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THE INFLUENCE OF CONVENTIONAL BANKING AND SHARIA BANKING ON ECONOMIC GROWTH IN INDONESIA

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Abstract

The financial sector is referred to as one of the factors influencing the monetary crisis. This study examined the relationship between the banking development score in the dual banking system model and economic growth in Indonesia. This study used a quantitative method, using the VECM approach and the Granger Causality model. The findings showed that Conventional Banking Credit Growth, Sharia Banking Financing Growth, PMTB, LDR and FDR, and ROA of conventional and Sharia banks had a positive effect on economic growth in Indonesia. The inflation variables, NPF, and NPL had a negative effect on economic growth in Indonesia. This finding provided us with an understanding that the existence of Sharia banking could drive economic growth in Indonesia. In conventional banks, in the long term, there was a long-term relationship between the independent variables and the dependent variables. This study provided new insights into the influence of the banking sector on economic growth in Indonesia, highlighting the importance of synergy between conventional and Islamic banking in creating diverse financial instruments and enhancing access to banking services, especially in areas with limited financial access.

Keywords: *Conventional Banking; Sharia Banking;* Granger Causality; *VECM.*

A. Introduction

GDP is an indicator that reflects the total added value of all economic activities within a country. This added value comes from the difference between the final output value of goods and services and the input costs used. When a country's GDP increases, it indicates higher production and economic activity, reflecting better economic performance. An increase in output can reflect the fact that a country's economy has a conducive and stable climate it will encourage investment. This also applies to Islamic Banks, with the higher the output growth of a country, the non-performing loans (NPL) will decrease and will increase total assets.

According to Abduh & Azmi Omar (2012), the relationship between the financial sector and economic growth can be mutually supportive, unrelated, or reversed. The development of the financial sector can drive economic growth and vice versa. If the financial sector develops without control, it can harm the economy in the short term. This relationship is influenced by the conditions and policies implemented (Abidin et al., 2023).

When discussing the topic of economic growth, financial factors are very important. Especially when the scope of the country is Indonesia. If a country's finances are not conducive and stable, then efforts to improve the nation's economy will not run well. The banking sector has an important role in driving the economy (Hasanudin et al., 2024). This can be seen from the source of financing, the openness of opportunities for people to invest in various financial instruments, and the organizers of financial service industries with an intermediary function. A well-developed banking sector can encourage economic activity and vice versa, if it does not develop well, it will cause the economy to experience liquidity constraints in efforts to achieve better economic growth (Pauzi et al., 2024; Yahya et al., 2023).

The financial sector is the center of current Money turn Because the profit sector also contributes to the growth economy. Stability system finance depends on various factors and can be disturbed by events like turmoil in politics, imbalance in trade, natural disaster, circumstances emergency health, rapid inflation, and others. The financial sector holds an important role in pushing the economic growth of a country, that is as the mover growth sector

(A. Zaenurrosyid et al., 2024; Prihasmoro et al., 2024). This is what can be seen from the ability of the financial sector to mobilize savings. Sector finance also has a role in triggering and enhancing the economic growth of a region. In 2019, Indonesia scored 81.93 on the Islamic Finance Country Index (IFCI), indicating that Indonesia is considered an important player in the global Islamic finance market. In 2020, Indonesia dropped to second place behind Malaysia, but this high score still reflects Indonesia's significant influence in the international Islamic finance industry (Global Islamic Finance Report, 2019).

The financial sector plays an important role in economic growth. Allocating capital to the real sector allows businesses and industries to grow, innovate, and increase productivity, ultimately driving economic growth (Suwanposri et al., 2021). The financial sector supports the accumulation of capital needed for investment and promotes technological innovation (Naisabur et al., 2024). Technological innovation helps industries become more efficient and productive, contributing to economic growth (Bauer et al., 2022). The financial sector can mobilize savings and provide high-quality, low-risk financing instruments, which drive investment and accelerate economic growth (Eshugova & Khamirzova, 2020). An efficient financial sector can reduce issues of asymmetric information, lowering high transaction and information costs in financial markets (Böhm et al., 2023).

Within the scope of macroeconomic policy, the financial sector is a means of transmitting monetary policy. Thus, shocks experienced by the financial sector also influence the effectiveness of monetary policy. (Bauer et al., 2022) identified several impacts resulting from shocks in financial markets on monetary policy transmission. First, the phenomenon *of monetization* (the process of converting securities into available currency used to purchase goods and services) and securitization (the process of determining illiquid assets or grouping assets through financial mechanisms into securities) in the form of financial product innovation (Miranda-Agrippino & Nenova, 2022). Definition of the causes, scope, and behavior of the money supply experiencing changes. Symptoms: This has the potential to cause instability in the relationship between prices (inflation), money circulation, and a reduction in the central bank's ability to control monetary quantities (Singh, 2011). Second, the growing trend of

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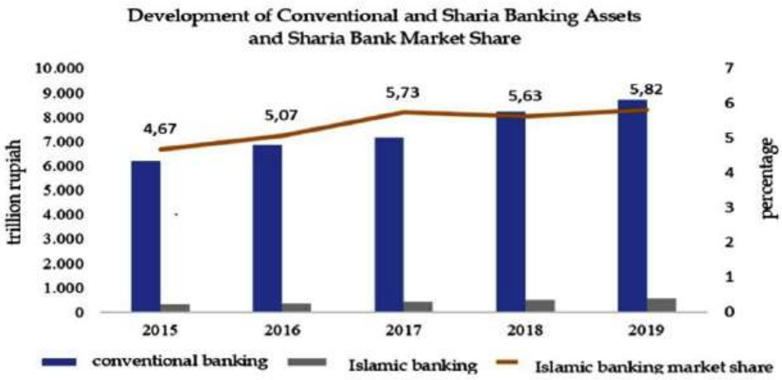
encouraging financing for the development sector has resulted in a disconnection between the monetary sector and the real sector (*decoupling*) (Katsampoxakis, 2022). The causal relationship between monetary variables and the real sector is becoming increasingly complex and challenging to predict, with the money demand function used in monetary management not yet stable.

