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Islamic Banking and Economic Growth: A Case Study in Indonesia

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Article Info	Abstract
Received: 13-01-2025 Accepted: 20-03-2025 Published: 23-03-2025 **Keywords:** Sharia Banking; Economic Growth; GDP; Total Assets; Total Financing; Total Deposits; VECM	This research analyzes the influence of total assets, total financing, and total sharia banking deposits on economic growth in Indonesia, as measured by Gross Domestic Product (GDP). Secondary data is used from the first quarter of 2015 to the last quarter of 2023, using the Vector Error Correction Model (VECM) method to identify long-term and short-term relationships between these variables. The research results show that total Islamic banking assets have a positive and significant effect on GDP in the long term, but have a negative effect in the short term. Total financing does not show a significant effect in the short term and even has a negative impact in the long term. On the other hand, total deposits have a significant positive effect on GDP in the long term. These findings highlight the importance of efficiency in asset management and Sharia banking financing as well as the need for policies that support stability and public trust in Sharia banking. The contribution of this research lies in providing empirical evidence regarding the role of Islamic banking in Indonesia's economic growth, especially through the analysis of the long-term and short-term relationship between total assets, total financing, and total deposits to GDP. These findings enrich the literature regarding the effectiveness of sharia banking in the national financial system and provide implications for policies aimed at increasing the efficiency of asset management and sharia financing. In addition, this research provides insight for regulators and banking practitioners in designing strategies that can increase the contribution of Sharia banking to the economy in a sustainable manner.
Info Artikel	**Abstrak**
Kata Kunci: Perbankan Syariah; Pertumbuhan Ekonomi; PDB; Total Aset; Total Pembiayaan; Total Deposito; VECM.	Penelitian ini menganalisis pengaruh total aset, total pembiayaan, dan total deposito perbankan syariah terhadap pertumbuhan ekonomi di Indonesia, yang diukur melalui Produk Domestik Bruto (PDB). Data sekunder digunakan dari kuartal pertama 2015 hingga kuartal terakhir 2023, dengan menggunakan metode Vector Error Correction Model (VECM) untuk mengidentifikasi hubungan jangka panjang dan jangka pendek antara variabel tersebut. Hasil penelitian menunjukkan bahwa total aset perbankan syariah berpengaruh positif dan signifikan terhadap PDB dalam jangka panjang, namun berpengaruh negatif dalam jangka pendek. Total pembiayaan tidak

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menunjukkan pengaruh signifikan dalam jangka pendek dan bahkan berdampak negatif dalam jangka panjang. Sebaliknya, total deposito berpengaruh positif signifikan terhadap PDB dalam jangka panjang. Temuan ini menyoroti pentingnya efisiensi dalam pengelolaan aset dan pembiayaan perbankan syariah serta perlunya kebijakan yang mendukung stabilitas dan kepercayaan masyarakat terhadap perbankan syariah. Kontribusi penelitian ini terletak pada penyediaan bukti empiris mengenai peran perbankan syariah dalam pertumbuhan ekonomi Indonesia, khususnya melalui analisis hubungan jangka panjang dan jangka pendek antara total aset, total pembiayaan, dan total deposito terhadap PDB. Temuan ini memperkaya literatur terkait efektivitas perbankan syariah dalam sistem keuangan nasional serta memberikan implikasi bagi kebijakan yang bertujuan meningkatkan efisiensi pengelolaan aset dan pembiayaan syariah. Selain itu, penelitian ini memberikan wawasan bagi regulator dan praktisi perbankan dalam merancang strategi yang dapat meningkatkan kontribusi perbankan syariah terhadap perekonomian secara berkelanjutan.

INTRODUCTION

In recent decades, the role of the financial sector in economic development has become a major concern in various countries. A strong and stable financial sector contributes to increased investment, job creation, and sustainable economic growth (Ayyubi et al., 2017; Demirguc-Kunt et al., 2003; Love, 2003). The existence of an efficient financial system not only enables the mobilization of funds from the community, but also encourages economic activity through financing provided to the real sector (Bahri & Vinni, 2023). Therefore, the increasing development of the financial sector, both conventional and sharia-based, has become an important factor in supporting financial inclusion and accelerating the acceleration of economic growth in various parts of the world (Goldsmith, 1959; Gurley & Shaw, 1955).

