

**THE POTENTIAL OF ISLAMIC BANKING IN THE INDONESIAN ECONOMY**

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**ABSTRACT**

Islamic banking has the potential to have a significant impact on the Indonesian economy, by offering sharia-compliant financial solutions that promote financial inclusion and support the growth of small and medium enterprises (SMEs). This study aims to explore the potential of Islamic banking in the Indonesian economy by looking at its historical development, current status, and future prospects. The research methods used include a comprehensive literature review, case studies on the role of Islamic banks in financing SMEs, and an analysis of the regulatory and policy environment for Islamic banking in Indonesia. The findings reveal that the Islamic banking sector in Indonesia has experienced impressive growth, with financing growth surging by 18.8% in 9M22. However, the adoption of Islamic banking in the MSME sector is still relatively low, mainly due to the novelty of Islamic financial institutions and the weakness of MSMEs in meeting Islamic financing requirements. The research also highlights the role of Islamic finance in promoting financial inclusion, deepening financial inclusion not only by providing Shariah-compliant products to the Muslim community, but also by meeting the needs of the underserved Muslim community. The study emphasizes the importance of policy reforms and regulatory support in driving the growth of Islamic banking in Indonesia. In conclusion, the potential of Islamic banking in the Indonesian economy is considerable, offering valuable opportunities to promote financial inclusion and support SME growth. However, to fully capitalize on this potential, Islamic banks and financial institutions need to address the challenges and limitations that currently prevent them from effectively serving the MSME market.

**Keyword:** Islamic Banking; UMKM; OJK; Islamic Finance; Economic Growth

**1. Introduction**

Islamic banking is banking in which the bank adheres to Islamic principles and the teachings of the Quran. Islamic banking is one of the fastest growing aspects of financial institutions worldwide. Its origins can be traced back to 1963 when it first opened in Egypt. Islamic banks emerged and became mainstream in the global system, directly impacting the real economy. The growth of Islamic banking is supported by the Muslim population, and this is expected to be more than 25% of the world's population by 2030. In this period, it will likely increase to 6.2 million from 2.6 million in the US. In some European countries it may increase even more from 10% of the total population. Therefore, the Muslim population plays an important role in the development of Islamic financial institutions.

Islamic banking, also referred to as a financial system based on the principles of Islamic law, has gained significant attention in recent years as a potential tool to promote financial inclusion and support the growth of small and medium enterprises (SMEs) in many countries, including Indonesia. The Indonesian economy, which is the largest in Southeast Asia, has been actively working to develop its Islamic finance sector, with the aim of capitalizing on the potential benefits of this sharia-compliant financial system. This introduction will provide an overview of the Islamic banking landscape in Indonesia, highlighting its historical development, current status, and future prospects. This study aims to explore the potential of Islamic banking in the Indonesian economy by examining its historical development, current status, and future prospects. The novelty of this research is that it emphasizes the factors

that cause customer interest, especially the MSME sector, in choosing Islamic banking. Determinants such as service quality, mentoring, accessibility and financing products have a role not only limited to empowering the MSME sector, but can also be a promotional medium for Islamic banks. Thus, this study aims to provide valuable insights into the potential of Islamic banking in the Indonesian economy, as well as provide recommendations for policy reforms and regulatory support to encourage the growth of this sector.

## 2. Method

1. Literature review: A comprehensive review of the existing literature on Islamic banking in Indonesia, including academic papers, industry reports, and government publications, can provide valuable insights into the historical development, current status, and future potential of Islamic banking in Indonesia.

2. Case Studies: Examining specific case studies on the role of Islamic banking in financing small and medium enterprises (SMEs) in Indonesia can provide practical insights into the challenges and opportunities faced by Islamic banks in supporting the growth of the SME sector.

3. Policy Analysis: Studying the regulatory and policy environment for Islamic banking in Indonesia, including the role of the government and central bank in promoting Islamic finance, can provide valuable insights into potential policy reforms to support the growth of Islamic banking in Indonesia.

Using this combination of research methods, a comprehensive understanding of the potential of Islamic banking in the Indonesian economy can be achieved, and provide valuable insights for this journal.

## 3. Result and Discussion

### A. Contribution of Islamic Banking to Financial Inclusiveness

Islamic banking promotes financial inclusion by providing access to underserved populations. Its emphasis on microfinance, cooperative financing, and ethical investments offers customized financial products for individuals and communities that are excluded from the traditional banking system. Islamic banking has become an integral part of the global financial system and has contributed immensely in enhancing financial inclusion by providing access to financial services, especially in non-Muslim countries. A World Bank study shows that about 9% of the population excludes themselves from the formal financial system due to religious reasons, and Islamic finance can deepen financial inclusion not only because it provides sharia-compliant products for the Muslim community but also because it can meet diverse needs especially for minorities and vulnerable sectors. However, while physical access to financial services has grown more rapidly in Muslim countries, the use of these services has not increased as fast.

Islamic banking has contributed to financial inclusion in Indonesia, but the level of Islamic financial inclusion in Indonesia is still relatively low. According to a study, the percentage of Islamic financial inclusion in Indonesia was only around 0.89% in 2019, much lower than the financial inclusion rate in conventional banking. The study also found that Islamic financial inclusion in Indonesia is determined by demand and supply factors, as well as policies and regulations that significantly affect it. While Islamic banking has the potential to deepen financial inclusion by offering Shariah-compliant products to the Muslim community, it has not yet fully met the financial needs of the Muslim community in Indonesia. The low level of Islamic financial inclusion in Indonesia suggests that there is still room for the Islamic banking sector to contribute further to the country's overall financial inclusion efforts.

