



# THE IMPACT OF ECONOMIC CONTRACTION ON THE FINANCING COLLECTABILITY OF ISLAMIC BANKING IN INDONESIA

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## ABSTRACT

The COVID-19 pandemic affected Indonesia's economic growth, which experienced a contraction in the first and second quarters of 2020. This study examines how economic contraction affects the collectability of Islamic banking in Indonesia, period for 2019: IV - 2020: II. The measurement of financial collectability is based on non-performing financing (NPF). The research data source comes from secondary data in publications from the Central Statistics Agency (CSA) and the Financial Services Authority (FSA). Data analysis uses descriptive statistics with the help of percentages, growth, and graphs. The results indicated that the economic contraction significantly impacted the decline in Islamic banking performance, as evidenced by an increase in NPF. The NPF increase occurs in all debtor groups: MSMEs, non-MSMEs, and households (consumption financing). The collectability of financing is separate from the area where COVID-19 spreads; where DKI Jakarta, East Java, and West Java are in the top five highest COVID-19 cases, they have better financing collectability than other provinces. Based on economic sectors, only mining and quarrying did not experience an increase in the NPF during the economic contraction period. These findings show differences with the growth-led finance paradigm. Regions that experience high cases of COVID-19 infection have better financing collectability. The practical implication of these findings is the importance of coordinating macro prudential policies with others, such as fiscal and actual sector policy, in encouraging the resilience of MSMEs, including managing the collectability of financing during economic contraction periods.

**Keywords:** non performing financing, collectability, growth.

## INTRODUCTION

The COVID-19 pandemic impacted various aspects of life, including health, education, socio-culture, and the economy. In the economic sector, pandemics impact the demand and supply of goods and services. In Indonesia, consumption expenditure in the third quarter of 2020 contracted by 4.04% year on year (BPS 2020b), but it was lower than the contraction in the second quarter of 5.52% (BPS 2020a). Some components experiencing contractions are food and beverage, clothing, footwear, care services, transportation and communication, restaurants and hotels, and others. In the second quarter, restaurants and hotels experienced the most significant contraction, followed by transportation and communications in the third quarter.

In the second quarter of 2020, gross domestic fixed capital formation contracted in all components: buildings, machinery and equipment, vehicles, other equipment, cultivated biological resources (CBR), and intellectual property products (BPS 2020a). In the third quarter of 2020, all components contracted except for CBR. Furthermore, government spending in the third quarter of 2020 grew 9.76%; previously, the second quarter of 2020 had a contraction of 6.90%



(BPS 2020b). The export and import sectors also experienced contractions in the second and third quarters 2020. In the export contraction phenomenon, non-oil and gas exports contracted, declining the value and volume of critical commodities such as vehicles and their parts and mineral fuels. Oil and gas exports contracted with the decline in the value and volume of oil and gas exports. Service exports contracted with the decline in foreign tourists entering Indonesia and the decline in foreign exchange inflow. Meanwhile, imports contracted in line with the decline in the value and volume of oil and gas imports. Imports of services experienced a contraction in line with the decline in export transportation services and imports of goods (BPS 2020a).

The decline in demand during the COVID-19 pandemic impacted the decrease in the supply of goods and services. Economic growth in the third quarter of 2020 contracted by 3.49% but was lower than the previous quarter's 5.32% (BPS 2020b). Economic slowdowns cause financial stability shocks for businesses. Several large-scale businesses collapsed during the 1998 Indonesian monetary crisis and the 2008 global financial crisis due to high production costs. The current crisis is more devastating than the previous crisis. Its impact extends to large entrepreneurs and micro, small, and medium enterprises (MSMEs). The weak financial stability of companies has led to a decline in their ability to pay debts. This condition undoubtedly affects banking as an intermediary institution, leading to decreased loan or financing collectability, a phenomenon also evident in Islamic banking. Islamic banking's performance has decreased not only in terms of return on assets (ROA) but also in terms of non-performing financing (NPF). In the second quarter, there was a decrease in ROA from the period before the pandemic in Indonesia (or Quarter IV 2019), which was 1.73% to 1.40% (OJK 2020). The NPF indicator increased from the pre-pandemic period of 3.23% to 3.43% and 3.34% in the first and second quarters of 2020, respectively.