In developing countries, such as Indonesia, the role of the financial sector is increasingly prominent in supporting various economic sectors, especially micro, small and medium enterprises (MSMEs). As the backbone of the national economy, MSMEs are highly dependent on access to financing to develop their businesses. In this case, the existence of banking, both conventional and sharia, is an important element in creating an inclusive financial ecosystem. Furthermore, Islamic finance is increasingly attracting attention because of its principles based on justice, transparency and balance in economic transactions, which have the potential to provide more stable financial solutions than conventional financial systems (Cevik & Charap, 2011).

Not only limited to Muslim-majority countries, the development of sharia finance is also starting to be adopted in various parts of the world, including Europe and America. Increasing awareness of the importance of ethical and sustainable finance has encouraged many countries to develop sharia-based financial instruments (Abduh & Azmi Omar, 2012; Chowdhury et al., 2018; Kassim, 2016; Rahmawati & Martika, 2018; Zaini et al., 2019). Various studies show that the Islamic financial system has great potential in supporting economic growth by offering a more stable business model and more diversified risks than the conventional financial system. In addition, sharia banking products, such as profit sharing-based financing and investments that comply with sharia principles, are increasingly in demand by the public because they are considered fairer and more transparent (Olson & Zoubi, 2008).

At a more macro level, the financial sector plays a vital role in supporting real economic development, both at the domestic and global levels (Ayyubi et al., 2017; Demirguc-Kunt et al., 2003; Love, 2003). As an intermediation institution, the financial sector functions in mobilizing community savings to be allocated to productive projects (Hasyim, 2016; Rama, 2013). In this context, Islamic finance also has the advantage of ensuring that the financing provided is oriented to the real sector and not to speculative transactions. This is in line with the views of Schumpeter & Swedberg (2021), who state that increasing entrepreneurial productivity can be achieved through access to credit which enables new production techniques and innovation. Thus, the financial sector not only plays a role in job creation, but also in encouraging productivity and innovation, which will ultimately contribute to sustainable economic growth and development (Bahri & Vinni, 2023; Goldsmith, 1959; Gurley & Shaw, 1955).

Gross Domestic Product (GDP) is the market value of all final goods and services produced in a country in a certain period. In this case, GDP is often used as the main indicator of a country's economic health as well as reflecting the size of a country's economy and economic growth.

Nowadays, attention to the Islamic financial sector is increasing frequently with projected asset growth which is estimated to reach $5,955 trillion in 2025/2026, an increase of 49.4% compared to 2021/2022. The role of Islamic banking in the financial sector in supporting economic growth continues to grow rapidly, by expanding its assets and reaching various countries (Abduh & Azmi Omar, 2012; Chowdhury et al., 2018; Kassim, 2016; Rahmawati & Martika, 2018; Zaini et al., 2019).

In the context of the development of the sharia financial sector, attention to indicators such as total assets, financing and deposits in sharia banking is crucial. Total assets in Islamic banking are defined as all assets owned by a Islamic bank, including cash, investments, financing provided, and other assets. In this case, total assets in Islamic banking reflect the bank's financial strength and capacity to provide financing and investment in economic projects (Olson & Zoubi, 2008).

Meanwhile, total financing refers to the amount of funds distributed by Islamic banks to customers in the form of financing, both for consumption and investment (Demirguc-Kunt et al., 2003; Dusuki, 2008; Hanif, 2011). Meanwhile, total deposits refer to funds deposited by customers in Islamic banks as well as being one of the main sources of funds for Islamic banks to carry out their operations in providing financing (Ali & Sarkar, 1995; Demirguc-Kunt et al., 2003).

These three components have significant implications for GDP. An increase in total assets allows Islamic banks to expand financing capacity, which in turn increases real sector productivity (Srairi, 2010). Meanwhile, total financing supports the growth of small and medium enterprises (MSMEs), which are the backbone of the Indonesian economy and with easy access to financing, MSMEs will continue to grow and contribute more to GDP (Kayed & Hassan, 2011). Meanwhile, increasing total deposits provides greater liquidity for banks to support investment. The higher the deposits, it shows the public's trust in sharia banking and ensures that the bank has enough funds to channel it as productive financing (Cevik & Charap, 2011).

In Indonesia, the sharia banking industry shows significant growth (Wahyudi et al., 2024). According to the State of the Global Islamic Economy Report 2023, Indonesia is ranked 7th in terms of sharia finance. Meanwhile, inside Islamic Finance Development Index, Indonesia is ranked 3rd with the highest score on education indicators. This positive growth reflects increasing public interest in financial products and services that comply with sharia principles (Solé, 2007; Wahyudi et al., 2024).