According to (Chan, 2000), four possible relationships exist between economic growth and financial sector development, illustrating how the financial sector influences economic growth through channels such as investment, credit, and risk management. The possible relationship is that there is no link between development sector financing and a growing economy, development sector financing that encourages economic growth, an economy that encourages growth, development sector financing, and development sector financing (even in the short term) will hurt economic growth (Nandiwardhana et al., 2022).

Since 1992, the Indonesian banking sector has implemented a dual banking *system* (Rissy, 2021). This means that conventional banking and Sharia banking systems are allowed to operate simultaneously (Kasri et al., 2022). This system was marked by the establishment of Bank Muamalat Indonesia (BMI), which was the first Sharia bank in Indonesia.

One of the important players in the Sharia financial market is Sharia banking. In 2018, Islamic banking contributed 70% of the total assets of the global Islamic financial industry, equivalent to US$ 1.76 trillion. There are 72 countries with Islamic banks, most of which are commercial banks (Yusmad et al., 2024). Additionally, most Islamic banks worldwide are part of conventional banks (Sukardi et al., 2019). Of the 520 Sharia banks in the world, 219 of them are Sharia banks that are part of conventional banks.

In Indonesia, the Islamic banking sector has grown rapidly and plays a significant role in the country's economy. Islamic banks in Indonesia contribute significantly to economic activity and financial sector stability, providing financing alternatives that comply with Sharia principles and supporting sustainable economic growth (Fitri et al., 2022). The first Sharia Bank that was born was Bank Muamalat Indonesia in 1992, in 1998 Law no. 10 of 1998 provides instructions for conventional banks and gives permission to conventional banks to open Sharia Business Units (UUS) (Utami et al., 2023).



Source: OJK, 2021 (graphics processed by researchers)
Figure 1. Development of conventional and sharia banking assets, 2015-2019

Based on Figure 1, illustrates that during 2015-2019, in terms of total assets, conventional banking was still leading compared to the banking sector that implemented the Sharia system. The Sharia banking *market share* since 2015-2019 has remained on average at 5% of the total banking market.

Even though the contribution of Sharia banking is still low to the national banking industry, the existence of Sharia banking is very important for economic growth and is expected to be able to move the real sector in countries with the largest Muslim populations in the world (T. Hidayat et al., 2024). The Sharia banking sector itself plays a big role in the economy in Indonesia (Shofiana et al., 2019). The performance of Sharia banking has also increased, which can be seen from data on Sharia commercial banking business activities and the collection of Third Party Funds (DPK) from year to year (Nopriansyah et al., 2022). The largest composition of TPF is found in mudharabah deposits.

The banking sector in Indonesia plays a crucial role for decision-makers as it can influence the country's economy (Azizah, 2023). This includes both banking and non-bank financial institutions and the capital market, all of which contribute to the economy through the flow of funds, financing, and investment (Saputra et al., 2023). If the financial sector does not significantly impact the economy, resources allocated to it could be wasted, potentially reducing the overall effectiveness of economic policies (Setiawan, 2019). Development funds would certainly be more useful if allocated for other purposes, such as increasing workforce capabilities and developing technology.

B. Method

The data used in this research is secondary, namely quarterly time series data from 2010-2022. The data sources come from the Financial Services Authority (OJK) and the Central Statistics Agency (BPS). Data processing in this research will use Eviews 10+ software.

Table 1. Data, symbols, units, measurements, and data sources

Variable/ Description	Symbol	Period	Source
Gross Domestic Product (Real Gross Domestic Product (GDP))	GDP	2010Q1-2022Q4	BPS
Conventional bank credit (conventional banking credit)	CBC	2010Q1-2022Q4	FSA
Islamic bank financing (financing sharia banking)	IBF	2010Q1-2022Q4	FSA
Inflation (Inflation)	INF	2010Q1-2022Q4	BPS
Non-Performing Financing (financing problems)	NPF	2010Q1-2022Q4	FSA
Problematic Credit (problem credit)	NPLs	2010Q1-2022Q4	FSA
Loan-to-deposit ratio (conventional bank deposit ratio)	LDR	2010Q1-2022Q4	FSA
Financing to deposits ratio (Islamic bank deposits ratio)	FDR	2010Q1-2022Q4	FSA
Return on assets (bank profitability ratio)	ROA	2010Q1-2022Q4	FSA

Data analysis methods

This empirical research model uses *the Vector Error Correction Model* (VECM) and Multivariate Granger Causality via *Vector Error Correction Model* (VECM). This model was adapted from (Abduh & Azmi Omar, 2012). With general modeling in learning, this can be written as follows.

Model 1.

in $GDP_i = \beta_0 + \beta_1\ CBC + \beta_2$ in $INF + \beta_3\ NPL + \beta_4\ LDR + \beta_5\ ROA + \varepsilon_i$…………………...(1)

Model 2.

in $GDP_i = \beta_0 + \beta_1$ in $IBF + \beta_2$ in $INF + \beta_3\ NPF + \beta_4\ FDR + \beta_5\ ROA + \varepsilon_i$……………… (2)

Where:

GDP : *Gross Domestic Product*
CBC : *Conventional bank credit*
IBF : *Islamic bank financing*
INF : *Inflation*

NPF : *Non-Performing Financing*
FDR : *Financing to deposit ratio*
NPL : *Non-Performing Loan*
LDR : *Loan-to-deposit ratio*
ROA : *Return of assets*
β_1 - β_5 : Suspected parameters (n = 1,2,3, …)
ε_t : *error term*

To see the causal relationship that may occur between the variables that will be used in the research model, the *multivariate Granger causality test is used.* Based on the model/ variables used in this research, the *Granger Multivariate Causality model* via VECM to test the impact of the development of the conventional banking sector and Islamic banking on economic growth is as follows.

