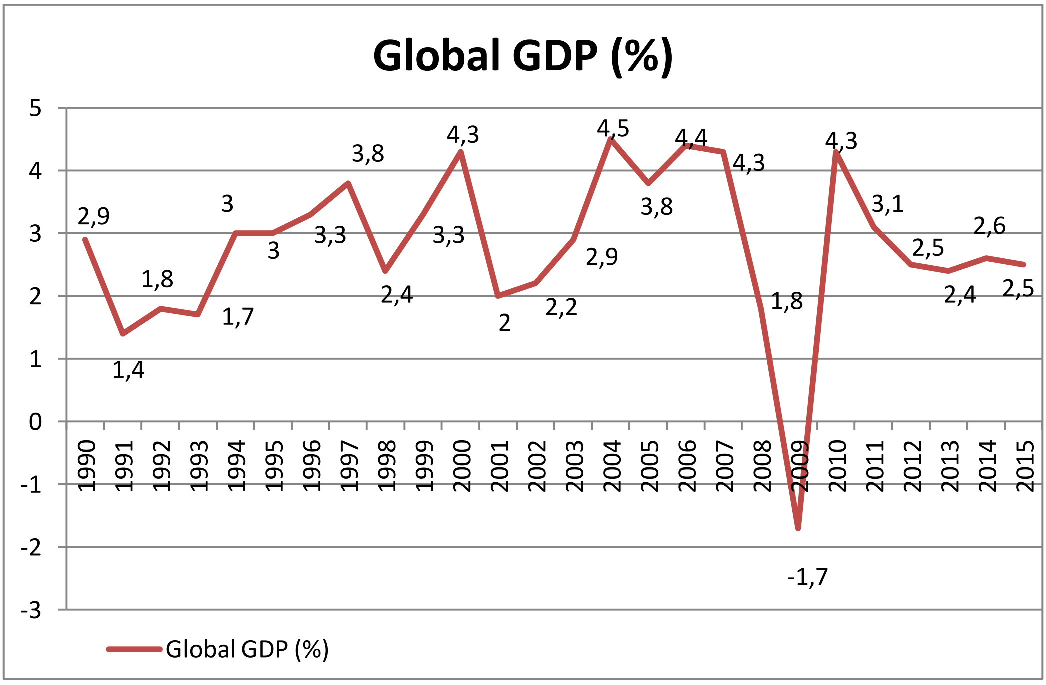
CHAPTER I

INTRODUCTION

A. Background

It has been more than twenty years after Asian financial crisis (AFC) and nine years after Global financial crisis (GFC). The global and national economy has been trying to recover from the crisis damage. A new chapter of new normal global economy has been a witness of the growth of national economy. New Normal is a term in business and economics that refers to financial condition following the financial crisis of 2007-2008 and the aftermath of the 2008-2012 global recessions. This new normal occurs after one cycle of business cycle (expansion, peak, recession, through, and recovery phase). In new normal In the last two years national economy has been growing to 5,01% in 1st quartile 2017. It is higher than 4,92% 1st quartile 2016 and 4,94% in 4th quartile 2016 even though in the last three years the global economy only grew averagely around 2,5% weaker compared to 3,3% during 1994-1997 (World Bank, 2017).

During the GFC in 2006 until 2009, the volatility of several global macroeconomic indicators has become the indicator for the global economy slowing down. Global GDP growth in 2009 sharply dropped to the -1,7% from 1,8% in 2008 and 4,3% in 2007. The drop of global GDP growth in 2009 was significant after its higher growth in 2004 around 4,5 % that was considered as the highest growth of global GDP.



Source: World Bank Data (data processed)

FIGURE 1.1

The growth of global GDP 1990 - 2015

The drop of global GDP was because of the Subprime mortgage crisis during 2006 until 2009. The United States subprime mortgage crisis was triggered by a huge decline in home prices after the collapse of a housing bubble leading to mortgage delinquencies and foreclosures and devaluation of housing related securities and investment. Declines in house or residential investments preceded the recession and were followed by reductions in households spending and also business investment, thus this leads to the high household debt and larger housing price declines. This subprime mortgage crisis caused collapse of 16 banks in US and more than 100 banks were under the Fed's surveillance during September 2007 until October 2008 (Hamidi, 2012). The condition of Islamic banking showed the opposite result during the GFC. It was shown in the end of 2008 by an increase in profit sharing along with an increase in the financing. This opposite result was because of Islamic banking adopts the profit loss sharing (PLS) that is relevant with Shariah compliant. This PLS is different with interest based that is adopted by conventional banking.