According to data from the Financial Services Authority (OJK) in May 2023, total assets in sharia banking in Indonesia experienced growth of 15.63%, reaching 15.63% to 802 trillion rupiah (Kartika & Maulidya, 2021). This increase is in line with the increase in total financing and deposits, which not only strengthens sharia banking capacity but also has the potential to contribute significantly to national GDP growth (Abduh & Azmi Omar, 2012; Kassim, 2016).

Although many studies have highlighted the contribution of the Islamic financial sector to the economy, most studies focus more on qualitative analysis or specific aspects of Islamic banking in certain countries. The lack of comprehensive research regarding the direct influence of total assets, financing and deposits of Islamic banking on GDP in Indonesia has created a significant gap in the literature. For example, research (Abduh & Azmi Omar, 2012; Rahmawati & Martika, 2018) identifies a positive relationship between Islamic banking and economic growth, but does not explicitly outline the impact of these three main indicators on overall GDP.

The aim of this research is to provide an empirical analysis of the influence of total assets, total financing and total deposits in Islamic banking on GDP in Indonesia. The quantitative approach used to measure the comprehensive impact of these three indicators simultaneously will provide new insights that are useful for policy makers and financial practitioners in optimizing the role of sharia banking. Specifically, this research aims to examine the short-term and long-term relationship between Islamic banking variables and economic growth, as well as identifying obstacles and opportunities for further development. The following sections will outline the methodology, present empirical results, discuss findings, and summarize policy implications and future research directions. Given the increasing role of Islamic banking in Indonesia's financial system, understanding its impact on economic growth is critical to ensuring sustainable development.

RESEARCH METHOD

This research uses secondary data in the form of data time series and starting from the first quarter of 2015 to the last quarter of 2023 (2015Q1 – 2023Q4). Economic growth data is obtained from the Central Statistics Agency (BPS), while data on total assets, total financing and total deposits comes from Sharia Banking Statistics published by the Financial Services Authority (OJK).

The endogenous variable in this research is economic growth which is proxied by Gross Domestic Product (GDP). Meanwhile, the exogenous variable used is Sharia Bank with proxies for total assets, total financing and total deposits. To more easily understand the variables and proxies used can be seen in table 1 below:

Table 1. Operational Definition of Variables

Symbol	Variable	Proxy.
In(PDB)	Economic growth	Logarithm of Indonesia's GDP with expenditure approach
In(TA)	Total Assets	Logarithm of total Indonesian sharia banking assets
In(TP)	Total Financing	Logarithm of total Indonesian sharia banking financing
In(TD)	Total Deposits	Logarithm of total Indonesian sharia banking deposits

Source: Author (2024)

This research aims to determine the long-term relationship of the Islamic financial sector (total assets, total financing and total deposits) on economic growth in Indonesia in the short and long term. The data analysis method used is quantitative descriptive. The analytical tool used in this research is Vector Error Correction Model (VECM). The stages in this analysis are stationary test, optimum lag test, VAR stability test, and cointegration test. The following is the model used in this research.

RESULTS AND DISCUSSION

Stationarity and Cointegration Analysis

Stationary tests are needed in research with time series data which aims to avoid false regressions. Therefore, a stationarity test using the Phillips-Perron approach was carried out in this study. Based on table 1, it can be seen that none of the research data is stationary at the level and all of it is stationary at the first difference level. The stationarity results show that the requirements for using VECM analysis have been achieved, but cointegration testing must be carried out first.

Tabel 1. Stationarity Test

	Variable	T-Statistics	Probability	Information.
FACING	At Level	-0.772814	0.8144	Not Stationary
	First Different	-1.017.861	0.0000	Stationary
City	At Level	-1.098.497	0.7054	Not Stationary
	First Different	-6.334.640	0.0000	Stationary
TD	At Level	-1.760.887	0.3930	Not Stationary
	First Different	-6.951.840	0.0000	Stationary
PDB	At Level	-0.702026	0.8333	Not Stationary
	First Different	-5.428.108	0.0001	Stationary

Source: Processed data (2024)

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The Cointegration Test was applied in this research using an approach Johansen Cointegration Test which can be seen in table 2. Based on table 2, it can be concluded that the variables total assets, total financing and total deposits have a long-term relationship with economic growth. This can be seen in the probability value of 0.0171 smaller than 0.05.

