

IMPACT OF COVID-19 ON THE FINANCIAL SYSTEM IN INDONESIA: ISLAMIC AND CONVENTIONAL FINANCIAL SYSTEM

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Abstract

This research intended to open a discussion regarding the Islamic Financial System (IFS) by providing an in-depth explanation, comparing with the Conventional Financial System (CFS), and seeing the impact of pandemic Covid-19 on the financial system in Indonesia. Through qualitative-descriptive research method specifically utilizing literature studies and case analysis, it is noticeable that Covid-19 has had a very significant impact on the financial system in Indonesia which can be found from money market and capital market. The results depicted that in general, IFS should be applicable not only to Muslim countries, but also to non-Muslim countries. Also, it is known that the impact of the Covid-19 pandemic is real and large, especially on the financial system globally and in Indonesia particularly.

Keywords: Financial System, Islamic Financial System, Covid-19.

Introduction

The emergence of the Islamic financial system (IFS) is becoming part of the rapid growth of the Islamic financial sector in the world. This system is not limited to Islamic countries, but spreads in countries with a large population of Muslim community. According to some estimates, there are more than 100 financial institutions in more than 45 countries that have implemented several forms of Islamic finance. Furthermore, the industry has grown at a rate of more than 15 percent per year for the past five years¹.

¹ Zamir Iqbal, "Islamic Financial Systems," *Finance & Development*, no. June (1997): 42–45, <https://doi.org/10.4337/9781843762959.00012>.

One of the major features of the IFS is an absolute prohibition on the payment and receipt of interest. Therefore, countries that will implement the IFS is obliged to restructure the previous financial system to fit the restrictions on interest-based financial transactions². With many countries flocking to open themselves to study the IFS, it becomes an evident that the IFS own an advantage over the Conventional Financial Ssyetm (CFS). This was also proven when the financial crisis occurred which had a major impact on most countries adopting a CFS. On the other hand, countries with Islamic financial systems or even practiced dual financial systems are more prudent to crises.

Ascarya (2015) argues that financial crises in CFS can be prevented or reduced gradually by adopting economic, financial and Islamic regulations partially or completely, especially for the main pillars of the IFS, namely the prohibition of usury (*riba* or interest), prohibitions on *maysir* (gambling or speculation) and prohibitions on *gharar* (excessive uncertainty), in various forms³.

From the background above, it can be seen that the research on IFS is essential to be continued, studied and linked to the current situation both in the scope of the country and worldwide. In this study, the authors applied a literature study with cased-based research to specifically discuss Covid-19 that is currently affecting all economic systems including Indonesia. The author specializes in case studies in Indonesia so that the analysis will focus more on one object, and compare between IFS and CFS.

Role of Financial System in Economy

A financial system - Islamic or Conventional - generally consists of Central Banks, Commercial Banks, Development Banks and Non-Bank Financial Institutions including Insurance Institutions, Securities Exchanges, Stock Exchanges, Investment Institutions, Government Bonds and Securities, Policies Government Fiscal, and so on. Therefore, it can be

² Abbas Khan, Mohsin S; Mirakhor, "The Financial System and Monetary Policy in an Islamic Economy," *Journal of King Abdulaziz University-Islamic Economics* 1 (1989): 39-57, <https://doi.org/10.4197/islec.3-1.5>.

³ Ascarya, "Determining the Real Causes of Financial Crisis in Islamic Economic Perspective: ANP Approach," *Tazkia Islamic Finance and Business Review* 9, no. 2 (2015): 109-27.

concluded that the financial system covers both the Money Market and the Capital Market which includes Stock Exchange and Commodity Exchange⁴.

The difference between the two objectives is that the Money Market is involved with short-term debt instruments and serves to bridge economic units in order to minimize the gap between the receipt and payment of funds such as in providing liquidity. Meanwhile, the purpose of the Capital Market is to channel savings to long-term productive investments, which consist of long-term debt instruments and fulfillment of capital. Thus, it can be said that financial markets are vital in the financial system, since it is determining on how much money and credit is available, procedures for attracting and regulating savings transactions, providing short-term and long-term financing, forming investment opportunities, allocating resources, and supporting and assisting them. in producing essential goods and services.

In general, Loqman (1999) concluded that the role of the financial system in the economy is: *first*, strengthening financial institutions as a form of a country's development process; *second*, as a means of accelerating economic growth and stability; *third*, maintaining welfare both socially and economically, ensuring equitable distribution of income and wealth; and *last*, a role in poverty alleviation. Therefore, a country that possessed a stable financial system is reflected through the good performance of its financial institutions and the people's economic activities in terms of production, consumption and distribution.