Several previous studies have examined the influence of macro variables on banking profitability, as in research Q. Ali et al. (2018); Al-Homaidi et al. (2018); Acharya and Vyas (2022); Masindi and Singh (2022) and non-performing loans (NPL), as researched by Nadham and Nahid (2015); Azeem et al. (2017); Alnabulsi, Kozarević, and Hakimi (2022). Several studies have also discussed the specific impact of COVID-19 on NPL, such as research Mulyati et al. (2022); Loang, Ahmad, and Naveenan (2023); Susanti, Putra, and Bahtiar (2023). However, research regarding the collectability of MSMEs sectorally and regionally, especially during the pandemic, is still minimally studied. The novelty of this research lies in studying the collectability of MSMEs and sectoral collectability in Islamic banking during economic contraction because, in pandemic conditions, the economic sector experiences contraction in general, but other sectors experience growth, such as the agricultural sector. This research examines the impact of contraction on the collectability of sectoral financing and MSMEs. Then this research also discusses the problem of collectability of financing in various provinces in Indonesia during the COVID-19 pandemic.

## LITERATURE REVIEW

Demand-led growth theory states that the level of aggregate output is determined in the long run by aggregate demand (Smith 2012). This theory



implies that economic growth affects the output level of the industrial sector, including MSMEs, which in turn impacts MSMEs in managing finances and collectability of financing (Menne et al. 2022). The relationship between the financial sector and national income (gross domestic product) is reciprocal (Al-Shimari, Jawad, and Jihad 2021). Assuming that supply-led growth supports causality from finance to economic growth if it follows the demand-led growth mechanism, it refers to growth-led finance (Samuel et al. 2019). Finance-led growth is a concept in economics that states that a country's economic growth is triggered by the financial sector. In this concept, the financial sector is the main driving force in increasing a country's economic growth. This can happen through increasing access to capital sources, investment financing, and efficient risk management. The financial sector is expected to facilitate more significant and efficient investment, encouraging job creation, increased productivity, and sustainable economic growth (Ibrahim and Alagidede 2018). On the other hand, growth-led finance refers to a mechanism where financial sector development is driven by economic progress (Lauretta, Chaudhry, and Santamaria 2023). If the economy progresses and grows, the financial sector will grow, and vice versa (Ibrahim and Acquah 2021).

The use of the growth-led finance assumption during the COVID-19 period, where there was an economic contraction, shows that the economic downturn during the pandemic worsened the financial sector, both corporate and household finances (Bayar, Günçavdı, and Levent 2023). On the other hand, economic growth will improve the financial conditions of corporations and households (Ratnawati 2020). The research findings of Akinlo and Emmanuel (2014) show that economic growth improves non-performing loans in banks, which is in line with the findings of Chizoba et al. (2020) and Chowdhury et al. (2023). Several studies show that COVID-19 has an impact on MSMEs.

Suryani, Zulfikar, and Vitria (2021), using a sample of 233 respondents in South Kalimantan, found significant differences in the financial condition of SMEs during the pandemic, where there was a decrease in gross income (-41.6%) and profit levels in the SME sector (-62.8%). Based on survey results, 96% of business actors experienced a negative impact from the COVID-19 pandemic on their business processes (1,785 cooperatives and 163,713 micro, small, and medium business actors) (Soetjipto 2020). The sluggish tourism sector has a domino effect on the MSME sector, where micro food and beverage businesses reached 27%. Meanwhile, the impact on small food and beverage businesses is 1.77%, and on medium businesses, it is 0.07%. The influence of the COVID-19 virus on wood and rattan craft units and micro businesses will be 17.03%. For small businesses in the wood and rattan crafts sector, it is 1.77%, and for medium businesses, it is 0.01%. Meanwhile, household consumption will also be corrected between 0.5% and 0.8% (Amri 2020).