Table 2. Cointegration Test

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.** Critical Value
None *	0.557945	5.251.352	4.785.613	0.0171
At most 1	0.400016	2.557.492	2.979.707	0.1419
At most 2	0.226524	8.716.771	1.549.471	0.3922
At most 3	0.007257	0.240364	3.841.465	0.6239

Source: Processed data (2024)

These results are in line with research by (Abduh & Azmi Omar, 2012), which states that sharia banking can contribute to economic growth in the long term. However, these results are different from the findings of (Cihak & Hesse, 2010), who argue that the effectiveness of Islamic banking is very dependent on regulations and the efficiency of financing allocation.

Short-Term and Long-Term Impact of Islamic Banking on GDP

The results of VECM estimation in the short term using lag 2 which can be seen in table 3 show that total assets have a negative and significant effect with the T-Statistics > T-Table value showing the number 2.08110 > 2.03. Meanwhile, the financing and deposit variables have a T-Statistics value < from the T-Table with numbers 0.40939 < 2.03 and -0.98009 < 2.03 which indicates that total financing and total deposits have no effect on GDP. Meanwhile, it is known that the Cointeq1 coefficient value is -0.193136 and is significant, meaning that in this model there is an adjustment mechanism from the short term to the long term. Therefore, it can be concluded that the error in each quarter will be corrected by 19.31% to achieve the optimal economic growth target

Table 3. Short Term VECM Estimates

Variable	Coefficient	T-Statistics
Cointeq 1	-0.193136	[-3.53958]
D(ASSET(-1))	-0.531634	[-2.08110]
D(FINANCE(-1))	0.061040	[0.40939]
D(DEPOSIT(-1))	-0.212113	[-0.98009]

Source: Processed data (2024)

These results indicate that although sharia banking assets have increased, the impact on economic growth is not immediately visible. According to (Atici, 2018), Islamic banking tends to be more stable but its growth is slower than conventional banking, so it takes time to show an impact on GDP.

On the other hand, Table 4 is the result of VECM estimation in the long term which shows that the total assets variable has a positive and significant effect on GDP with a T-Statistic value > T-Table with the number 3.22621 > 2.03. Meanwhile, total financing has a negative and significant influence on GDP with a T-Statistics value > T-Table with the number 5.46884 > 2.03. Then the deposit variable has a positive and significant influence on GDP with a T-Statistics value > from T-Table with the number 3.39375 > 2.03.

Table 4. Long Term VECM Estimates

Variable	Coefficient	T-Statistics
ASSET(-1)	-1.438.618	[-3.22621]
FINANCE(-1)	1.955.433	[5.46884]
DEPOSIT(-1)	-1.992.237	[-3.39375]
C	4.859.049	

Source: Processed data (2024)

These results indicate that in the long term, increasing assets and deposits in Islamic banking contributes to economic growth. According to (Srairi, 2010), increasing total assets allows Islamic banks to expand productive financing, which in the long term will have a positive impact on economic growth.

However, the finding that total financing has a negative impact in the long term is controversial. (Beck & Levine, 2004) stated that financing that is not managed efficiently can increase credit risk, thereby suppressing economic growth. (Cihak & Hesse, 2010) also added that sharia banking often faces challenges in allocating financing optimally due to the limitations of sharia-based financial products.

Policy Implications and Future Considerations

Based on the results above, total assets have a significant positive impact on long-term economic growth in Indonesia. Total Islamic banking assets in the country have grown by more than 10% in the last four years. This increase creates great opportunities for Islamic banking to provide working capital and investment financing to MSMEs, which play an important role in their contribution to Indonesia's GDP. In the latest report, the amount of financing increased to IDR 95,410 billion, up 37.21% from 2020.

However, Islamic banking does not show a significant impact on economic growth in the short term. This is because the size of the sharia banking market is still small in Indonesia, only reaching 7.09% of the total banking market, much lower than conventional banking which reaches 92.91%. This finding is consistent with previous research which highlights the vital role of Islamic banking in supporting the country's economic growth (Abduh & Azmi Omar, 2012; Atici, 2018; Gani & Bahari, 2021; Rafay & Farid, 2017).

Meanwhile, total financing and total deposits do not show a significant effect in the short term. This may indicate that over a short period of time, changes in financing and deposits have not been sufficient to show a real impact on GDP. This result is in line with several literatures which state that the impact of financing and deposits on economic growth usually takes longer to materialize (Demirguc-Kunt et al., 2003; Beck & Levine, 2004).

However, in the long term, total financing shows a negative and significant influence on GDP. This could be caused by several factors, such as higher credit risk or less efficient financing allocation. Previous research also shows that although financing has the potential to increase economic growth, there are risks and challenges that must be managed properly (Cihak & Hesse, 2010).