$$\begin{bmatrix} \Delta\ln GDP_t \\ \Delta\ln CBC_t \\ \Delta INF_t \\ \Delta NPL_t \\ \Delta LDR_t \\ \Delta ROA_t \end{bmatrix} = \begin{bmatrix} \beta_1 \\ \beta_2 \\ \beta_3 \\ \beta_4 \\ \beta_5 \\ \beta_6 \end{bmatrix} + \sum_{i=1}^{p} \begin{bmatrix} \partial_{11} & \partial_{12} & \partial_{13} & \partial_{14} & \partial_{15} & \partial_{16} & \partial_{17} \\ \partial_{21} & \partial_{22} & \partial_{23} & \partial_{24} & \partial_{25} & \partial_{26} & \partial_{27} \\ \partial_{31} & \partial_{32} & \partial_{33} & \partial_{34} & \partial_{35} & \partial_{36} & \partial_{37} \\ \partial_{41} & \partial_{42} & \partial_{43} & \partial_{44} & \partial_{45} & \partial_{46} & \partial_{17} \\ \partial_{51} & \partial_{52} & \partial_{53} & \partial_{54} & \partial_{55} & \partial_{56} & \partial_{57} \\ \partial_{61} & \partial_{62} & \partial_{63} & \partial_{64} & \partial_{65} & \partial_{66} & \partial_{17} \end{bmatrix} \begin{bmatrix} \Delta\ln GDP_{t-1} \\ \Delta\ln CBC_{t-1} \\ \Delta MCB_{t-1} \\ \Delta NPL_{t-1} \\ \Delta LDR_{t-1} \\ \Delta ROA_{t-1} \end{bmatrix} + \begin{bmatrix} \delta_1 \\ \delta_2 \\ \delta_3 \\ \delta_4 \\ \delta_5 \\ \delta_6 \end{bmatrix} \times [ECT_{t-1}] + \begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \\ \varepsilon_{3t} \\ \varepsilon_{4t} \\ \varepsilon_{5t} \\ \varepsilon_{6t} \end{bmatrix}$$

$$\begin{bmatrix} \Delta\ln GDP_t \\ \Delta\ln CBC_t \\ \Delta INF \\ \Delta NPF_t \\ \Delta FDR_t \\ \Delta ROA_t \end{bmatrix} = \begin{bmatrix} \beta_1 \\ \beta_2 \\ \beta_3 \\ \beta_4 \\ \beta_5 \\ \beta_6 \end{bmatrix} + \sum_{i=1}^{p} \begin{bmatrix} \partial_{11} & \partial_{12} & \partial_{13} & \partial_{14} & \partial_{15} & \partial_{16} & \partial_{17} \\ \partial_{21} & \partial_{22} & \partial_{23} & \partial_{24} & \partial_{25} & \partial_{26} & \partial_{27} \\ \partial_{31} & \partial_{32} & \partial_{33} & \partial_{34} & \partial_{35} & \partial_{36} & \partial_{37} \\ \partial_{41} & \partial_{42} & \partial_{43} & \partial_{44} & \partial_{45} & \partial_{46} & \partial_{17} \\ \partial_{51} & \partial_{52} & \partial_{53} & \partial_{54} & \partial_{55} & \partial_{56} & \partial_{57} \\ \partial_{61} & \partial_{62} & \partial_{63} & \partial_{64} & \partial_{65} & \partial_{66} & \partial_{17} \end{bmatrix} \begin{bmatrix} \Delta\ln GDP_{t-1} \\ \Delta\ln CBC_{t-1} \\ \Delta MIB_{t-1} \\ \Delta NPF_{t-1} \\ \Delta FDR_{t-1} \\ \Delta ROA_{t-1} \end{bmatrix} + \begin{bmatrix} \delta_1 \\ \delta_2 \\ \delta_3 \\ \delta_4 \\ \delta_5 \\ \delta_6 \end{bmatrix} \times [ECT_{t-1}] + \begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \\ \varepsilon_{3t} \\ \varepsilon_{4t} \\ \varepsilon_{5t} \\ \varepsilon_{6t} \\ \varepsilon_{7t} \end{bmatrix}$$

C. Result and Discussion

This section presents the research findings on the influence of conventional banking and Islamic banking on economic growth in Indonesia. The analysis is based on secondary data collected from financial authorities and national statistics within the period of 2010 to 2022. The presentation of results is organized to reveal how key variables, such as conventional banking credit, Islamic banking financing, and other indicators, contribute to national economic growth. Additionally, this section highlights the dynamics of the relationship between the banking sector and the economy through the Vector Error Correction Model (VECM) and Granger causality tests, both in the short and long term. The

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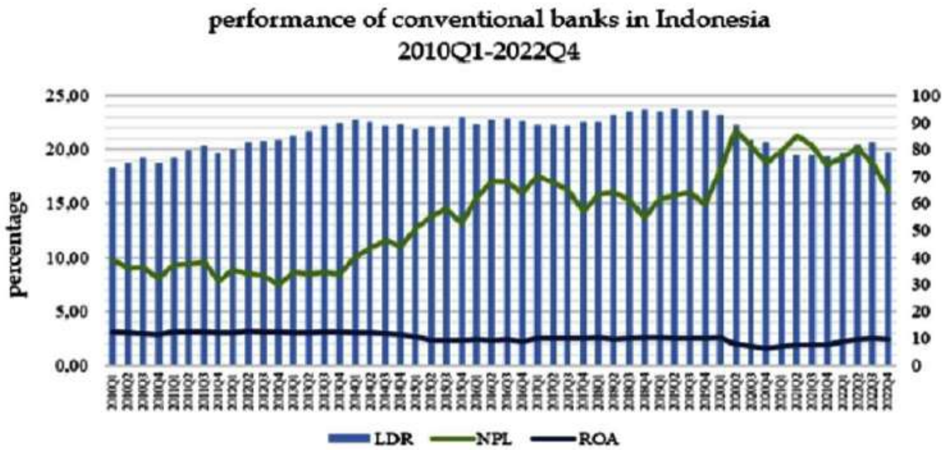
results presentation will be followed by an in-depth discussion to interpret these findings in the context of policy development and financial practices in Indonesia.