Islamic Financial System (IFS) VS Conventional Financial System (CFS)

The term of Islamic Financial System according to Iqbal (1997) began to appear in the mid-1980s with several previous references arguing that all activities or transactions in accordance with Islamic principles are under the auspices of "interest-free" or Islamic banking⁵. It should be note that the Islamic financial system is not limited to discussion of the Islamic banking sector, but it covers the entire process of capital formation, the capital market, and all types of financial intermediary practices.

Atyeh (2015) stated that the growth of the Islamic Financial System in the world specifically began with the formation of Mit Ghamar in

⁴ Muhammad Loqman, "A Brief Note on the Islamic Financial System," *Managerial Finance* 25, no. 5 (1999): 52–59, <https://doi.org/10.1108/03074359910765957>.

⁵ Iqbal, "Islamic Financial Systems."

Egypt, beginning the transactions in the form of providing Islamic loans for various purposes and then offering project investment with a profit-sharing system⁶.

Aside of IFS and CFS, there is the Global Financial System (GFS) as a worldwide framework on legal agreements, institutions and economic actors, both formal and informal, which jointly facilitate the flow of international financial capital for investment and trade financing purposes with one of the main players, namely the International Monetary Fund (IMF). Reporting from the official website of the IMF (imf.org), it was mentioned that there are loan facilities (lending) intended for countries facing crisis, with low interest rates. Consequently, with the interest element, it can be concluded that the global financial system is absolutely adopts a conventional system.

It should be noted that there are clear differences between the Islamic Financial System (IFS) and the Conventional Financial System (CFS) both in terms of philosophy and ethics. The following describes several studies⁷ on the differences between the two systems:

1. **In terms of principles and foundations.** The CFS has a secular philosophical basis with the principle of building capitalist finance, and making the ownership of private property an absolute right to own wealth. On the other hand, IFS is a product that uses Islamic principles, and is based on the use of sharia law. Humans are considered as representatives of Allah (*khalifah*) on earth, and all assets are only entrusted by Allah swt.
2. **In terms of the benefits taken.** CFS purely benefits from interest and has an impact on economic benefits and strength that only a few parties have. While the IFS profits are taken as the result of a reward, benefits, and even if the losses will be shared, and in the end will result in equitable economic distribution and productivity of society in the long run.
3. **In terms of financing.** Capital financing in CFS is obtained through the issuance of shares when dividends are obtained by investors, while

⁶ M. H Atyeh, "The Development of the Islamic Financial System," *International Journal of Arts & Science* 8, no. 7 (2015): 1-9.

⁷ Atyeh; Loqman, "A Brief Note on the Islamic Financial System"; T; Rehman K U Shahzad, A; Ahmed, "Islamic Financial System: A System To Defeat Inflation," *Kuwait Chapter of Arabian Journal of Business and Management Review* 2, no. 4 (2012): 10-13.

debt-based financing will make loan interest rates a source of company profit. As for the IFS, capital financing will be based on production sharing contracts such as *mudharabah* and *musyarakah*, because these alternatives can alleviate investment constraints faced by the private sector in many developing countries⁸. Meanwhile, Islam allows sale and purchase contracts with postponement of payment such as *ba'i muajjal*, *ijarah*, and *murabahah*.

4. **From the impact of inflation caused**, as described by Shahzad et al., (2012), CFS can cause inflation which was initially made by the absence of the role of religion in business transactions and personal life and then has an impact on the formation of unethical behavior and transactions. , such as containing elements of gambling, speculative transactions, future contracts, and so on. This transaction is only profit-oriented, and will ultimately increase inflation in a country. If the interest rate rises, the cost of capital will also increase, as a result, it will give significance increase of productivity costs as well as imports yet a decrease in exports, and finally cause the phenomenon of inflation. In contrast, IFS eliminate the element of interest, that gives impact on reducing production costs, so that business activity will increase, and will increase the opportunity to absorb more labor, so the level of income per capita will increase.
5. **From the integration with commercial and social finance**. IFS cover both the commercial aspects and social aspects (such as *zakat*, *infaq*, *waqf* and microfinance), these two aspects cannot be separated and/or there is no dichotomy⁹. In contrast to CFS, especially in commercial finance which do not include social finance since its objectives are profit maximization that contradicted to the objectives of the triple bottom-line (scope, sustainability, and the impact of welfare on social finance as mentioned by Zeller and Meyer (2012), Armendariz, et al (2013) and Hamada (2010)¹⁰ that triple bottom-line in conventional social finance will not be possible because of a shift in mission and

⁸ Abbas Askari, Hossein; Iqbal, Zamir; Mirakhor, *Introduction to Islamic Economics: Theory and Application* (John Wiley & Sons, 2014).

