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**THE ISSUE OF ISLAMIC BANKING IN INDONESIA:
EXISTING CONSTRAINTS AND FUTURE
PROSPECTS**

BY

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This is to certify that Bro./~~Srs~~ PILOT SAGARAN ANTONIO
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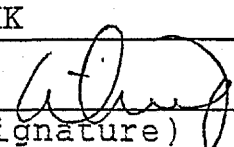
AND FUTURE PROSPECTS

under my supervision. The relevant comments made on the paper during its presentation have been incorporated in the present version of the paper to my full satisfaction.

I have pleasure in recommending that the graduate committee may approve the paper in partial fulfilment of the requirements for the degree of Master of Economics.

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(Signature)

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INTRODUCTION

Indonesia, as one of the unseparable parts of the Muslim world, perhaps has a different story in terms of having an Islamic bank. Interestingly, up to the middle of 1991, such an institution has yet to be established in the country. On the other hand profit and loss sharing based financial institution has taken roots and started offering an alternative for the existing riba-based system in most of the Muslim and in some of the non-Muslim countries as well.

The absence of a well-established Islamic bank in Indonesia prompts a question as to why such an institution does not yet exist in a country with the highest number of Muslim population in the world.

This paper attempts to provide an assessment to the problem and analyze the factors responsible for the late coming of Islamic financial institution into the country. At the same time the paper will also analyze the attempts deserve to be reckoned with in eliminating interest from bank and non-bank financial institutions.

After analyzing some issues relating to banking interest in Indonesia, the legal constraints in national banking system, and political consideration behind the late coming of an interest-free financial institution in the country, the paper will analyze the progress made so far in introducing PLS system both in the co-operative and banking sectors in Indonesia. For the pur

pose of having a more comprehensive information on the Indonesian experience in eliminating the element of interest from the financial sector, the analysis will be divided into two parts namely, attempts prior to the deregulation in banking policies and attempt in post-deregulation period.

Finally, in conclusion part of the paper, an attempt will be made to visualize the policy implications of the existence of PLS based financial institutions in Indonesian economy, especially during the time of high-rate of inflation and after the imposition of a tight monetary policy in the middle of 1990.

I. BACKGROUND

A. Social and Political Structures

With an estimated population of about 190 million people out of which about 89 % are Muslims, Indonesia is the largest Muslim country in the world. The Indonesian population, however, is not entirely homogenous. There are over 300 ethnic groups and more than 250 distinct languages in Indonesia today. With a total land area of 1.9 million kilometers square spread over 13,677 islands throughout the Indonesian archipelago, the homogeneity that characterize Indonesia is understandable.¹ Apart from Islam, Hinduism, Buddhism, Catholicism and Protestantism are accorded official recognition.

Politically, although Indonesia is predominantly a Muslim majority country, she declares herself as a secular state² espousing the ideas of "Pancasila" which symbolize her national ideology.³

1. Omar Farouq, "The Muslim of South East Asia : An Overview", in Islamic Banking in Southeast Asia, Mohammad Ariff (ed.), Singapore . ISEAS, 1988, p.18.

2. According to Donald Eugene Smith, "The secular state is a state which guarantees individual and corporate of religion, deals with the individual as a citizen irrespective his religion, is not constitutionally connected to particular religion, nor does it seem either to promote or interfere with religion". See Rafiq Zakaria, The Struggle within Islam : the conflict between religion and politics, London . Penguin Book, 1989, p.20.

3. Pancasila incorporates five basic principles which are (1) Belief in the Oneness of God, (2) Humanitarianism, (3) National Unity (4) Democracy or People's Sovereignty, and (5) Social Justice.

Following the independence, Indonesia has had to focus her attention on a search for a viable political system. After a very short period of liberal democracy, guided democracy was envisaged by Soekarno as the only way to bring about a political compromise between the conflicting ideological forces of Communism, Nationalism, and Islam, thereby preserving national unity in Indonesia. But an abortive coup by the Communist in 1965 abruptly ended Indonesia's experiment with guided democracy. The political system has since been restructured under military leadership with a view to removing decisive and disruptive elements within it.¹ Under the "Orde Baru" or "New Order" (envisaged in 1966), emphasis has been placed on economic development and political stability. Only "Pancasila Democracy" is sanctioned, and political parties espousing Islam has been told to regroup under the banner of the "Partai Persatuan Pembangunan," (PPP - United Development Party). Presently, there are three parties involved in the nation's general elections, namely Golkar (the ruling party), PPP, and Partai Demokrasi Indonesia ,(PDI - Indonesian Democratic Party).

B. Economic and Banking Systems

With regard to the economic system in Indonesia, the official system is "Ekonomi Pancasila" (Economy of Pancasila) and is some-

1. For more details see Yahya Muhaimin, Military and Political Development in Indonesia 1945-1966, Yogyakarta. Gajah Mada University Press, 1982, pp.10 and after.

times also named as Co-operative Economy. The economy of Pancasila came into being as a realization of article no. 33 of Undang-Undang Dasar 1945 (1945 Constitution) which mentioned that:

- (1). The economy shall be organized as a common endeavour based on the principle of family system.
- (2). Branches of production which are important for the state and which affect the life of the most people shall be controlled by the state.
- (3). Land and water, and the natural riches contained therein shall be controlled by the state and shall be used of for the people.¹

Basically, the economic system of Pancasila is distinguished by four main characters, which are :

- (1). Human-oriented economy.
- (2). Co-operative as the leading figure of national economy.
- (3). Non-etatism of the state's control.²
- (4). Guided development of private sector.

