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Determinants of Financial Sector Performance on Economic Growth of Sharia and Conventional Banks: Case Study in OIC Countries

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Abstract

This research aims to analyze the influence of financial sector developments on the economic growth of sharia and conventional banking in twelve Islamic countries during the 2015-2022 period. This research uses panel data to provide empirical estimates involving 12 Islamic countries during the 2015-2022 period. We collected secondary data from the World Bank. The study's results indicate that the variables of interest rate, total assets of conventional banks, financing, and total assets of Islamic banks do not significantly impact economic growth. Meanwhile, the deposit variable has a negative effect, and the number of Islamic banks has a positive effect on economic growth. In the meantime, examining the impact of the sharia financial sector on economic growth reveals that the financing variables and the number of sharia offices significantly boost economic growth. The variable total assets of Islamic banks have no effect on economic growth. This study fills a research gap by investigating determinants of financial sector performance on sharia and conventional banks.

Keywords:
Finacial Sector; Total Aset; Islamic Bank; Economic Growth

Abstrak

Penelitian ini bertujuan untuk menganalisis pengaruh perkembangan sektor keuangan terhadap pertumbuhan ekonomi yang diproksikan dengan perhitungan GDP pada perbankan syariah dan konvensional di negara-negara Islam di dua belas negara Islam untuk periode 2015-2022. Penelitian ini menggunakan data panel untuk memberikan estimasi empiris yang melibatkan 12 negara Islam selama periode 2015-2022. Data sekunder dikumpulkan dari bank dunia. Hasil penelitian ini menunjukkan bahwa variabel suku bunga, total aset bank konvensional, pembiayaan dan total aset bank syariah tidak berpengaruh terhadap pertumbuhan ekonomi. Sementara itu, variabel simpanan berpengaruh negatif dan variabel jumlah bank syariah berpengaruh positif terhadap pertumbuhan ekonomi. Sementara itu, pengujian sektor keuangan syariah terhadap pertumbuhan ekonomi, variabel pembiayaan dan jumlah kantor syariah berpengaruh positif signifikan terhadap pertumbuhan ekonomi. Variabel total aset bank syariah tidak berpengaruh terhadap pertumbuhan ekonomi. Penelitian ini mengisi kesenjangan penelitian dengan menyelidiki determinan kinerja sektor keuangan pada bank syariah dan konvensional.

Kata Kunci:
Sektor Keuangan; Total Aset; Bank Islam; Pertumbuhan Ekonomi

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1. Introduction

One sector that can influence economic growth is the financial sector. The financial sector has played a strong and significant role in triggering economic growth in a country. According to the World Bank, an increasingly developed financial sector is believed to be able to encourage economic growth and reduce poverty. However, this recommendation still raises debate both theoretically and empirically. Debates primarily revolve around the relationship between the financial sector's development and economic growth. Specifically, the question arises as to whether the financial sector's development propels economic growth, or vice versa. The mostThe crisis in 1997-1998 was considered the most serious due to its multidimensional nature, spanning from economics to politics. a is the worst-hit country in the South Asia region (Budiono, 2016). And it will take four years for this economic growth to stabilize again. The resolution of this crisis took a very long time compared to other countries.

In general, economic growth in Indonesia always increases. World Bank data consistently shows Indonesia's economic growth, despite fluctuations in the growth percentage. However, the ups and downs remain within safe limits because they do not decrease significantly. There was a significant decline in 1998. At its peak in 1998, Indonesia's economic growth dropped to 13.13%. Riots in various countries accompanied the Asian financial crisis at that time. However, after that, Indonesia continued to experience good growth. Indonesia's economic growth in 2018 was 5.17%, or an increase of 0.11 from 2017. The economic crisis in 1997-1998 has provided lessons for us in Indonesia in responding to future crises. The subprime mortgage crisis in 2009 finally brought this memory to the forefront. During that period, Indonesia outperformed other countries, particularly those in Asia. The financial sector plays a crucial role in driving economic growth in Indonesia, enabling it to recover quickly.