Yet, in 1997 until 2000 the cause of AFC made the sharp fall in assets prices and currency value in several countries includes Indonesia. Bank Indonesia (BI) reported in 1998 showed that the bad debt in the national bank reached IDR 10,2 trillion on April 1997, increased by 7,7% compared to the end of 1996. At the same time, banking sector faced mismatch liquidity, people put their distrust to the bank to deposit their money and also the high inflation rate made the value of money is not equal with the quantity, then bank-rush where people withdrew their saving at the same period of time while banking has the high level of vulnerability and could not return the funds to the people could not be ignored. The distrust on banking performance led the massive withdrawals of the funds. Then, adequacy of capital and liquidity that continued to weaken becomes the factor of bank collapse in Indonesia.

During the AFC, national economy also showed the slowing down in the macroeconomic indicator. GDP growth dropped to -13,1% in 1998 from 4,7% in 1997 and 7,8% in 2006. Yet, the inflation rate also increased to 75,3% in 1998 from 12,6% in 1997 and 8,7% in 1996 (World Bank). It means the hyperinflation happened during the AFC.

TABLE 1.1

The Growth of Inflation Rate Based on Consumer Price Index (CPI) and Gross Domestic Product in Indonesia 1995-2016

Year	Inflation Rate (%), Based on CPI	GDP Growth (%)	Year	Inflation Rate Based on CPI (%)	GDP Growth (%)
1995	9,9	8,2	2006	14,1	5,5
1996	8,7	7,8	2007	11,3	6,3
1997	**12,6**	**4,7**	2008	18,1	6,0
1998	**75,3**	**-13,1**	2009	8,3	4,6
1999	14,2	0,8	2010	15,3	6,2
2000	20,4	4,9	2011	7,5	6,2
2001	14,0	3,6	2012	3,8	6,0
2002	5,9	4,5	2013	5,0	5,6
2003	5,5	4,8	2014	5,4	5,0
2004	8,6	5,0	2015	4,0	4,9
2005	14,3	5,7	2016	2,5	5,0

Source: World Bank Data

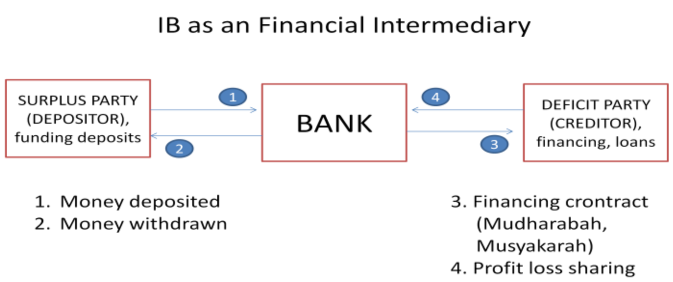
The new phase of a new normal with the interconnectedness and interdependences of global economy has resulted the heightening global financial market dynamic where the high potential risks are exist is now become well-known problem. The volatility, uncertainty, complexity, and ambiguity (VUCA) in the global economy has become the growing acronym in the economy world (Bank Indonesia, 2017). Under VUCA, the economic disturbances become unpredictable and worsen the vulnerability of Islamic banking in Indonesia. Thus, the worsened vulnerability of Islamic banking that is resulted from the economic disturbance or economic shocks can jeopardize the stability of entire banking system and even the stability of financial system, the economic fluctuation which can disturb the resilience of Islamic banking should be the focus of policy maker and government. Therefore, maintaining the resilience of the banking system would reduce the possibility of a crisis occurring and also preserving the financial system stability.

According to Bank Indonesia (2003) about financial system stability (FSS) means that the financial system has the capability to allocate funds efficiently and absorb shocks as they arise, thus preventing disruption of real sector activities and the financial system. Islamic Banking as one of the financial institution under the financial system that gives the support for the funds allocation and financial system stability should be resilient from several shocks.

Indonesia's banking system is a dual banking system in which banks operate two types of businesses consisting of Islamic banks and conventional banks according to Law No. 7 of 1992 about Banking which is amended by Law No. 10 of 1998 that exhaustively rules and regulates the operation of dual banking system. The amendment of Law No. Law No. 7 of 1992 by Law No. 10 of 1998 become the fundamental law of the dual banking system operation in Indonesia, where conventional banking and Islamic banking stand together to serve the country financial transaction.

During 1998, The AFC has dropped the conventional banks and many banks were liquidated due to the failure of the interest rate system. However, Islamic banking that implements the Sharia system can still survive. The main cause was caused the Islamic banking are still focused on domestic economic activities and not having a big integration to the global financial system. Nowadays, the growth of Islamic banking is really satisfying and Islamic banking also put a big integration to the global financial system. As one of the supports to the economic growth and development, Islamic banking should be resilient toward several economic disturbances. The disturbances that could hit the resilience of Islamic banking are from global economy environment, national macroeconomic environment, financial system, and also banking system itself.