⁹ Ascarya, "Integrasi Keuangan Komersial Dan Sosial Islam Untuk Meningkatkan Soft Launching Forum Wakaf Produktif Dan Inisiasi Pencanangan Hari Wakaf Produktif A s c a r y a Deputy Direktur – BANK INDONESIA," Bank Indonesia, 2016, <https://doi.org/10.13140/RG.2.2.24410.75201>.

¹⁰ Ascarya.

commercialization, so that integration between commercial finance and conventional social finance is very unlikely to achieve social welfare

Nature and Objectives of the Islamic Financial System

After discovering the difference between the CFS and the IFS, then it is necessary to understand the nature and objectives of the IFS. Identically, IFS has several characteristics such as the absence of interest-based transactions or institutions, questionable transactions, company shares that against the law, and unethical and immoral transactions such as market manipulation, insider trading, or short-selling.

The objective of the IFS is to base all of its activities on the aspects of Islamic law or *syari'ah*, as an intermediary for channeling funds from surplus units to deficit units. In addition, IFS also purposed to ensure that the surplus funds to be managed for investment are in accordance with the preferences of the fund owners in terms of risk, rate of return, and investment period.

Khan in (Loqman, 1999) explained that IFS is seen by Muslims as an alternative to the current interest-based financial system, while non-Muslims view this system as a healthy development in adding to the variety of the formation of a tightly competitive financial system. The establishment of an economic system based on Islamic values requires fundamental changes in the operations of financial institutions. Since interest rates are prohibited in Islam, alternative mechanisms that rely primarily on profit-sharing or capital participation should be developed to replace transactions using an interest-based IFS is Malaysia, in a study entitled "Islamic Financial System: the Malaysian Experience and the Way Forward" by Laldin (2008), mentioned that the IFS in Malaysia has been implemented since 1963 to this day covering the area of Islamic Banking, Capital Market, and *Takaful* (Sharia' Insurance)¹¹.

The results of this study depicted that Malaysia has a great history of encouraging the development of the sharia' banking sector, and even has great potential for success in this sector. Furthermore, it was stated that Malaysia's model in developing the Islamic financial industry can

¹¹ Mohamad Akram Laldin, "Islamic Financial System: The Malaysian Experience and the Way Forward," *Humanomics* 24, no. 3 (2008): 217-38, <https://doi.org/10.1108/08288660810899377>.

be used as a benchmark by other countries.

Principals of Islamic Financial Instruments

There are several basic principles in the Islamic financial system¹² including (1) prohibition of the practice of *riba* (interest); (2) the principle that money is not a commodity, but used as a medium of exchange, a store value, and a unit of measurement; (3) the principle of risk sharing without interest so that the owner of the capital (investor) is not a creditor; (4) the principle of no speculation including the practice of *gharar* (uncertainty) and *maysir* (gambling); (5) sanctity of contract means that Islamic finance highly upholds contractual obligations and disclosure of information as a noble task so that it is expected to reduce the risk of asymmetry and moral hazard (6) the principle that all investment activities are avoided from prohibited activities by Islamic teachings, and (7) the principle of social justice, or prohibition of transactions that contain tyranny or exploitation.

From the basic principles of IFS above, the following are the principles in Islamic financial instruments collected from several studies¹³, namely:

1. Generation of Deposit on Profit and Loss Sharing: in Islamic finance, means that all deposits must be invested in a profit and loss sharing (PLS) investment scheme that is free of usury investment¹⁴
2. *Mudharabah* (Trust Financing, Trust Investment): by applying a *mudharabah* contract, it is indicated that that every business carried out the profit is divided according to the agreement between the owner of the capital (*shahibul maal*) and the manager (*mudhrib*). The loss will

¹²Abbas Iqbal, Zamir; Mirakhor, "The Stability of the Islamic Financial System," in *An Introduction to Islamic Finance: Theory and Practice*, Second Edi (Asia: John Wiley & Sons, 2011), 137–49, <https://doi.org/10.1002/9781118390474.ch7>; Ahmad M Mashal, "Islamic Financial in the Global Financial System," *Asian Economic and Financial Review* 2, no. 1 (2012): 207–23.

