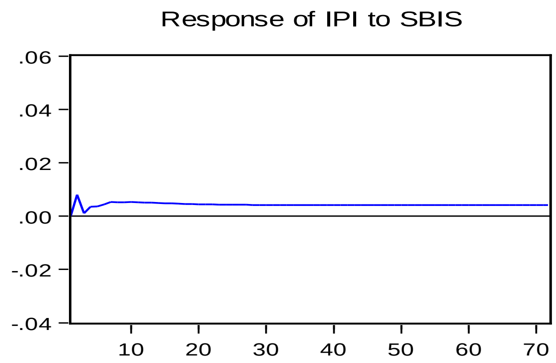


Figure 1 IPI's Response to Assets

IPI's response to SBIS shocks

In figure 3 IPI's response to SBIS below shows the effect of SBIS variable shocks on IPI. The shock to SBIS was responded positively by IPI with a standard deviation of 0.008022 at the beginning of the period and began to stabilize in the 41st period with a standard deviation of 0.004113. Then also the SBIS variable shock to SBIS responded positively with a standard deviation at the beginning of the period 0.252449 and began to stabilize in period 47 with a standard deviation of 0.652610. This means that based on existing data, SBIS variables have a significant impact on economic growth. In accordance with the results conducted by Marseto (2012) that SBI has a significant effect on economic growth. This is because the lower SBI interest rate will reduce the level of business risk and increase the amount of credit / financing so that the real sector will increase which will ultimately increase economic growth.



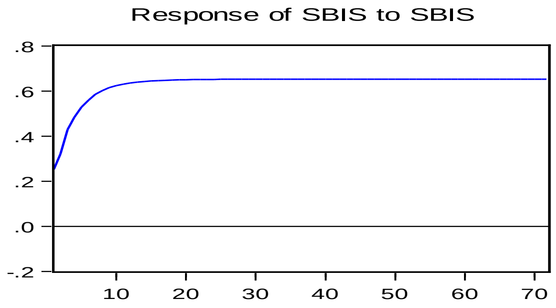


Figure 3. IPI's response to SBIS

Analisis Forecast Error Variance Decomposition (FEVD)

After looking at the current or future response of each variable due to changes or shocks from certain variables through *IRF, then we will see the characteristics of the model through* Forecast Error Variance Decomposition (FEVD), FEVD serves to predict the percentage contribution of each variable to shocks or changes in certain variables (Ascarya, 2009). The results of *Forecast Error Variance Decomposition* are as follows.

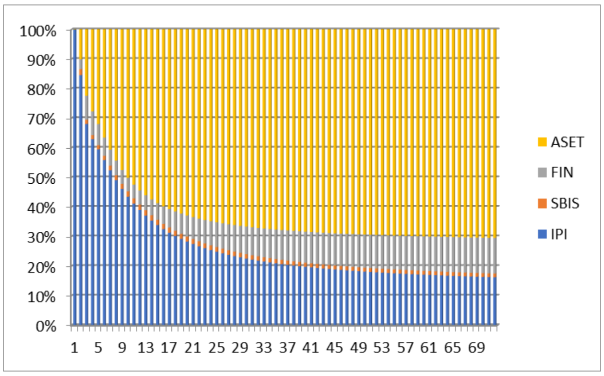


Figure 4. FEVD result of all variables in IPI

In Figure 4 of the FEVD results, all variables in the IPI below show that at the beginning of the shock period, the IPI is dominated by the IPI, which is influenced 100% by the IPI itself. Then in the second period there was a decrease in the influence of IPI to 84% until the end of the period continued to decline to 16%. *Financing* variables initially affect 3%, assets affect 10%, and SBIS affects 2%.

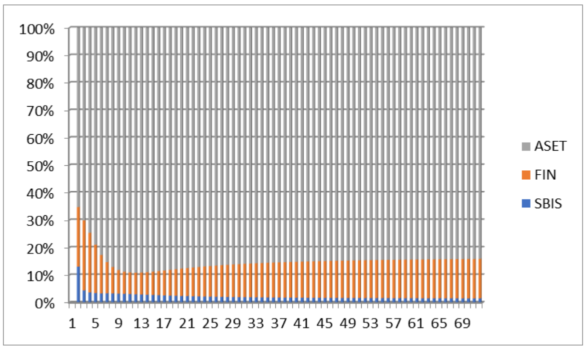


Figure 5. FEVD Results of Islamic Banking Variables

Then in Figure 5, the results of the FEVD of Islamic banking variables show that of the three existing variables, namely Assets, Financing, and SBIS, it is the Asset variable that has the most influence or contribution, followed by *the Financing variable*, then SBIS. In the initial period, the Asset variable has an influence of 10%. While variable *financing* contributed 3%, and SBIS 2%.

IV. CONCLUSION

The results of the *Impulse Response Function* (IRF) analysis show that the Asset variable is stable faster than the Financing and SBIS variables. Assets against IPI were able to stabilize in period 36, followed by SBIS in period 41 and *Financing* in period 48.

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