These exogenous disturbances such as mentioned will make Islamic banking has problem to run its function as the financial intermediary that serves as a middleman among diverse parties in order to facilitate financial transaction. Due to the function of Islamic banking, the resilience of Islamic banking is required. Christine Berry (2015) defined the resilience of banking sector as the condition where individual bank is able to restrain from various shocks either external or internal shocks, and individual bank can adjust and absorb or respond immediately to every possible risks appear. Thus, bank can anticipate various possible potential risks that can affect the bank's performance and function. So this ability can preserve the soundness of its balance sheet then bank can do its function as the financial intermediary between surplus side and deficit side.



Source: Bank Indonesia (2011)

FIGURE 1.2

Islamic Banking as a Financial Intermediary

According to Bank Indonesia, Islamic banking has two main risk assessments due to its function; they are financing risk and liquidity risk. Figure 1.2 shows that the surplus parties save their money in Islamic banking under specific and agreed instrument, it is known as deposit. While, the deficit parties such as entrepreneurs, businessmen, and households who need extra money for several financial purposes loan money from Islamic banking. According to BI, Islamic banking has two main risk assessments due to its function; they are financing risk and liquidity risk.

Financing risk can be defined as any of various types of risk associated with financing, including financial transaction that includes company loans in risk of default. In term of financing risk, on October 2017 the growth of Non-performing financing (NPF) dropped to 4,91% from 5,61% on August 2009 after GFC, this growth is still higher than 2,82% in 2005 (Otoritas Jasa Keuangan, 2017). According to financing risk assessment, the resilience of Islamic banking is on alert condition if the NPF ratio almost reaches the stipulated tolerance limit of BI, around maximum at 5% (BI Regulation No. 15, 2013).

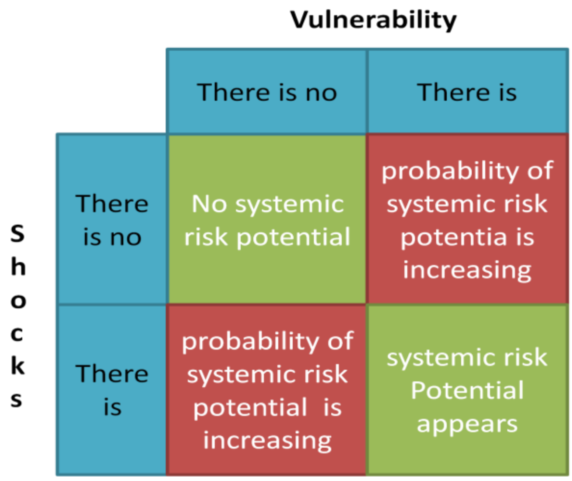
Liquidity risk refers to the risk that bank may be unable to meet the short term financial demands. This occurs when an individual investor, business, or financial institution cannot meet short-term debt obligation. In term of liquidity risk, the growth of liquidity short term mismatch dropped to 28,72% on October 2017 from 43,83% on September 2017. This is still higher than 18,22% in 2014 and 20,04% in 2015 (Otoritas Jasa Keuangan, 2017). Islamic bank may expose to liquid risk due to an increased in liquidity short term mismatch. Dimas et.all

(2016) stated that Islamic banking may expose to liquid risk due to a decreased in the amount of liquid assets.

Additionally, the market share of Islamic banking in Indonesia in 2017 remained low compared to conventional banks. This evident from the total Islamic banking assets which are 5,3% of total Indonesian banking assets. The Profitability of Islamic Banking that is indicated by the amount of Return on Asset (ROA) is declining from 1,67% in the end of 2010 to 0,63% in the end of 2017. The inefficiency in Islamic banking is also characterized by the high ratio of operating costs to operate income (BOPO). The average BOPO was 94,16% versus 78,39% of conventional banks. The NPF of Islamic banking had risen to 4,91% from 4,80% on December 2016 higher than NPL of conventional banks in 2,92% on October 2017. NPF of Islamic banking almost reaches the stipulated tolerance limit of BI, around maximum at 5% (Otoritas Jasa Keuangan, 2017).

These two main risk assessment that are conducted by BI on Islamic banking and the collapse of many banks during GFC in several countries includes Indonesia indicates the vulnerability of banking system. According to BI (2016) in "*Mengupas Kebijakan Makroprudensial*" defines the vulnerability as the preexisting features condition that can strengthen, amplify and speed up the shocks deployment.