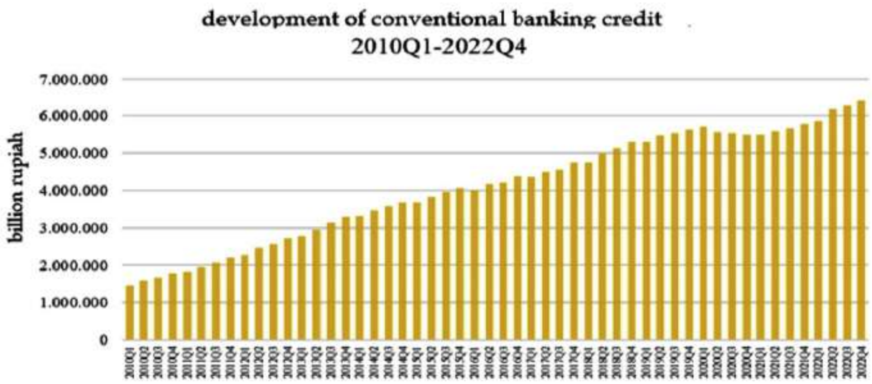
1. Result

General Overview of Conventional and Sharia Banking in Indonesia Overview of Conventional Banking in Indonesia the conventional banking industry in Indonesia is still the main determinant of Indonesia's economic growth, although Sharia banking institutions have begun to develop since the birth of Bank Muamalat Indonesia in 1992. Apart from that, 1998 Law No. 10 of 1998 regulates instructions for conventional banks to open Sharia Business Units (UUS).



Source: OJK, 2023 (graphics processed by researchers)
Figure 2. Conventional development credit banking, 2010Q1-2022Q4

Based on Figure 2, conventional banking shows positive performance with rapid credit growth until the fourth quarter of 2022, reflecting an increase in credit allocation to sectors supporting community development. Figure 3 shows other key performance indicators.



Source: OJK, 2023 (graphics processed by researchers)
Figure 3. Conventional banking performance 2010Q1-2022Q4

Based on Figure 3, the performance of conventional banking is relatively stable. This can be seen from the LDR value which is still below the capital owned by banks. In terms of ROA from the first quarter of 2010 to the fourth quarter of 2022, it shows a relatively stable trend even though the level of benefits tends to decrease.

a. General overview of Sharia Banking in Indonesia

The Islamic banking industry in Indonesia plays an important role in the economy by providing financial services by Sharia principles that avoid *riba*, *gharar*, and *maysir*. Islamic banking supports economic growth through financing the real sector, including SMEs, and promotes financial inclusion. The development of the Sharia banking sector has grown rapidly and dominates Indonesia's economic activity. The first Sharia Bank that was born was Bank Muamalat Indonesia in 1992, in 1998 Law No. 10 of 1998 provides instructions for conventional banks and permits conventional banks to open Sharia Business Units (UUS).

Based on Figure 4, illustrates that during 2010Q1-2022Q4, seen from the financing side, from year to year it tends to increase, although it experienced a decline in the first quarter of 2015. However, from the first quarter of 2015 to the fourth quarter of 2022 it shows a clear trend and continues to improve. This illustrates that the allocation of Sharia banking financing continues to increase to the public.

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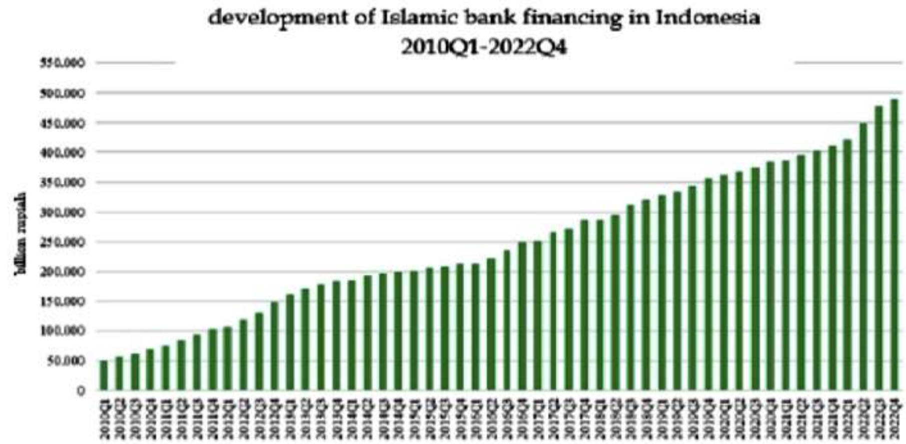
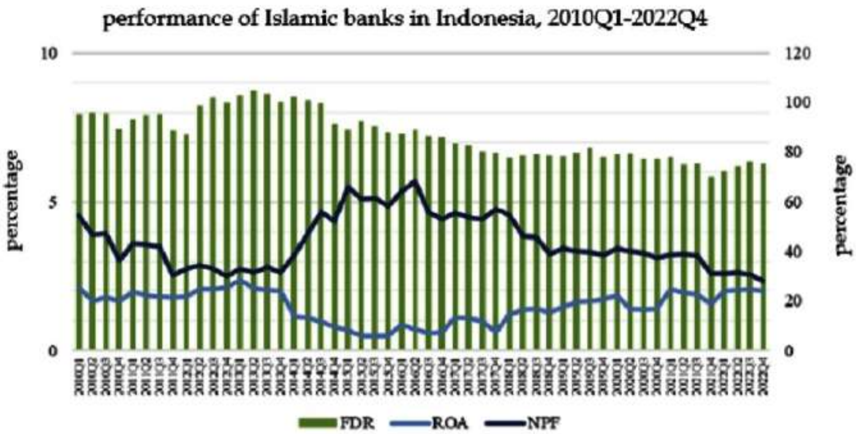


Source: OJK, 2023 (graphics processed by researchers)
Figure 4. Sharia banking development financing, 2010Q1-2022Q4