¹³M S Antonio, *Bank Syariah Dari Teori Ke Praktik* (Jakarta: Gema Insani, 2001); Jamal Fianto, Bayu Arie; Gan, Christopher; Hu, Baiding; Roudaki, "Equity Financing and Debt-Based Financing: Evidence from Islamic Microfinance Institutions in Indonesia," *Pacific-Basin Finance Journal* 52, no. Desember (2018): 163–72, <https://doi.org/10.1016/j.pacfin.2017.09.010>; Iqbal, Zamir; Mirakhor, "The Stability of the Islamic Financial System"; Khan, Mohsin S; Mirakhor, "The Financial System and Monetary Policy in an Islamic Economy."

¹⁴Loqman, "A Brief Note on the Islamic Financial System."

be covered by the owner of the capital, except for the risk arising from the negligence of the manager, so the manager is responsible.

3. *Bay salam* (in-front payment sale): in Islamic finance the contract instrument used is a contract to purchase goods delivered at a later date while payment is made at the beginning of the sale and purchase contract in cash
4. *Qardhul Hassan* (Soft and Benevolent Loan): is a loan agreement without service fees provided to people in need for education, medical treatment or other noble purposes
5. *Murabahah (bai al-muajjal)*: is a contract of sale and purchase of goods carried out by a bank and selling to its customers with an additional profit that has been agreed upon by notifying the purchase price and determining the level of a profit in addition.
6. *Ijarah* (Leasing): is a contract of transfer of use rights over goods or services through payment of rental wages without being followed by transfer of ownership of the goods themselves
7. *Musharaka* (Partnership, Project Financing Participation): is a co-operation agreement between a bank and its customers or clients with the principle of mutual profit and loss in accordance with the agreement that this *musyarakah* contract consists of many people who contribute funds (investors of more than one person) are different from *mudharabah* agreement with only one/sole owner of capital.

The Impact of the COVID-19 on Financial Market in Indonesia

The initial case of the novel coronavirus or COVID-19 began in China on December 31, 2019 which then spread to various parts of the world including Indonesia¹⁵. On Monday, March 2, 2020, the government officially announced the first case (01) and the second case (02) of patients for Covid-19 in Indonesia and this confirmed case has spread to 32 provinces throughout Indonesia

The impact of COVID-19 does not solely to have an impact on global economic growth, as stated by JP Morgan (2020) that currently the world is facing a dual crisis in which a health crisis and an economic crisis have

¹⁵ Muhammad Hasbi; Al Anshory, Ali Chamani; Hudaefi, Fahmi Ali; Junari, Ulfah Lathifah; Zaenal and Reza Ramdhoni, "The Role of Zakat Institution in Preventing Covid-19 . Policy Brief March 2020," *Puskaz Baznas Policy Brief*, no. March (2020): 1–11.

resulted in a recession. Moreover, the IMF (2020) also gave a recent statement saying that we will face an economic recession caused by COVID-19 which is worse than the crisis in 2009. The given table is providing the scenarios of the COVID-19 impact on Indonesia's macro economy:

Table 1, Macro Economics Scenario During the Covid-19 Pandemic in Indonesia

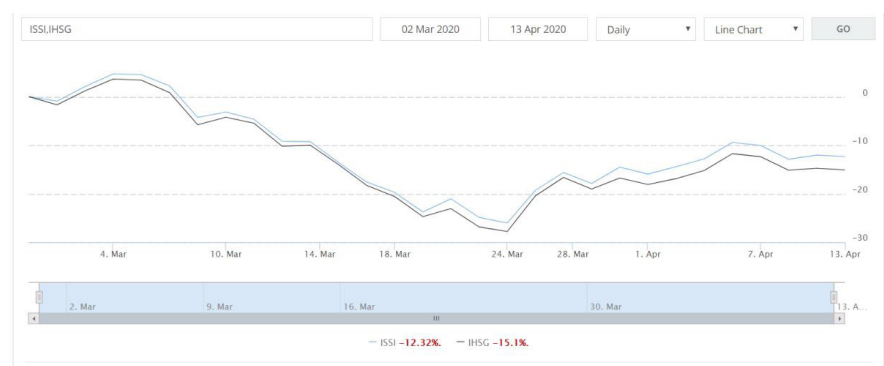
Indicators	APBN	Scenario	
		Heavy	Very Heavy
Economic Growth (% yoy)	5.3	2.3	-0.4
ICP Price (USD/barel)	63	38	31
Exchange Rate (per USD)	14.4	17.5	20
Inflation (% yoy)	3.1	3.9	5.1
Nominal GDP (Rp trillion)	17.464,7	16.829,8	16.574,9