Meanwhile, total deposits show a positive and significant influence on GDP. Higher deposits indicate greater liquidity, which allows banks to have more freedom in providing financing. High public trust in Islamic banking also means that banks have sufficient funds to support various economic projects (Cevik & Charap, 2011).

This research provides several important policy implications. *First*, there is a need to increase efficiency in asset management and financing in Islamic banks. Islamic bank managers must be more selective in providing financing to reduce credit risk and increase resource allocation to more productive sectors (Srairi, 2010; Cihak & Hesse, 2010). *Second*, the increase in deposits must be balanced with an effective strategy to allocate these funds to productive investments. Regulations and policies that support stability and public trust in Islamic banking also need to be improved (Ali & Sarkar, 1995). *Third*, this research shows that Islamic banking has great potential to contribute to economic growth, but it needs to be supported by appropriate policies so that the impact can be more optimal (Kayed & Hassan, 2011).

CONCLUSION

This research shows that total Islamic banking assets have a significant positive impact on long-term economic growth in Indonesia. However, in the short term, total assets actually show a significant negative impact, which is likely caused by the initial adjustment process in asset allocation before making a real contribution to economic growth. In addition, total financing does not show a significant effect in the short term and even has a negative impact on GDP in the long term. Meanwhile, total deposits have a positive and significant impact on economic growth in the long term, indicating that increasing deposits can strengthen sharia banking liquidity and increase long-term financing capacity.

Although providing valuable insights, this study has several limitations that need to be noted. First, the data used in this study only covers the quarterly period from 2015 to 2023, which may limit the generalizability of the findings, especially in capturing broader long-term trends in the development of Islamic banking in Indonesia. Second, this research only considers total assets, total financing, and total deposits as the main variables in determining the impact on GDP. Other factors such as monetary policy, macroeconomic stability, inflation rates, and financial regulations can influence the relationship between Islamic banking and economic growth but are not included in the model. Third, the method used in this research is Vector Error Correction Model (VECM), which although effective in capturing dynamic relationships between variables, still has limitations in explaining causal mechanisms in more depth. Other approaches like Generalized Method of Moments (GMM) or Structural Equation Modeling (SEM) can provide a broader understanding of the impact of Islamic banking on economic growth. In addition, external factors such as fiscal policy and the development of global Islamic banking are also not included in the analysis, so the results of this research must be interpreted by considering the possible influence of these external factors.

Based on these limitations, it is recommended that further research extend the observation period in order to capture broader economic cycle trends and analyze the impact of policy changes in the long term. In addition, future studies also need to include other macroeconomic variables, such as inflation, interest rates, consumer confidence index, or fiscal policy, to understand a more comprehensive influence on the relationship between Islamic banking and economic growth. In terms of methodology, further research can use this approach panel data econometrics, machine learning forecasting, or GMM estimation to get more robust results. In addition, considering the important role of regulations in the sharia financial sector, further exploration of the impact of policies such as tax incentives, sharia financial literacy programs, or harmonization of regulations between sharia and conventional banking also needs to be carried out.

Academically, this research makes an important contribution in enriching the empirical literature regarding the relationship between Islamic banking and economic growth in Indonesia. Use of methods VECM This research allows simultaneous analysis of short-term and long-term relationships, which can be a reference for further research in the field of Islamic finance. From a policy perspective, the results of this research can be a basis for policy makers in designing more effective regulations to increase the role of Islamic banking in the economy. For example, by increasing transparency in asset and financing management, as well as strengthening incentives for the sharia banking industry to be more competitive with conventional banking. In terms of industrial practice, this research provides insight for Islamic banking to focus more on managing financing risks so that they do not have a negative impact on economic growth. Apart from that, these results also show that increasing deposits can be a key factor in strengthening the role of Islamic banking as a provider of stable and sustainable financing.

Overall, this research confirms that Islamic banking has great potential in supporting economic growth in Indonesia, although the impact is not always immediately visible, especially in the short term. Therefore, more supportive policies are needed, such as incentives for sharia banking to channel more productive financing as well as regulations that ensure stability and public trust in the sharia financial industry. By considering the existing limitations, it is hoped that future research can expand the scope of analysis by including more macroeconomic variables and using more sophisticated methods to identify more complex relationship patterns. In this way, a better understanding of the contribution of Islamic banking to economic growth can be gained, which will ultimately help in formulating more effective policies and strategies in the future.

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