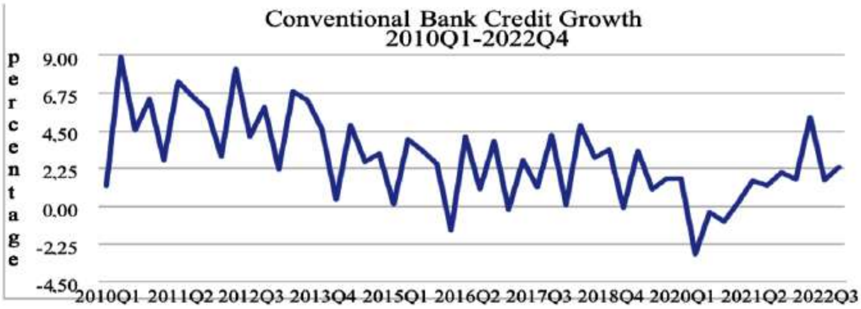
Judging from the FDR value, from quarter to quarter until the end of the period it was still within normal limits, except for the first quarter of 2012 to the fourth quarter of 2014 which was above 100 percent. From the NPF side, it can be seen that the bad credit mark is decreasing until the end of the fourth quarter of 2022. Furthermore, from the ROA side, it shows that the ratio of profit to total assets is increasing until the end of the period. This shows that the performance of sharia banking shows that the condition is getting worse Healthy from each observation period.



Source: OJK, 2023 (graphics processed by researchers)
Figure 5. Conventional banking performance 2010Q1-2022Q4

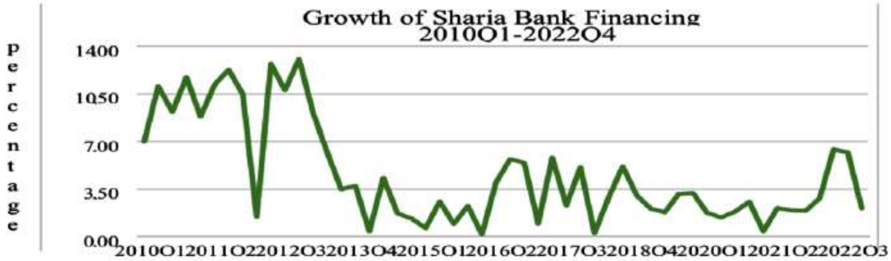
Even though the contribution of Sharia banking is still low to the national banking industry, the existence of Sharia banking is very important for economic growth and is expected to be able to move the real sector in countries with the largest Muslim populations in the world. The Sharia banking sector itself plays a big role in the economy of Indonesia. The performance of Sharia banking has also increased, which can be seen from data on Sharia general banking business activities and the collection of Third Party Funds (DPK) from year to year.

Growth of Banking Credit/ Financing in Indonesia Credit distributed by banks to the public is one of the instruments that will increase economic growth. Based on Figure 6 during the 2010Q1-2022Q4 period, conventional banking credit growth in Indonesia experienced fluctuations. The economic shock caused by the pandemic also contributed to low credit growth. Where in 2020 credit growth decreased drastically and increased again in the following period.



Source: OJK, 2023 (graphics processed by researchers)
Figure 6. Conventional banking credit growth, 2010Q1-2022Q4

Likewise with the condition of sharia banking where financing growth fluctuates. However, the growth of Sharia banking financing is not negative. This is a sign that Sharia banking is more resilient than conventional banking. Even though financing growth during the pandemic decreased, the decline was not negative.



Source: OJK, 2023 (graphics processed by researchers)
Figure 7. Conventional banking credit growth, 2010Q1-2022Q4

b. The Relationship between Conventional Banking and Economic Growth

Granger causality results

Table 2 displays the causality relationship between GDP, CBC, INF, NPL, LDR, and ROA over 2010Q1-2022Q4 in Indonesia. In the short term, there is a bidirectional causality relationship between CBC, INF, and NPL variables and GDP. In addition, there is a unidirectional relationship between ROA and GDP. In the long run, all variables have no causal relationship.

Table 2. Granger Causality VECM Test Results

Dependent Variable	Short-run						Long-run
	Δln*GDP*	Δ*CBC*	Δ*INF*	Δ*NPL*	Δ*LDR*	Δ*ROA*	ECM_{t-1}
Δln*GDP*	-	23,941***	24,290***	28,732***	0,676	0,579	-1,040
Δ*CBC*	108,053***	-	2,153	33,612***	1,959	0,050	-66,493
Δ*INF*	9,273***	0,313	-	0,609	5,727**	0,054	-3,983
Δ*NPL*	7,197***	0,001	9,552***	-	0,013	4,515*	1,287
Δ*LDR*	0,105	0,025	0,649	0,117	-	1,605	19,118
Δ*ROA*	3,346*	0,042	0,909	7,804***	2,630	-	1,223

*Notes: ***significant at the 1% level, **significant at the 5% level, and *significant at the 10% level.*
Source: Authors' calculations

This study's findings align with previous studies that found a relationship between economic growth and banking sector development (e.g., Pradhan et al., 2014; Pradhan et al., 2017; Shahid et al., 2015). In conjunction with economic growth, inflation also affects economic growth (Cham, 2018). Concerning bank performance, this finding is consistent with studies conducted by previous researchers (e.g., Daly & Frikha, 2016; Zeqiraj et al., 2020).

c. The relationship between Islamic Banking and economic growth

1) VECM test results

The VECM estimation results show the influence of conventional banking credit on economic growth in Indonesia in the long and short term. The existence of an adjustment mechanism from the short term to the long term is indicated by the alleged negative error correction parameter (CoeintEq1). Based on Ariefianto (2012), the error correction model is declared valid and stable if the parameter value is negative.