Source: Ministry of Finance Indonesia

Meanwhile, according to news reported from www.finance.detik.com, on that first day of announcing the first case, the IHSG (Indeks Harga Saham Gabungan) closed at 91 points (1.67%) to the level of 5,361. Moreover, the IHSG trend was indeed bearish (the tendency of prices to move down/weaken). However, news of the entry of the corona virus into Indonesia directly infected the capital market. Prior to the entry of Covid-19 into Indonesia, the IHSG had begun to experience a downward trend as a result of negative sentiment from the corona virus which was spreading so fast in China. As a country with a sizeable economy, China certainly has a significant influence on the world economy. With the increase in cases of Covid-19 patients in Indonesia, the IHSG continued to decline with a quite severe decline. It was recorded that on trading on March 9, 2020, IHSG closed down by 6.5% to the level of 5,136.

This weakening was not only experienced by the IHSG, but also followed by the same trend by the ISSI (Indonesian Syaria'h Stock Index) but was still above the IHSG figure by a difference of around 0.1 - 2%. The historical data of IHSG and ISSI from beginning of Covid-19 case in Indonesia to the second week of April can be seen as follow:

Graph 1. Historical Data of IHSG and ISSI



Source: Indopremier.com

One of the causes of the weakening of the IHSG was because investors fled their money from risky investment instruments such as the Indonesian Rupiah (IDR) and IHSG to safe assets or safe haven such as gold to secure funds and avoid losses. It can be seen in the following graph, that gold prices fluctuated and experienced significant increases during the Covid-19 pandemic.

Graph 2. Gold Price Data in Rupiah



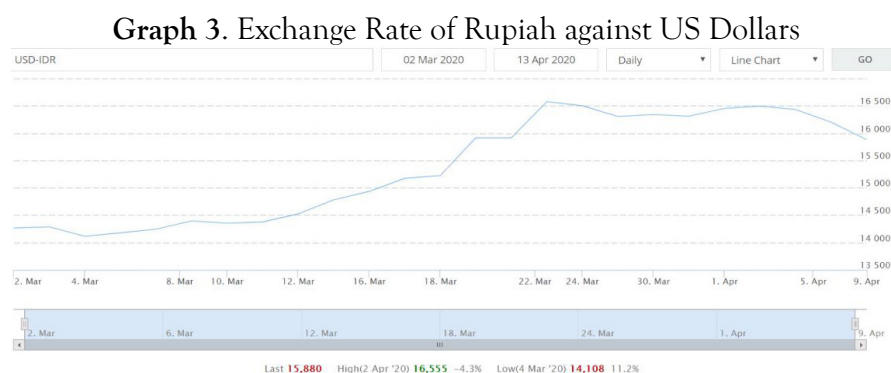
Source: Indopremier.com

Supplementary to this, the pandemic of Covid-19 also had an impact on the money market by weakening the rupiah exchange rate against the US dollar. During this pandemic period, it was noted that the rupiah exchange rate against the US dollar had increased by around 14%, which was originally 1 USD = Rp. 14,318 had reached its highest

point on March 30, 2020, namely Rp. 16,336, and the latest data as of April 13, 2020, at Rp. 15,840.

One of the reasons for the weakening of the rupiah is the decreasing level of investor confidence in Indonesia in overcoming this outbreak. As well as having an impact on the withdrawal of investment funds in the capital market. There are at least eight reasons for the weakening of the rupiah against the US dollar according to Aristanti (2020) through the Koinworks.com website¹⁶, namely: (1) Rich people are much more interested in investing in America and Europe than in Indonesia, (2) Imports have increased, but exports are not, (3) Indonesia's debt to other countries is increasing, (4) The Fed and other World Governments policies related to the economic conditions of their respective countries, (5) Differences in inflation in Indonesia and other countries, (6) Interest rates given by banks or Other Financial Institutions, (7) Political Influence on Foreign Currency Exchange Rates against Rupiah, and (8) Recession or monetary crisis in Indonesia and other countries.