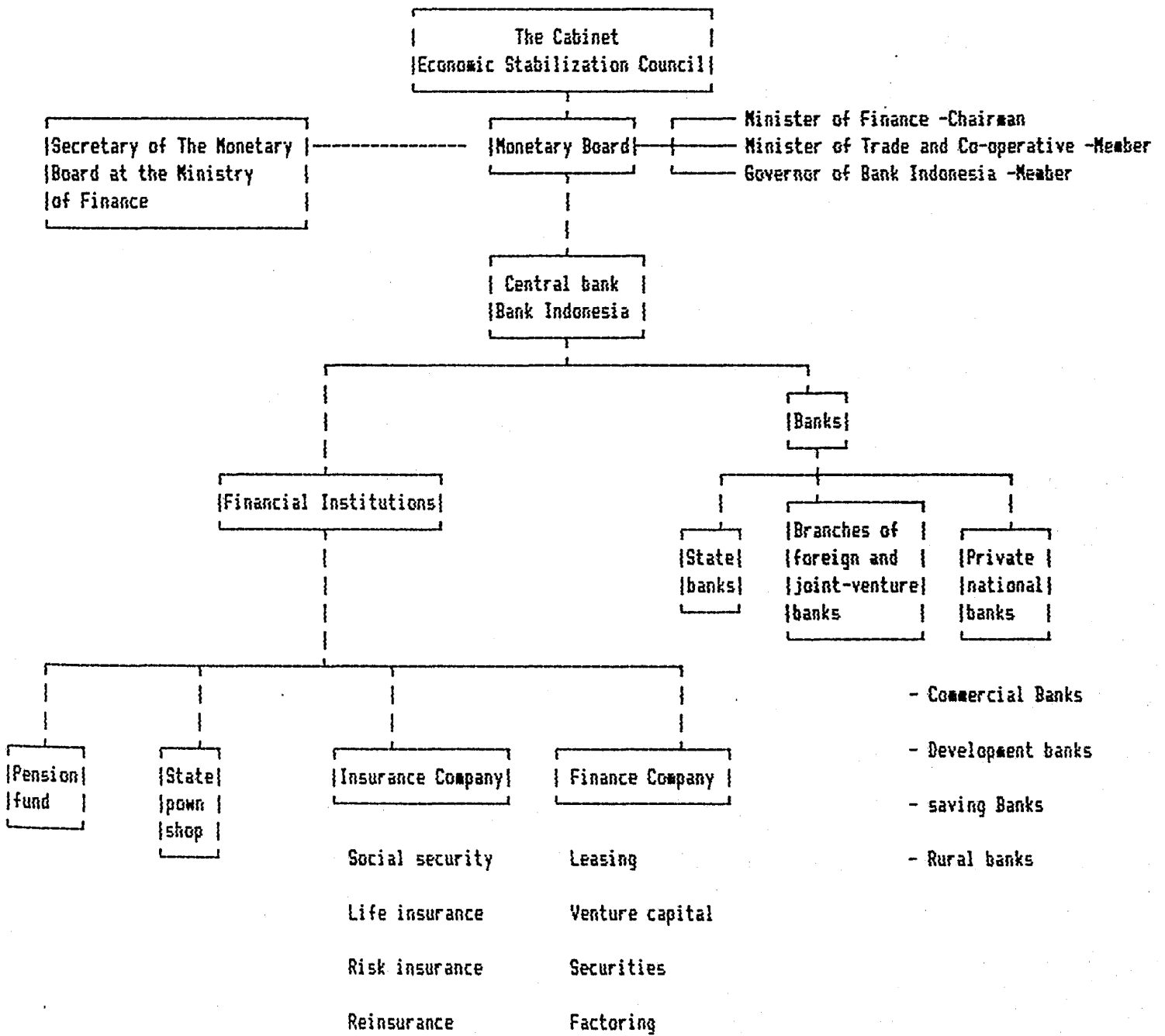
Regarding financial and banking systems in Indonesia, the general structure, according to the General Law of Banking 1967, could be summarized in the following diagram.

1. Selo Soemardjan, Indonesia : A Socio-Economic Profile, New Delhi. Sterling Publisher, 1988, p.107.

2. Mubyarto "System and Moral of Indonesian Economy", Jakarta. LP3ES, 1990, pp.42-54.

Chart (1)

The Indonesian Financial System



ce:

- Anwar Nasution , Financial Institution and Policies in Indonesia, Singapore: ISEAS, 1982 p.64

- Joyosumarto, S, Indonesian Banking System and Islamic Bank, Jakarta: Jakarta OIC Economic Consultative Forum, 1991, p.1