The combination of exogenous shocks and the vulnerability of Islamic banking will trigger the imbalances on various indicators in Islamic banking and causes the problem for the resilience of Islamic banking. Blancher et,all (2013) explained the interaction between shocks and vulnerability resulted the several probability. The probability is divided into four possibilities, they are; no systemic risk potential occurs when there is no vulnerability problem in Islamic banking and no external shock comes to worsen to vulnerability. Probability of systemic risk is increasing occurs when Islamic banking has vulnerability problem but has no shock from exogenous. The probability of systemic risk potential is increasing occurs when Islamic bank has no vulnerability problem but has shock from external. The last, systemic risk potential appears, this occurs when Islamic bank has the vulnerability problem at the same time, it is also exposed by the external shock or exogenous shock.



Source: Blancher et.al (2013)

FIGURE 1.3

The Interaction between shock and vulnerability

Figure 1.3 shows that if there is shock and vulnerability simultaneously, then depending on the severity of shock and the size of vulnerability, the probability of occurrence of crisis will increase if high level of vulnerability is existing in Islamic banking.

This Study selects several macroeconomic variables that are correlated to the resilience of Islamic banking and also the variables from the internal of Islamic banking to determine how the selected macroeconomic variables influence the resilience of Islamic banking. Makram Nouaili et. al (2015) in their research "The Determinants of Banking Performance in Front of Financial Changes" expose the various potential determinants of banking performance by splitting them into internal variables (specific to banks), macro-financial (related to banking industry) and external (macroeconomic). The selected macroeconomic variables are gross domestic product (GDP), inflation rate, exchange rate, and Jakarta Stock Exchange. While, the variables from the internal Islamic banking are return on assets (ROA), capital adequacy ratio (CAR), and third party fund (DPK).

According to above explanation, this study reveals a point of significance regarding study of the resilience of Islamic banking by referring to exogenous shocks. Therefore, knowing the exogenous variables that are capable of giving adverse shocks toward the resilience of Islamic banking in Indonesia is needed.

Based on the problems above as well as previous studies, this study is important and interesting to be investigated further. This study will be titled as "**Analysis The Impact of Selected Macroeconomic Variables Towards The Resilience of Islamic Banking in Indonesia Period 2010 - 2017"**

B. Limitation of The Study

There are a lot of factors that may worsen the resilience level of Islamic banking. One of the factors is from the exogenous shocks. The unpredictable exogenous shock will trigger the resilience of Islamic banking to drop. The worsened resilience of Islamic banking that is resulted from the exogenous shocks variables can jeopardize the stability of entire banking system and even the stability of financial system. Therefore, this study is restricted to following limitations:

1. Focusing on Islamic banking in Indonesia
2. Examining several selected macroeconomic variables that are capable of giving adverse shocks toward the resilience of Islamic banking in Indonesia over periods of observation.
3. The study period is ranging from 2010 – 2017, quarterly data.

C. Problem Statements of the Study

Based on the background and the limitation of study, then the problems we need to solve in this paper include:

1. How does the gross domestic product affect on the resilience of Islamic banking?
2. How does the exchange rate affect on the resilience of Islamic banking?
3. How does the inflation rate affect on the resilience of Islamic banking?

D. Objectives of the Study

Based on the description of the background and the formulation of the problems, the objectives of this study are:

1. To determine the effect of gross domestic product affect on the resilience of Islamic banking.
2. To determine the effect of nominal exchange rate affect on the resilience of Islamic banking.
3. To determine the effect of inflation rate affect on the resilience of Islamic banking.

E. Benefits of the Study

The result of this study is expected to provide benefits to related parties.

1. It is expected to give suggestion for the banker to have deep understanding about the exogenous variables that are capable of signaling adverse shock toward the resilience of Islamic Banking in Indonesia.
2. It is expected to be references for other researchers.

F. Research Plan

In order to understand the undergraduate thesis clearly, so the researcher divided the materials into several sub-chapters with systematic writing as follows:

Chapter I, Introduction; This chapter describes the general information that the research background, limitation of the study, problem formulation of the study, purpose of the study, and benefit of the study.

Chapter II, literature Review; this chapter contains the theory that some excerpts taken from the book, in the form of understanding and definition. This chapter also explains the basic concepts of Islamic banking, the resilience of Islamic banking, the vulnerability of Islamic banking, banking crisis in Islamic perspective, economic stability, business cycle, banking performance, macroeconomic condition, internal indicator of Islamic banking.

Chapter III, Data and Research Methodology; This chapter contains the research variables and data type, data collecting method and sources, operational definitions of researched variables, research model and analysis method, and research plan.

Chapter IV, Research Findings; This chapter describes the influence of the selected macroeconomic variables; gross domestic product, exchange rate, inflation rate toward resilience index of Islamic banking in Indonesia. It also contains the result from the analysis of indexes, regression test, the result table and diagram, the analysis of empirical result with the theoretical framework and previous study.

Chapter V, Conclusions; This chapter contains of conclusion from the research, suggestion for the policy maker of Islamic bank in Indonesia and suggestion for the next research.