Research in Bangladesh shows that 58.3% of SMEs have closed down due to the COVID-19 pandemic (Hossain et al. 2023). Then, it can be observed that demand for goods decreased by 83.5%, production costs increased by 21.4%, and the overall production of goods in SMEs decreased by 48.5%. Most owners (90.3%) stated that their profits fell by 50% to 100% during the COVID-19 pandemic, and 68.9% of owners had to fire workers from their organizations to reduce costs. Around 78.3% of respondents stated that their products remained



unsold from 10% to 70% during the pandemic. Sari (2021) researched the impact of the pandemic on Batik MSMEs in Sumenep Regency, finding that large-scale social restrictions and the closure of the tourism sector led to a decline in sales, the acquisition of raw materials and receivables and the payment of employee salaries. However, MSMEs maintain their business continuity. Batik MSMEs in the Sumenep district use social media for online marketing. Paunović and Aničić (2021) found that the impact of the crisis varies on the SME sector, depending on business activity, size, the region where the SMEs operate, and the extent of digitalization and business networking achieved during the pandemic.

However, several MSMEs were able to survive the COVID-19 conditions. Lai et al. (2020) review the significant adaptations made by SME restaurants in Malaysia during the movement control order (MCO) period. Adaptations generally reflect actions to foster creativity, maintain reputation, and maintain profitability. Adam and Alarifi (2021) researched 259 randomly selected SME managers in Saudi Arabia, finding that the innovation practices adopted by SMEs to deal with the impact of COVID-19 had a positive impact on the performance and likelihood of business survival. The PLS-SEM bootstrap results show that external support strengthens the positive impact of SME innovation practices on business continuity compared to its performance. Rinofah and Sari (2022) found that working capital and accounts receivable turnover had a positive and significant effect before and during the pandemic, while cash turnover had a negative effect before and during the COVID-19 pandemic. The higher the working capital and receivables turnover rate, the profitability will increase, but the higher the cash turnover rate, the profitability can decrease.

Subriadi and Wardhani (2022) developed a scenario for SMEs' ability to survive the impact of the COVID-19 pandemic based on a social commerce framework with four components: customer, platform, merchant, and context. Found that social commerce scenarios can be implemented to boost the ability of SMEs to withstand the impact of the COVID-19 pandemic. On the other hand, the banking sector is expected to encourage the resilience of MSMEs during COVID-19. Islamic banking in Turkey behaved counter-cyclically during COVID-19 regarding SME bank loans (Doruk 2023). Countercyclical behavior shows that Islamic banking increased MSME financing during COVID-19, thereby reducing the economy's MSME failure.

## METHOD

This research uses a comparative quantitative approach to compare the collectability of MSMEs before and during the pandemic (the economy experienced contraction). The period before COVID-19 is represented by Quarter IV of 2019, while Quarters I and II of 2020 represent the COVID-19 period. This research analyzes sectoral collectability based on 15 sectors. The research also examines the collectability of MSMEs based on provinces consisting of 34 provinces. The sectoral and provincial populations in this research also serve as research samples. The research data source comes from secondary data in publications from the Central Statistics Agency (CSA) and the Financial Services Authority (FSA) of the Republic of Indonesia. Data analysis uses descriptive statistics with the help of percentages, growth, and graphs. MSME collectability is



measured by changes in non-performing financing (NPF). Changes in non-performing financing were obtained from the difference between the NPF of the COVID-19 period and the NPF of the fourth quarter of 2019, both sectorally and regionally. On the other hand, a chained quarterly growth rate (q-to-q) measures sectoral economic growth. Graphs and percentages were analyzed in the data, and then a comparative analysis was carried out between the NPF sectoral and economic growth.

## RESULTS AND DISCUSSIONS

Economic growth in the first quarter of 2020, as presented in Table 1, shows that all sectors experienced contraction except AGRI, FIN, and HSSA. In the second quarter of 2020, all sectors experienced a contraction except for AGRI, which has continued to grow since the first quarter of 2020. Several sub-sectors drove this growth. A shift in the planting season drove the growth of the Food Crops sub-sector, resulting in the peak of the rice harvest occurring in the second quarter of 2020. The upstream forestry sector's increased performance in producing industrial forest logs propelled the Forestry and Logging sub-sector forward. The Plantation Crops sub-sector has grown, driven by increased production of palm oil, coffee, and sugar cane in several production centers and an increase in foreign demand for processed palm oil (CPO) commodities.