Table 3. VECM Test Results

Variable	Coefficient	T-statistic
Short-term		
CointEq1	-1.246521	[-5.09363]
ΔlnGDP	0.585073	[3.42966]
Δ*IBF*	0.003177	[3.78489]***
Δ*INF*	0.002149	[1.24931]***
Δ*NPF*	-0.008356	[-1.03614]***
Δ*FDR*	0.001186	[1.16440]***
Δ*ROA*	-0.010468	[-1.05396]***
Constant	0.000231	[0.06843]***
Long-term		
Variable	**Coefficient**	**T-statistic**
IBF	0.002996	[4.65844]***
INF	0.004989	[5.67426]***
NPF	0.002620	[0.73822]***
FDR	0.000416	[0.81292]***
ROA	-0.013481	[-2.40793]***
Constant	-0.004839	

*Note: ***significant at the 1% level, **significant at the 5% level, and *significant at the 10% level*
Source: Authors' calculations

Based on Table 3, the interpretation of the error correction value is -1.246521, which means there is an adjustment from the short term to the long term in Indonesia's economic growth which is corrected in each quarter by -1.246521%. In the short term, all independent variables are significant, each at the 1%, 5%, and 10% levels. Likewise, in the long-term relationship, all variables, namely: IBF, INF, FDR, and ROA, affect Indonesia's economic growth.

2) Causality test results

A unidirectional relationship occurs between FDR and inflation (INF) with economic growth (GDP). In the long term, the IBF, the inflation variable (INF), NPF, FDR, and ROA with economic growth (GDP).

The results of this study are generally in line with the research findings by Abduh & Omar (2012) for Indonesia, Abusharbeh (2017) for Palestine, (Ledhem & Mekidiche, 2022) for Turkey, Majid & Salina (2015) for Malaysia. In relation to economic growth, inflation also affects economic growth (Cham, 2018).

Table 4. Causality Test Results

Variabel Dependent	*Short-run*						
	Δln*GDP*	**Δln*IBF***	**Δ*INF***	**Δ*NPF***	**Δ*FDR***	**Δ*ROA***	**ECM_{t-1}**
Δln*GDP*	-	13,888***	16,219***	0,677	11,070***	0,036	-1,247
Δln*IBF*	14,325***	-	4,009**	2,905*	11,485***	0,324	-57,671
Δln*INF*	1,561	1,148	-	1,181	0,108	4,350**	-8,965
Δ*NPF*	1,074	1,068	1,767	-	0,316	2,018	-13,927
Δ*FDR*	1,356	0,079	6,432**	1,619	-	0,691	-121,176
Δ*ROA*	1,111	0,473	0,188	1,189	0,256	-	-6,524

*Note: ***significant at the 1% level, **significant at the 5% level, and *significant at the 10% level.*
Source: Authors' calculations

2. Discussion

When talking about economic growth, the financial factor is the most important thing, especially when the scope is as large as Indonesia. If the finances are not strong and stable, efforts to improve the nation's economy will not go well. The banking sector plays an important role in driving the Indonesian economy (Trishananto et al., 2024) (Trishananto et al., 2024). This is reflected in its role as a source of financing, an opportunity for people to invest in various financial instruments, and an organizer of the financial services industry with an intermediary function. A well-developed banking sector can drive economic activity and vice versa, if it does not develop well, it will cause the economy to experience liquidity constraints in efforts to achieve high economic growth.

The financial sector has been functioning well and stably and is very important for the economic growth and development of a country. According to Arner (2007), there are several lessons and reasons for the importance of the financial sector, namely: (1) A series of financial crises that hamper economic growth and development, and burden countries with large fiscal and social costs; (2) Research that shows that when finance functions well, it will drive economic growth. The growth resulting from a broad, deep, and liquid financial system provides goods, services, and jobs that benefit all members of society (A. Zaenurrosyid et al., 2024). In a recent review of research on the role of the financial sector, Patrick Honohan in Arner (2007) suggests four main functions of finance:

1. Mobilizing savings (thus creating a concentration of capital that allows for the exploitation of economies of scale),
2. Allocating capital (and thereby helping to assess where returns are most likely to be obtained through economically profitable ventures),
3. Monitoring the use of financial resources (thus increasing the likelihood that they will generate economic benefits), and
4. Transforming and redistributing risk to those most interested and most able to bear it.

The main function of Indonesian banking is as a collector and distributor of public funds and aims to support the implementation of national development to increase the distribution of development and its results, economic growth, and national stability, towards improving the standard of living of the people (Fidhayanti & Jannah, 2022). In addition, banking also plays an important role in helping the community to achieve its needs. Through the distribution of financing, banking helps increase investment and economic growth. The banking system is a collection of institutions that provide us with financial services. These organizations are tasked with running the payment system, providing loans, accepting deposits, and assisting with investment.

Since 1992, the Indonesian banking sector has implemented a dual banking system. What is meant by a dual banking system is that banks can carry out two activities at once, namely interest-based banking activities and non-interest-based banking activities. This means that conventional banking systems and Islamic banks are allowed to operate simultaneously (A. S. Hidayat et al., 2022). This system is marked by the establishment of Bank Muamalat Indonesia (BMI), which is the first Islamic bank in Indonesia. For those who convert their banks to Islamic banking, all work mechanisms follow the principles of Islamic banking, while for those who do both, the work mechanisms are regulated in such a way, especially concerning the interaction between interest-based activities which are the characteristics of conventional banking with interest-free activities which are the characteristics of Islamic banking, so that the two can be separated (Nurhisam et al., 2024).

In conventional banking systems, the primary method of generating revenue is through the charging of interest on loans disbursed to customers. This interest, calculated as a percentage of the loan amount, serves as the core of their financial operations. Additionally, conventional banks accrue income by paying interest on the deposits they hold, creating a cycle of interest accumulation that supports their overall financial stability and growth.