Deposit mobilization is the most important service and an integral part of banking operations. In Ethiopia, the major task of banking is to mobilize savings through intense deposit collection. The financial sector, which includes banking, capital markets, and other non-bank financial institutions, plays an important role in a country's development. This is due to the financial sector's ability to mobilize capital from surplus funds for investment in various economic sectors that require financing. Based on the background described above and previous research, there are several differences in test results, including the independent variables used to measure financial growth, the different research years, and the different research objects used.

This research differs from previous studies in that it will take place in an Islamic country experiencing rapid economic growth. We chose the time period for this research from 2015 to 2022 to ensure its relevance and potential for future learning. According to the description above, several problem formulations in this research can be formulated as follows: What impact does the development of the overall financial sector, including both Sharia and conventional aspects, have on the economic growth of Islamic countries? What impact does the development of the Sharia financial sector have on economic growth in Islamic countries?

2. Literature Review

According to research by Baroroh (Baroroh, 2012), titled "Financial Sector Analysis on Regional Economic Growth in the Java Region: A Levine Approach," financial assets and financial credit positively impact GDP. Meanwhile, another study by Putra (Putra, 2016) has the title The Influence on the Development of Islamic Commercial Banks on Indonesia's Economic Growth for the 2010–2015 Period, with the result that the total assets of Islamic commercial banks have a positive or significant influence on the bound variable, namely the gross domestic product of the banking sector in Indonesia in 2010–2015.

The relationship between the financial sector and economic growth has become a significant area of research for conventional finance. Thus, Harrold Domar has developed numerous economic theories, ranging from classical to neoclassical, that explain the relationship between the development of the financial sector and economic growth. Harrold Domar's theory of economic growth uses the assumptions of a closed economy: the desire to save is constant, the production process has a fixed coefficient, and the growth rate of the workforce is constant. Then this theory states that, in order to grow, each economy must save and invest a certain share of GDP. Therefore, the more GDP saved, the higher the productivity of the economic growth rate.

Economic growth is the main measuring stick for assessing the development of an economy and a country. The very high growth of an economy reflects the development of economic activities. According to Zumaidah, economic growth is a process of increasing per capita output in the long term. Economic growth refers to the expansion of economic activities that consistently lead to an increase in the production of goods and services in society, thereby enhancing the welfare of society. We can view the issue of economic growth as a long-term macroeconomic problem. An increase in production factors typically does not lead to a corresponding increase in the production of goods and services. The increase in production potential is often greater than the actual increase in production. Thus, economic development is slower than its potential.

In general, the financial system carries out the following functions in the development of the financial sector: (i) collecting savings; (ii) allocating capital to productive investment; (iii) monitoring investment, diversification if there is risk, and exchange of goods and services. In the scope of economic policy, the financial sector is a means of transmitting monetary policy. Therefore, the financial sector's experience of shock influences the effectiveness of monetary policy.

Hypotheses

Real deposits contribute to economic growth. Therefore, a decrease in the real deposit rate will result in a corresponding decrease in the demand for real money and the supply of real credit. Additionally, the attractive deposit interest rate attracts individuals seeking to invest their capital in deposit deposits. Deposit interest rates provide a rate of return on funds deposited within a specific timeframe. In an effort to attract public interest, the bank competes to raise funds from the public in various ways, including offering higher interest rates on deposits, improving services, issuing prized products, and so on. Thus, deposits can contribute significantly to the economic value of each country. The hypothesis of this research is based on the problem formulation, theoretical basis, and literature review that have been explained.