**Table 1 Growth and Changes of Non-Performing Financing Sectoral of Islamic Banking of Indonesia in Quarters I and II 2020**

Sector	Growth		Changes in NPF	
	I	II	I	II
Agricultures, Hunting and Forestry (AGRI)	12.12	21.32	-0.57	1.10
Fishery (FISH)	-0.03	-4.11	0.29	0.19
Mining and Quarrying (MQ)	-0.73	-3.75	-0.13	-0.48
Processing Industry (IND)	-1.17	-6.49	0.06	-0.87
Electricity, Gas and Water (EGW)	-5.31	-7.18	0.69	-1.59
Construction (CONS)	-6.92	-7.37	0.02	-0.28
Wholesale and Retail Trade (WRT)	-1.38	-6.71	0.37	0.43
Provision of accommodation, eating and drinking (AED)	-3.54	-22.31	0.40	-0.21
Transportation, Warehousing and Communications (TWC)	-1.15	-10.22	0.42	0.28
Financial intermediaries (FIN)	10.68	-15.93	0.23	-0.02
Real Estate, Business, Ownership, and Business Services (RE)	-0.62	-5.70	-0.08	0.33
Government administration, Defense and Compulsory social security (GOV)	-8.54	-2.64	0.06	-1.38
Education Services (EDU)	-10.39	-0.68	0.25	0.42
Health Services and Social Activities (HSSA)	1.09	-4.14	0.09	0.71
Others (Others)	-1.19	-15.12	0.61	-1.13

Source: secondary data (CSA and FSA, processed)

The sectors that have had the most impact due to the COVID-19 pandemic are AED, FIN, others, and TWC. According to Statistics Indonesia, the AED sector experienced an economic slowdown due to several factors: (1) a decline in





tourism; (2) the closure of recreational and entertainment venues, leading to a drop in hotel and restaurant patronage; and (3) shifts in people's consumption patterns, with the growing popularity of cooking and eating at home (BPS 2020a). Meanwhile, the government's appeal to implement work-from-home and school-from-home as a preventive measure against COVID-19, the government's policy prohibiting people from returning to their hometown during Eid al-Fitr, and the decrease in cargo activity during the COVID-19 pandemic all contributed to the economic slowdown in the TWC sector.

The TWC sector's growth contraction seems closely linked to the collectability of financing, as evidenced by an increase in non-performing financing in Q1 and Q2. This aligns with the slowdown's impact on increased non-performing financing in the FISH, WRT, and EDU sectors. However, a random pattern occurs in other sectors: when there is an economic slowdown, the collectability of financial returns is better, or vice versa, and financing quality worsens when economic growth occurs. Despite the economic contraction, the MQ sector has improved its quality of return on financing. Despite the economic contraction, the MQ sector has improved its quality of return on financing. Despite slowing down for two consecutive quarters, the MQ sector saw a decline in non-performing financing. Compared to AGRI, which increased non-performing financing in the second quarter, the sector experienced a high growth rate of 21.32%.

Table 2 presents the NPF based on usage type and debtor group. The highest NPF of Islamic banking financing user groups in Indonesia is MSMEs, greater than 5% or above the threshold. Consumption financing recipients are the group with the lowest NPF. Compared to the NPF in Quarter IV 2019, there appears to be an increasing trend in the NPF during the COVID period, except for the non-MSMEs group for the first quarter of 2020. Consumption financing shows a consistent increase in NPF since the fourth quarter of 2019. In the MSMEs group, NPF experienced a decline in the second quarter of 2020 but was still higher than quarter IV of 2019. MSMEs' high NPF during the pandemic indicates that this group is vulnerable to economic shocks.

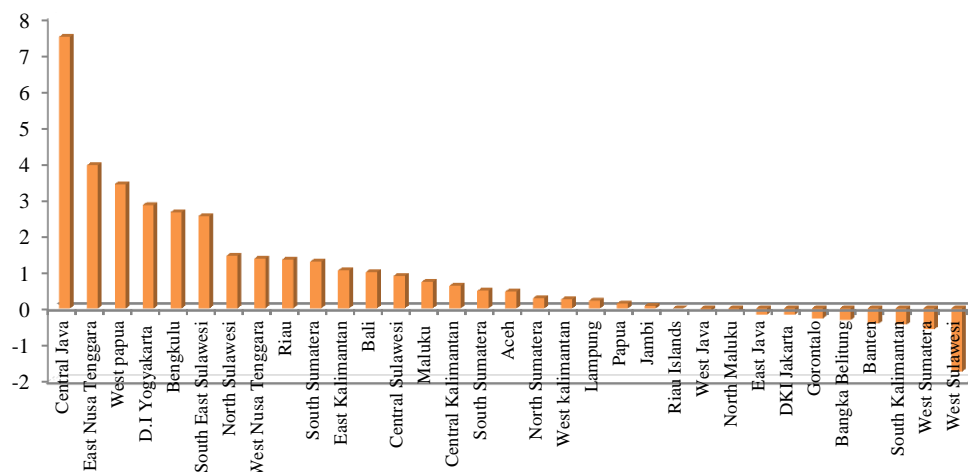
**Table 2 Non-Performing Financing Based on Islamic Banking's Debtor Group in Indonesia**