The following is historical data on the rupiah exchange rate against the US dollar since the entry of the corona virus in Indonesia:



Source: Indopremier.com

The following are government policies during the handling of COVID-19 as outlined in PERPPU (Government Regulation in Lieu of Law) No.1 of 2020 concerning State Financial Policy and Financial

¹⁶ N D Aristanti, "Penyebab Melemahnya Nilai Mata Uang Rupiah Terhadap Dollar USA Dan Mata Uang Lain," Koinworks.com, 2020, <https://koinworks.com/blog/faktor-melemahnya-rupiah/>.

System Stability, namely with an additional budget of IDR 405.1 trillion which still unavailable on 2020 State Budget. During the handling of the COVID-19 situation, it was stated that deficit budgeting and financing could exceed 3% (three percent) of the Gross Domestic Product (GDP). However, this deviation is no longer than the fiscal year (FY) 2022. In 2023, the deficit will return to normal to a maximum of 3% with gradual adjustments. The sources of the budget that can be used in handling COVID-19 are the remaining budget (SAL), endowments and accumulated education endowments, funds controlled by the state with certain criteria, funds managed by the Public Service Agency (BLU), and funds originating from from the reduction of State Capital Participation in State-Owned Enterprises (BUMN)¹⁷.

In meeting the financing target for COVID-19, the government can also issue SUN / SBSN with certain objectives to be purchased by BI, BUMN, corporate investors and retail investors. Then, the government can also provide loans to the Deposit Insurance Corporation (LPS), refocus and / or cut / delay the distribution of Transfers to Regions and Village Funds (TKDD), provide grants to local governments (Pemda), and simplify the mechanism and simplify financial documents. country¹⁸.

Additionally, the policy also issued by OJK Regulation (POJK) No. 11/POJK.03/2020 concerning National Economic Aids¹⁹ which is summarized as follows:

1. OJK urges debtors not to come to a bank or finance company (leasing). Wait and follow the announcements submitted by the bank / leasing through the official website and / or official call center.
2. The priority for Debtors who receive relief is to meet the following minimum requirements:
 - a. Debtors affected by COVID-19 with credit / leasing values below IDR 10 billion include informal workers, daily income, micro and small businesses (UMKM and KUR loans).
 - b. The quality of restructured credit or financing is determined to

¹⁷ Kemenkeu, "Ini Daftar Kebijakan Keuangan Negara Dalam Perppu No. 1 Tahun 2020," Kemenkeu.go.id, 2020, <https://www.kemenkeu.go.id/publikasi/berita/ini-daftar-kebijakan-keuangan-negara-dalam-perppu-no1-tahun-2020/>.

¹⁸ Kemenkeu.

¹⁹ KNEKS, "Dampak Pandemi COVID-19 Terhadap Institusi Keuangan Mikro Syariah Di Indonesia," 2020.

- be current since the restructuring is carried out
- c. Credit relief can be given within a maximum period of 1 year in the form of adjustments to principal/interest installments, an extension of time or other matters determined by the bank/leasing.
 - d. Apply to bank/leasing by submitting an application through the bank/leasing communication channel. If done collectively for example

Conclusion

The Financial System covers both the Money Market and the Capital Market which includes Stock Exchange and Commodity Exchange. The role of the financial system in the economy is to strengthen financial institutions as a form of the development process of a country, as a means of accelerating economic growth and stability, maintaining welfare both socially and economically, ensuring an even distribution of income and wealth, and playing a role in poverty alleviation.

There is a clear difference between the Islamic Financial System (IFS) and the Conventional Financial System (CFS) from a philosophical and ethical perspective. Specifically, the differences between the two can be seen in terms of principles and basis, benefits taken, in terms of financing, and the resulting impact of inflation.

The IFS has several characteristics such as the absence of interest-based transactions or institutions, questionable transactions, company shares that are against the law, and transactions that are unethical and immoral, such as market manipulation, insider trading, or short-selling. The objective of the IFS is to base all of its activities on aspects of Islamic law or syari'ah, as an intermediary for channeling funds from surplus units to deficit units.

The impact of Covid-19 on Indonesia's financial system can be seen from the volatile money market and capital market which gave a big blow, especially in March. This impact can actually be seen from the scenario of Indonesia's macroeconomic conditions, IHSG and ISSI, gold prices, and the IDR-USD exchange rate.

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