## **B. Impact of Islamic banking on the micro, small and medium enterprise sector**

Islamic banking has had some impact on the micro, small and medium enterprise (MSME) sector, but the impact is still limited to several aspects. Some of the contributions of Islamic banking to the MSME sector include:

1. **Financing opportunities:** Islamic banks offer Shariah-compliant financing solutions, such as Murabahah financing, to support MSMEs. This provides an alternative for MSMEs that cannot access conventional financing for various reasons, such as insufficient collateral or creditworthiness.
2. **Improved accessibility:** Islamic banks have been encouraged to provide easier terms and conduct business training and mentoring to improve access to finance for MSMEs. This has made Islamic banking more attractive to MSMEs, which often face challenges in obtaining financing from conventional banks.
3. **Credit risk management:** Islamic banks have proven to be more effective in managing the credit risk of their investments in medium-sized enterprises compared to conventional banks. This suggests that Islamic banking can contribute to the growth and sustainability of MSMEs by providing better credit risk management.

However, there are still several areas where Islamic banking can improve its impact on the MSME sector:

1. **Low adoption rate:** The adoption of Islamic banking in the MSME sector is still relatively low, mainly due to the novelty of Islamic financial institutions and the weakness of MSMEs in meeting the requirements of Islamic financing.
2. **Limited awareness:** Many MSMEs are unaware of the benefits of Islamic banking, and there is a need to raise awareness about the availability of Islamic financial products and services for MSMEs.
3. **Regulatory support:** The government and regulatory bodies need to provide stronger support for the development of Islamic banking in the MSME sector, such as simplifying regulations, providing tax incentives, and promoting the use of Islamic finance in sustainable development goals.

The impact of Islamic banking on the micro and small enterprise sector in Indonesia is a topic of increasing interest. Although Islamic banking is still relatively new in Indonesia, it has the potential to significantly influence the growth of micro, small, and medium enterprises (MSMEs) in Indonesia. A systematic literature review shows that Islamic financial practices positively influence the growth of MSMEs in Indonesia. However, there are several challenges, such as the dominance of conventional banks and the relatively low penetration of Islamic banking products in Indonesia, which is around 7%. In addition, lack of collateral and insufficient financing have limited access to external financing for micro enterprises in similar contexts, such as Malaysia. In addition, a case study observed that Islamic banks in Indonesia impose collateral requirements, which can pose challenges for MSMEs, especially those without assets that can be used as collateral. Despite these challenges, the potential of Islamic banking to foster MSME growth in Indonesia is recognized, and further research and efforts to address the specific needs of MSMEs in the context of Islamic finance are recommended.

## **C. Islamic finance solutions in supporting economic growth**

Islamic finance solutions have the potential to support economic growth in Indonesia. The Islamic finance industry has experienced an impressive annual growth rate of around 15% over the

past decade, with total volume projected to reach \$5.9 trillion USD by 2026. The global Islamic finance industry is emerging as a strong catalyst for economic development in several countries, including Indonesia.

In Indonesia, the Islamic finance industry has been growing rapidly. The total assets of Indonesia's Islamic financial industry increased to IDR 2,375.84 trillion or grew 15.87% year-on-year. The Financial Services Authority (OJK) released the Indonesia Islamic Finance Report, which provides valuable insights into the growth and trends of the Islamic finance industry in Indonesia. The report highlights the positive progress of the Islamic finance industry and encourages collaboration among stakeholders.

Islamic finance practices have been proven to positively influence the growth of micro, small and medium enterprises (MSMEs) in Indonesia. However, there are several challenges, such as the dominance of conventional banks and the relatively low penetration of Islamic banking products in Indonesia, at around 7%. Lack of collateral and insufficient financing have limited access to external financing for micro enterprises in similar contexts, such as Malaysia. In addition, a case study observed that Islamic banks in Indonesia impose collateral requirements.

Despite these challenges, the potential of Islamic banking to promote MSME growth in Indonesia is recognized, and further research and efforts to address the specific needs of MSMEs in the context of Islamic finance are recommended. In conclusion, Islamic finance solutions have the potential to contribute to economic growth in Indonesia by supporting MSME growth and promoting financial inclusion.

#### 4. Conclusion

Islamic banking has the potential to support economic growth in Indonesia by promoting financial inclusion and supporting the growth of small and medium enterprises (SMEs). The Islamic finance industry in Indonesia has experienced impressive growth, yet the adoption of Islamic banking in the MSME sector remains relatively low. Lack of collateral and insufficient financing have limited access to external financing for micro enterprises. Nevertheless, Islamic banking has been shown to positively influence the growth of MSMEs in Indonesia.

To fully utilize the potential of Islamic banking in the Indonesian economy, Islamic banks and financial institutions need to overcome the challenges and limitations that currently prevent them from effectively serving the MSME market. Future research needs to explore the critical factors affecting the supply and demand side of Islamic banking in Indonesia. In addition, policy reforms and regulatory support are essential to drive the growth of Islamic banking in Indonesia. Overall, Islamic financial solutions have the potential to contribute to Indonesia's economic growth, financial inclusion and development.

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