Type of Usage and Debtor Group	2019: IV			2020: I			2020: II		
	Financing (Billion IDR)	NPF (Billion IDR)	%	Financing (Billion IDR)	NPF (Billion IDR)	%	Financing (Billion IDR)	NPF (Billion IDR)	%
MSMEs	66,336	3,869	5.83	75,188	4,717	6.27	68,556	4,152	6.06
Non MSMEs	131,222	4,528	3.45	123,191	4,141	3.36	132,886	4,615	3.47
Consumption	157,624	2,632	1.67	163,272	3,034	1.86	165,579	3,594	2.17

Source: secondary data (FSA, processed)

Changes in the NPF of MSMEs by province in the second quarter of 2020, as presented in Figure 1, show that the most significant increase in non-performing financing occurred in Central Java province, around 7%. According to the average across all provinces, the increase in NPF for MSMEs in the second quarter of 2020 was 0.92% compared to the fourth quarter of 2019. Thus, 12

provinces have a lower quality of NPF for MSMEs than the provincial average, namely Central Java, East Nusa Tenggara, West Papua, DI Yogyakarta, Bengkulu, South East Sulawesi, North Sulawesi, West Nusa Tenggara, Riau, South Sulawesi, East Kalimantan, and Bali. The provinces that experienced a decline in NPF of MSMEs during the COVID pandemic were West Sulawesi, West Sumatra, South Kalimantan, Banten, Bangka Belitung, Gorontalo, DKI Jakarta, East Java, North Maluku, West Java, and the Riau Islands. Although several provinces have experienced COVID cases in the top five, such as DKI Jakarta, East Java, and West Java, they have a relatively better quality of return on financing.



**Figure 1 NPF Changes of MSMEs in Islamic Banking in Indonesia, Based on Province, Quarter II 2020**

*Source: secondary data (FSA, processed)*

Local governments implement large-scale social restrictions (LSSR) as prevention in several provinces, including East Java, DKI Jakarta, South Sulawesi, West Java, South Kalimantan, and South Sumatra. Meanwhile, Central Java, Papua, North Sumatra, and Bali chose other social restrictions. The economy is still growing in provinces that need to implement LSSR, indicating that it is unlikely to impact society or business. However, the research shows Central Java, which does not use LSSR, needs better collectability and MSME financing. Figure 1 shows that the change in NPF has a positive value or increase in Q2 2020.

This finding differs from the growth-led finance paradigm. Economic contraction reduces the collectability of financing, such as in the TWC, FISH, ERT, and EDU sectors, but not for other sectors. For example, the MQ sector, which experienced a contraction, showed improved loan collectability as indicated by a decrease in NPF. On the other hand, the agricultural sector, which experienced positive growth during the pandemic, actually had worse loan collectability. This implies high credit risk in the agricultural sector, which is less resilient than the mining sector. Minghui and Xin'ge (2018) found three factors that influence the ability to repay funds at rural commercial banks or agricultural commercial banks: (1) economic factors such as macroeconomic conditions, the

structure of sources of funds for repayment of farmer household loans, income level, and labor force destination; (2) internal factors such as personnel arrangements, capital reserves, and bank profitability; and (3) external disturbance factors such as emergencies caused by nature or man-made can disrupt the expected recovery of credit irregularly and unpredictably. This study implies that macroeconomic conditions are not the only factor influencing agricultural sector loans' collectability. Azeem et al. (2017) found that GDP conditions had an insignificant correlation with NPL in the agricultural sector, but what was correlated was credit assessment. The research findings of Alnabulsi, Kozarević, and Hakimi (2022) show that NPLs are more sensitive to bank-specific factors than macroeconomic factors. Bank-specific factors such as loan growth, loan-to-asset ratio, and net interest margin significantly reduce NPLs in Islamic banking in Bangladesh (Chowdhury et al. 2023).