H_1: The deposit variable has a positive effect on economic growth

The amount of mudarabah deposits is also influenced by the service factor of Islamic banks, specifically the number of Islamic bank offices. An increase in Islamic bank offices will facilitate the placement of funds in Islamic banks, particularly in mudharabah deposit products. That way, the more people will intend to allocate their funds in Islamic banding, it will also affect the growth of assets in Islamic banking, thereby also increasing economic growth in a country. Based on the problem formulation, theoretical basis, and literature review that have been explained, the hypothesis of this research is as follows:

H_2: The variable total number of Islamic banks has a positive effect on economic growth

An economy can use interest rates as a tool to control the supply and demand of money circulating. In addition, raising interest rates is the main tool for central banks to fight inflation. Raising interest rates will lead to a decrease in the amount of money in the community, which in turn will lead to a decrease in economic activity. The opposite will happen. Falling interest rates will make borrowing costs more affordable. This will encourage investors to expand their businesses and boost consumer spending. Thus, economic output will increase. The hypothesis of this research is based on the problem formulation, theoretical basis, and literature review that have been explained.

H_3: The interest rate variable has a positive effect on economic growth

For many people, especially those in Islamic nations who are looking to invest their money, the banking industry is still a faraway dream. The research on the composition of financial assets, notably in Indonesia, reveals that banks are responsible for around 78% of the total assets. This statement is particularly relevant in Indonesia. Obviously, banking makes it possible for the government to exert easy control over the economy, including the ability to finance operations carried out by businesses.

In addition, financing in Islamic banking is at the forefront of reducing informal finance. The large deposit ratio in conventional banking also demonstrates Islamic banking's commitment to driving the real sector. By implementing the profit-sharing system, a bank, particularly Islamic banking, becomes more resilient to economic challenges, thereby influencing economic growth. The hypothesis of this research is based on the problem formulation, theoretical basis, and literature review that have been explained.

H_4: The variable number of Sharia Bank Offices has a positive effect on economic growth

Assets are a source of economic growth that can be expected to provide business benefits in the future. Banking assets are all rights owned and used in the operation of commercial banks, such as buildings, cars, patents, and others. According to Adiyadnya (2016), when a person's consumption and investment patterns increase, it can be said that the person's income rises and is getting higher. This will lead to positive economic growth. The hypothesis of this research is based on the problem formulation, theoretical basis, and literature review that have been explained.

H_5: The variable Total Assets of Sharia banks has a positive effect on economic growth

3. Method

This study employs a quantitative methodology, utilizing secondary data. Researchers can interpret the population as a generalization of subjects with specific qualities and characteristics, enabling further study. The population under study in this research comprises Islamic countries within the Organization of Islamic Cooperation during the period of 2015-2022. The sample encompasses the number, characteristics, and representatives of the population under investigation (Arikunto, 2013).

Purposive sampling is a technique that takes into consideration and adapts itself based on particular parameters, as stated by Sugiono (2011). For the purpose of this investigation, we have selected samples based on the following criteria: 1. membership in the Organization of Islamic Cooperation; 2. the Islamic nation with the highest level of technological advancement; and 3. the Islamic nation with the largest gross domestic product. Twelve Islamic nations, including Qatar, the United Arab Emirates, Kuwait, Brunei Darussalam, Bahrain, Saudi Arabia, Oman, Turkey, Iran, Egypt, Indonesia, and Malaysia, will participate in this research. The sample criteria that were presented earlier will be used to choose which nations will participate.

4. Result and Discussion

During the course of this investigation, we made use of secondary data obtained from a variety of sources, such as reports that were released by Bank Scope and financial reports by each bank in Islamic countries. Panel data, which covers the years 2011-2018 and includes 12 Islamic nations, is the form of data that is utilized on this project. The objective of this study is to ascertain the extent to which conventional and sharia-compliant financial sectors have an impact on the expansion of the economy. The specific impact that the Islamic finance sector has on the expansion of the economy is another thing that we are aware of. Following the completion of these two steps of testing, we are able to make the observation that the application of FEM continues to be consistent. For the purpose of providing an explanation for the findings obtained from panel data estimate in both the Islamic and conventional finance sectors, we will make use of the estimation results obtained from the fixed effect model.