In stark contrast, Islamic banks adhere to Sharia principles, which strictly prohibit the practice of earning or paying interest (riba). Instead, Islamic financial institutions employ alternative profit-generating mechanisms that comply with Islamic law (Anggareni et al., 2024). These mechanisms primarily involve profit-sharing arrangements known as Mudarabah or risk-sharing contracts like Musharakah (Elvia et al., 2023). In a Mudarabah agreement, the bank provides the capital while the client manages the business venture, and profits are shared according to pre-agreed ratios (Hayati & Mujib, 2022). Conversely, Musharakah involves both the bank and the client contributing capital to a joint venture, with profits and losses shared based on their respective investment proportions (Maulana et al., 2024).

These Islamic banking models promote a system of ethical finance where the burden of risk is distributed equitably between all parties involved. This approach not only aligns with the Islamic values of fairness, transparency, and social welfare but also fosters a collaborative environment between the bank and its clients. By linking the bank's earnings to the success of its clients' ventures, Islamic banks inherently encourage practices that contribute to the economic well-being of the community (Sukma & Zulheldi, 2021).

Furthermore, the implementation of such profit and risk-sharing arrangements in Islamic banking has implications beyond mere compliance with religious directives. It introduces a financial system that is inherently resilient to the kind of speculative activities that have historically led to economic crises in conventional systems (Sukma & Zulheldi, 2021). This stability is particularly crucial in predominantly Muslim countries, where Islamic banking is not just a financial choice but also a matter of cultural and religious identity, influencing broader economic patterns and contributing to the macroeconomic stability of these regions.

Thus, while conventional and Islamic banking systems operate under fundamentally different principles, they both play pivotal roles in their respective contexts. Islamic banking, with its unique non-interest-based model, offers a compelling alternative that aligns economic activities with ethical standards and social justice, challenging traditional banking paradigms and gradually shaping a more inclusive financial landscape.

Islamic banking is the main channel for economic growth in countries with a Muslim-majority population. In addition, this also shows some policy implications, where Islamic banking makes a positive contribution to the country's macroeconomic stability (El-Galfy & Khiyar, 2012). Many studies have been conducted on the relationship between the banking sector and economic growth. These studies include Abusharbeh (2017) who conducted research in Palestine, Abdurrahman (2003) who conducted research in Indonesia, Daly & Frikha (2016) for 10 countries in the Middle East, Majid (2008) and Majid & Salina (2015) in Malaysia. The research has proven that both conventional banking and Islamic banking sectors drive economic growth.

This extensive body of research highlights the significant role that both Islamic and conventional banking play in stimulating economic development. For instance, in Muslim-majority countries, Islamic banking is not merely a financial institution but a vital component of the economic framework that resonates with the cultural and religious ethos of the population (Taufiki et al., 2022). By adhering to Sharia principles, these banks not only cater to the financial needs of their clients but also foster a unique economic environment where financial transactions are inherently linked to ethical and equitable practices. This alignment of financial services with religious values increases public trust and participation in the banking system, which in turn drives economic activity.

Moreover, the positive impact of Islamic banking on macroeconomic stability can be attributed to its risk-sharing feature, which distributes financial risks and rewards more evenly across the economy. This risk mitigation is particularly crucial during economic downturns, where the emphasis on partnership and equity investment in Islamic finance provides a buffer against the kind of speculative trading that often exacerbates financial crises in conventional settings (Ghalia et al., 2022). The studies mentioned provide empirical support for this theory, suggesting that Islamic banking could serve as a model for more sustainable banking practices globally.

Furthermore, the successful integration of Islamic banking into the national economies of various countries highlights the adaptability and robustness of this financial model. It suggests potential for replication in other contexts, offering a viable alternative to interest-based banking systems, especially in regions seeking economic solutions that align with cultural and ethical considerations. Thus, Islamic banking not only supports economic growth but also contributes to a more stable and equitable financial system (Sukma & Zulheldi, 2021).

Given the substantial role that Sharia banking plays in the global financial landscape, as evidenced by its commanding share of the total assets in the Islamic finance industry, it is clear that this banking model is not only viable but also thriving. The presence of Sharia banks in 72 countries and their dominance in commercial banking highlights a widespread acceptance and integration of Islamic financial principles worldwide. This broad adoption underscores the capacity of Sharia banking to cater to diverse economic environments and cultural contexts, promoting economic activities that are both ethical and sustainable.

Islamic banking provides financing without interest (riba) and avoids investment in businesses that are prohibited by Islam, such as gambling, or industries that are not by Islamic ethics. This helps encourage more sustainable economic activities by religious principles. One of the important players in the Sharia financial market is Islamic banking (Rasyid, 2021). The Islamic Corporation for the Development of the Private Sector - ICD (2020) noted that Sharia banking accounted for 70% of the total assets of the global

Sharia financial industry in 2018, or US$ 1.76 trillion. There are 72 countries worldwide with Sharia banks, 61 of which report their assets. The majority of Sharia banks are commercial. Of the 520 sharia banks in the world, 219 Islamic banks are part of conventional banks. The Islamic Corporation for the Development of the Private Sector (ICD) is a multilateral development financial institution that supports the economic development of its member countries. Headquartered in Jeddah, ICD is part of the Islamic Development Bank (IsDB) Group and was established in November 1999. With an authorized capital of $4 billion, ICD's shareholders include the IsDB, 56 Islamic countries, and five public financial institutions.

Despite its relatively modest share in the overall national banking industry, the importance of Islamic banking in driving economic growth, particularly in Indonesia, cannot be overstated. As the country with the largest Muslim population in the world, Indonesia presents a unique and significant opportunity for Islamic banking to expand its influence and support economic activities that are not only profitable but also adhere to ethical and religious principles.

The growth trajectory of Islamic banking in Indonesia is evident from the consistent increase in the business activities of Islamic general banks and the year-on-year growth in the collection of Third Party Funds (DPK) (Dahlan et al., 2023). This indicates a growing trust and reliance among the public on Islamic banking services. The increase in DPK, which refers to funds collected from customers that banks can use for various financing activities, highlights the robustness of Islamic banks in attracting and managing deposits in a Sharia-compliant manner (Wahyudi et al., 2021).