Research findings show that although several provinces have experienced COVID cases in the top five, such as DKI Jakarta, East Java, and West Java, they have a relatively better quality of return on financing. However, Central Java does not use LSSR and needs better MSME collectability financing. This is due to the resilience factor of MSMEs. The resilience of MSMEs to pandemics depends on their dynamic capabilities. Dejardin et al. (2023) studied 209 SMEs using structural equation modeling, finding that dynamic capabilities positively affected company performance both before and during the pandemic. After the start of the pandemic, the focus shifted to marketing their products. In line with this research, Martins (2023) examined how dynamic capabilities can influence SME performance through digitalization as a moderator of 400 SME managers and supervisors in Ghana. The research results show that dynamic capabilities (sensing, seizing, and transforming) positively affect SME performance. In addition, digitalization significantly improves the relationship between the three dynamic capabilities and SME performance. However, digitalization can only significantly moderate the relationship between transformation capabilities and SME performance. Digitalization strategies are one of the keys to MSMEs surviving during the pandemic.

MSMEs have a very strategic role in the Indonesian economy. However, MSMEs have limitations in terms of capital. Bank Indonesia issued regulation number 17/12/PBI.2015, mandating banks to provide financing to micro, small, and medium enterprise actors at a minimum of 20% (twenty percent), determined by the ratio of MSME credit (or financing) to total credit (or financing). Article 12 imposes a penalty of up to IDR 10 billion for training fees and other penalties if a bank fails to reach a credit distribution ratio of at least 20%.

In addition to protecting MSMEs, Bank Indonesia's regulation protects the Indonesian economy. However, the funds channeled by banks to MSMEs have yet to reach 20% (Aliudin 2019). In Islamic banking, the share of MSME financing in total financing in June 2020 was 18.7%, but in March 2020, it amounted to 20.8% (OJK 2020). Several factors cause banks' reluctance to channel credit or financing to the MSME sector, including the large number of non-performing loans. There is a negative influence between NPF and the distribution of financing to MSMEs (Effendi and Yasmin 2017; Zaimsyah 2020). This means that the higher the NPF of MSMEs, the lower the number of funds channeled by Islamic banking to them. Meanwhile, other types of Murabaha-based financing show that NPF has no





significant effect on Murabaha financing (H. Ali and Miftahurrohman 2016; Farianti, Pramuka, and Purwati 2020). During the COVID period, the NPF MSMEs were growing. For MSMEs, COVID-19 affects product absorption, the availability of raw materials, and the distribution process (Bahtiar and Saragih 2020).

## CONCLUSIONS

The economic contraction during the COVID-19 pandemic had an impact on increasing non-performing financing in several sectors, such as transportation, fisheries, wholesale and retail trade, education services, and real estate. However, despite the contraction, the mining and quarrying sectors experienced better collectability, as evidenced by the decline in non-performing financing in the first and second quarters. During the pandemic, small-medium and non-small-medium, as well as consumption financing, experienced an increase in non-performing financing. The spread of COVID-19 does not affect funding collectability. Although DKI Jakarta, East Java, and West Java are in the top five highest COVID-19 cases, they have better financing collectability than other provinces.

The theoretical implication of this finding explains why regions with high COVID-19 infection rates have greater finance collectability. The practical implications of these findings include the importance of coordinating macro prudential policies with other policies, such as fiscal policy and the real sector, in encouraging MSMEs' resilience in dealing with the collectability of MSMEs with diverse characteristics across sectors and regions. Improving the economy is only enough to manage loan collectability if other policies, such as the MSME empowerment policy, support it. This finding implies that the factors influencing collectability are the economic downturn and other factors not examined in this study, which is a research limitation. Another area for improvement of the research is that it needed to carry out inferential testing of the impact of economic contraction on sectoral and regional collectability. It is recommended that future researchers carry out inferential testing to study the influence of economic contraction on the collectability of MSMEs.

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