The analysis yielded statistics of 4.1205, a probability value of 0.000, and a significant alpha of 5%, indicating the acceptance of H_1 and the rejection of H_0. From these calculations, the correct model to use is the fixed effect model. Next, we continue the Hausman test by selecting either the random effect or the fixed effect. Researchers can see that the resulting probability value is 0.00, or smaller than alpha 5% (0.05). Thus, we can conclude that the fixed-effect model is the right one to use.

Following the completion of these two steps of testing, we are able to observe that the utilization of FEM is constant. For the purpose of providing an explanation for the findings obtained from panel data estimate in both the Islamic and conventional finance sectors, we will make use of the estimation results obtained from the fixed effect model.

Table 1. fixed effect model result

Dependent: Pertumbuhan Ekonomi

Variables	Coefficient	Std. Error	t-Statistics	Prob.
C	-3.133385	4.255640	-0.736290	0.4638
SB	0.729363	0.416666	1.750473	0.0840
DEP	-0.045513	0.020802	-2.187964	0.0317
LOG(TABK)	-0.000224	0.000705	-0.317969	0.7514
LOG(JKBS)	0.003994	0.001798	2.222029	0.0292
LOG(PS)	0.007148	0.005770	1.238985	0.2191
LOG(TABS)	-0.005107	0.053820	-0.094883	0.9247
R-squared	0.435452	Mean dependent var		3.557601
F-statistic	3.539034	Durbin-Watson stat		2.171181
Prob(F-statistic)	0.000069			

In this research, we can see that in Table 5, the p-value of interest rates is 0.08, or greater than alpha 0.05 (5%), with a coefficient of 0.72. This means that the interest rates provided by conventional banking statistically do not have a positive effect on economic growth.Meanwhile, the panel data results, proxied by the deposit variable provided by conventional banking and shown in Table 5, indicate a resulting coefficient of -0.04, a p-value of 0.03, and a smaller alpha of 0.05 (5%). According to the estimation results presented in Table 5, there is no significant impact of total assets in conventional banking (LnTABK) on economic growth in Islamic countries. This conclusion is based on the p-value of 0.75, which indicates it does not have a positive influence.

The estimation results, as shown in Table 5, indicate that Sharia bank offices (LnJKBS) have an impact on economic growth. This conclusion is based on the p-value of 0.02, which is smaller than alpha 0.05 (5%). While the coefficient is 3.06, The financing variable in sharia banking (LnPS), based on the estimates in Table 5, apparently does not have a positive effect on economic growth. The coefficient results indicate a value of -0.48, and the p-value is 0.77, which is greater than 0.05 (5%). Meanwhile, when we tested the impact of the sharia financial sector alone on economic growth, we found that the sharia financing variable actually had a positive influence on economic growth in Islamic countries. This conclusion is based on the p-value of 0.00, which is smaller than alpha 0.05 (5%). While the coefficient is 0.01.

Observations have shown that the variable total Islamic banking assets does not have any impact on the rate of economic growth in Islamic nations. As a result, we can see from Table 5 that the probability value of total Sharia banking assets is 0.92, which is higher than the alpha value of 0.05 (5%), and the coefficient is -0.48. According to the results of the regression analysis of the sharia financial sector on economic growth, which is presented in Table 6, the total assets held by sharia banking institutions do not have a statistically significant negative impact on economic growth. It can also be deduced from this conclusion that the decrease in total sharia banking assets did not have any impact on the expansion of the economy in Islamic nations.

In this research, the first variable is interest rate. Based on the results of the overall regression analysis (conventional and sharia financial sectors), it can be seen that interest rates have no effect on economic growth in Islamic countries. As in a study conducted by Malick (2018), the key component of monetary policy in overcoming the problem of poverty is the availability of credit in the business sector. Therefore, low credit interest rates or zero interest rates will encourage people to invest.