Moreover, Islamic banking's potential to catalyze the real sector is significant. By providing financing options that are in line with Islamic law, these banks enable numerous sectors, including agriculture, manufacturing, and services, to access capital without compromising their ethical standards. This is particularly crucial in Indonesia, where many businesses seek to align their operations with Islamic principles. As Islamic banking continues to mature and innovate, it is expected to play an even more central role in linking financial services with the real economy, supporting not just economic growth but also sustainable development in alignment with the country's cultural and religious values.

Furthermore, the strategic development of Islamic banking in Indonesia could serve as a model for other nations with significant Muslim populations. By effectively leveraging its unique position, Indonesia can demonstrate the viability of Islamic finance as a significant contributor to national and global economic stability. This could encourage more widespread adoption of Sharia-compliant financial practices, potentially leading to a broader transformation in the global banking landscape.

The results of this study indicate a two-way relationship between bank credit and economic growth in the short term. An increase or decrease in bank credit can affect economic growth; conversely, economic growth can also affect the amount of bank credit. Both factors influence each other and contribute to economic dynamics. A unidirectional causal relationship was found between Return on Assets (ROA) and economic growth, meaning that banking performance (in terms of profitability as measured by ROA) affects economic growth, not vice versa. These results indicate that good banking performance can support economic growth, but economic growth itself does not directly affect banking performance in the short term.

A study of forty developing countries over the period 1970-2012 showed limited support for the supply-driven, demand-driven, and complementarity hypotheses, but provided evidence of a causal relationship between banking sector development and economic growth in twenty-five countries (Mhadhbi et al., 2020). A study of 16 transition economies from Central and Southeastern Europe. By measuring development in the banking sector using bank credit to the private sector, interest rates, and quasi-money ratios, the study results showed that credit to the private sector and interest margins were negatively related to economic growth, while the quasi-money ratio was positively related to economic growth (Petkovski & Kjosevski, 2014). Efficient credit provision by banks can support the development of productive economic sectors, which stimulate overall economic growth.

Knowing how the banking sector plays a role in Indonesia is important for decision-makers. If the banking sector is considered to have an important influence, then the government must promote the development of the financial sector which includes the development of the banking sector, non-bank financial institutions, and capital markets to encourage economic growth (Dahlan et al., 2023). Through credit distribution, banking helps increase investment and economic growth. In this case, banking plays an important role in helping to finance small and medium enterprises, which are important economic resources for Indonesia.

Understanding the pivotal role of the banking sector in Indonesia is crucial for policymakers and decision-makers, especially in shaping strategies that bolster economic growth. Given the significant influence of the banking sector, it is essential for the government to not only foster the development of this sector but also ensure the growth of non-bank financial institutions and capital markets (Husein et al., 2024). These components are interconnected and collectively enhance the financial infrastructure, thereby facilitating more comprehensive economic development.

Banking, particularly through its function of credit distribution, plays a vital role in increasing investment. By providing necessary capital to businesses, especially small and medium enterprises (SMEs), banks act as a catalyst for economic expansion (Jamaluddin et al., 2024). SMEs, which form the backbone of Indonesia's economy, often struggle with access to traditional credit markets. By focusing on improving the availability and terms of credit, the banking sector can directly influence the success and growth of these enterprises, leading to greater economic stability and job creation (Hidayatullah & Fadillah, 2022).

Moreover, the government's role in promoting an inclusive financial sector is critical. Implementing policies that encourage financial inclusion can help integrate a larger portion of the population into the formal economy, providing more people with the opportunity to start businesses, invest, and consume. Such policies would not only drive demand within the economy but also create a more resilient and diverse financial sector capable of withstanding economic shocks (Muhammad, 2022).

Furthermore, enhancing the regulatory framework to ensure the stability and integrity of financial institutions will attract more investors and increase the confidence of the public in the banking system. Strengthening financial literacy programs across the country can also play a significant role in making these financial services more accessible and understandable to a broader audience, which is essential for fostering a culture of investment and financial planning. In conclusion, the government must adopt a holistic approach to developing the financial sector, recognizing the interconnected nature of banking, non-bank financial institutions, and capital markets. Such a strategy not only supports the growth of SMEs but also strengthens the overall economic fabric of Indonesia, paving the way for sustained economic growth and development.

D. Conclusion

This research provides new insights into the dynamics between economic growth and the development of the banking sector in Indonesia, with a specific focus on the simultaneous roles of conventional and Islamic banking. The analysis shows that both banking systems, despite operating on different principles, make a significant contribution to national economic growth. In the short term, bank credit, both conventional and Islamic, exhibits a bidirectional relationship with GDP, affirming that the banking sector not only reacts to economic conditions but also actively promotes economic growth through credit provision.

Furthermore, the findings emphasize the importance of stability and innovation in the banking sector as drivers of sustainable economic growth. On the other hand, Islamic banking, with its fundamental principles of avoiding usury (riba) and promoting fairness in transactions, offers an alternative model that is resilient to economic fluctuations. This indicates that integrating ethical values into banking practices aligns not only with social and religious needs but also supports inclusive and stable economic growth.

In the context of Indonesia, which has the largest Muslim population in the world, Islamic banking has significant potential to develop untapped economic segments while enhancing financial inclusion. The study suggests that strengthening the synergy between conventional and Islamic banking could be a national strategy to diversify financial instruments and expand access to banking services, particularly in areas with limited financial access.

This research has demonstrated that both conventional and Islamic banking sectors drive economic growth. Islamic banks have an advantage over conventional banks due to their operational principles that avoid interest-based transactions and high-risk financing. Islamic banks prioritize fair transactions based on risk-sharing, which makes them more stable during periods of financial uncertainty. Islamic banks can provide better solutions for maintaining economic stability due to their operational model, which is more resilient to economic shocks.

This study invites policymakers and banking practitioners to reflect on and integrate banking practices that are not only economically efficient but also fair and socially sustainable. Implementing policies that support the growth of both conventional and Islamic banking sectors will fundamentally strengthen Indonesia's economic foundation and promote a more inclusive and sustainable national development process.

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