The second variable is deposits. Based on the overall regression results, in this study deposits in conventional banking actually have a negative influence on economic growth in Islamic countries. The findings contradict the researchers' hypothesis. This contradicts the theory, which asserts that deposits promote economic growth. This research aligns with Grassa's (2013) findings, which suggest that the total deposit ratio has no bearing on economic growth.

The third variable is the "total assets" variable in conventional banking. Based on the results of the regression analysis, in this study, total assets in conventional banking have no effect on economic growth in Islamic countries. Researchers suspect that several Islamic countries have implemented numerous Islamic banking systems, leading Muslim-majority communities to shift their financial investments to sharia-compliant banking.

Following that, the number of sharia bank offices is the fourth variable that will be considered. According to the findings of the comprehensive regression research, the number of sharia bank offices has a considerable and favorable impact on the expansion of the economy. Researchers have a strong suspicion that a significant number of Islamic bank offices in Islamic countries have created and enlarged their network of branch offices and sub-branches in order to reach all segments of society.

The fifth variable is financing, which comes next. For Islamic nations, the results of the total regression analysis (both conventional and sharia) indicate that sharia banking funding does not have any impact on the rate of economic growth. In this particular instance, experts have a strong suspicion that the financing in Islamic countries that is given by sharia banking has not been successful in decreasing poverty. In contrast to the findings of Setiawan's (2017) study, which found that sharia banking in terms of funding had an impact on the reduction of poverty in Indonesia, this result contradicts those findings.

In Malaysia, the household financing sector receives the majority of sharia financing products, amounting to RM 312.2 billion, while the construction sector follows with RM 29.49 billion. In contrast, the agricultural sector received only RM 14.39 billion in sharia financing products. Therefore, the proportion of products eligible for capital participation is extremely low. However, the regression results for the Islamic financial sector demonstrate a significant positive impact on economic growth. Researchers suspect that the estimation results indicate a positive impact of sharia banking financing on poverty reduction, implying that a reduction in neediness leads to an increase in economic growth in a country (Setiawan, 2017). The last variable is total sharia banking assets. The regression analysis results indicate that total sharia banking assets do not negatively impact economic growth.

According to the findings of the researchers, there appears to be a concern with the decreasing expansion of total sharia banking assets across the world. Working data from the International Financial Services Board (IFSB) Secretariat indicates that the total assets held by sharia banks in 2018 amounted to USD 1,571.3 billion. In the meantime, the growth of sharia banking around the world reached 10% in 2016. In 2017, there was a 9.6% decrease in the growth of sharia banking businesses around the world. In 2018, it saw yet another decline, this time to 7.2%.

5. Conclusion

The development of the sharia financial sector in 12 Islamic countries over an 8-year period, from 2011 to 2018, has significantly contributed to economic growth in these countries. When combined with the conventional banking sector, the sharia financial sector actually contributes more to economic growth. This is because the role of sharia banking in contributing to economic growth is still lacking. Researchers suspect that the high level of financing that has been disbursed is not comparable to the funds collected by a bank. In the long run, it will affect sharia banking's total assets, making it insufficient to boost economic growth.

In the meantime, the findings tend to contribute more to the expansion of the economy in Islamic nations when researchers examine the conventional and sharia sectors combined, or if they are not separated apart. This might be attributable to the fact that conventional bank indicators continue to contribute to the expansion of the economy. In contrast to the findings of a study that was carried out roughly four years ago, which stated that the conventional and sharia financial sectors did not have a full contribution to economic growth, this finding contradicts those findings altogether. In this particular instance, the role of conventional banking continues to contribute to the expansion of the economy. When the outcomes of the traditional financial sector are examined, it is found that the role of deposits and interest rates continues to contribute to the expansion of the economy. For example, sharia banks should be able to provide finance for BMT development projects or other productive areas in order to stimulate economic growth. This would allow them to contribute to the expansion of the economy.

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