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World Development Vol. 41, pp. 157–167, 2013

0305-750X/$ - see front matter

http://dx.doi.org/10.1016/j.worlddev.2012.06.007

Development, Social Change, and Islamic Finance in Contemporary Indonesia

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Summary. — The global spread of Islamic finance has transformed the financial systems of many Muslim countries, but analysts know little about the factors that shape individuals' demand for Islamic finance. This paper examines the socioeconomic origins of consumer demand for Islamic financial products, using original survey data from Indonesia, where a growing Islamic financial market coexists with a large conventional financial system. Modernization and globalization play critical roles in shaping individual use of Islamic financial products. Perhaps surprisingly, there is no evidence that Islamic piety has any systematic effect on consumers' choice of Islamic versus conventional financial products.

Key words — Islamic finance, economics of religion, globalization, modernization, Muslim world, Indonesia

1. INTRODUCTION

The global spread of Islamic finance has transformed the financial systems of Muslim countries. Despite an abundance of theoretical research on how Islamic finance operates (Aggarwal & Yousef, 2000; El-Gamal, 2006; Henry & Wilson, 2004; Kuran, 2004; Visser, 2009; Warde, 2000), and a growing number of studies of Islamic financial institutions in various national contexts (Ariff, 1988; Khan & Mirakhor, 1990; Moore, 1990; Venardos, 2006; Wilson, 2009), we know little about Islamic finance from the perspective of ordinary Muslims who might choose to use it.

Traditionally, analysts have argued that pious Muslims are the primary users of Islamic financial products. Almost mechanically, the existence of a group of pious Muslims indicates a demand for Islamic banking products. In addition to the many industry studies that propose that pious Muslims are a large and untapped market segment, the marketing literature on bank choice has identified religious motivations as uniting consumers of Islamic financial products (see Gait & Worthington, 2008 for a review). Scholars rarely articulate the logic behind these findings, but implicitly it is one of Islamic orthopraxy: the choice of Islamic financial products signifies that a pious Muslim has internalized proper Islamic guidelines for behavior in various aspects of everyday life not directly tied to religious belief and practice.

An alternative is to approach Islamic finance as a phenomenon embedded within wider processes of development social change in the Muslim world. This approach draws on social scientists' research on the particular social contexts in which Islamic finance has grown in the past three decades. It is possible, in this vein, to recast consumers' views of Islamic finance in terms that are amenable to a more economic or sociological analysis, viewing the rise of Islamic banking as an instance of a more general process through which individuals claim or maintain a Muslim identity. Conceived this way, the choice of whether or not to use Islamic financial products is an indication of something deeper than expressed piety, and may in fact reflect the ways in which individuals respond to broader social, economic, and political changes.

Two transformations have occurred in the Muslim world in the past decade—each occurring alongside the rise of Islamic orthopraxy—that suggest different perspectives on consumers' use of Islamic banks than does the literature on bank marketing. The first transformation is the rise of a Muslim middle class (see e.g. Clarke, 2004; Nasr, 2009; Tanter & Young, 1990). Middle- and upper-class Muslims face distinct challenges of identity maintenance. On one hand, they have resources for consumption that set them apart from the poor and working classes. At the same time these same individuals face problems of social dislocation that are a product of the very processes of modernization that transformed their class status.[1] A common finding is that such feelings of social dislocation increase individuals' propensity to identify with Islam in their behavior, lifestyle, consumption choices, and political attitudes—many of which are more salient issue areas for members of the middle and upper classes than they are for the poor and working classes. For Khoury (1983, p. 251), "Islamic revivalism" in politics and social life is a central response to modernization by "classes that in recent years have been drawn into the modernization process but have not been assimilated by it." Because the distinctive feature of middle- and upper-class Muslims is their ability to consume, we should observe this process of identity maintenance in their consumption patterns. This class-based approach suggests that middle- and upper-class Muslims should be the primary users of Islamic financial products. This is not simply because they are wealthy enough to diversify their investments toward Islamic financial products (assuming such products, being new, are more risky), but rather because they

* Earlier versions were presented at the annual meeting of the International Political Economy Society, Cambridge, MA, November 12-13, 2010, and the conference Islam and Muslim Societies: An Analytical Examination, Harvard Kennedy School, April 8-9, 2011. This project employs data collected as part of a larger research project, joint with R. William Liddle and Saiful Mujani, and funded by the Smith Richardson Foundation, Inc. Liddle, Mujani, and the Smith Richardson Foundation are in no way responsible for the content of this paper or the conclusions drawn herein. Thanks to Nadira Purdayinta for outstanding research assistance, and to Lisa Blaydes, Lawrence Broz, Jean-Paul Carvalho, Jeff Frieden, Saumitra Jha, Amaney Jamal, Asim Khwaja, Sherry Kong, Timur Kuran, Chris Manning, Tarek Masoud, three anonymous reviewers, and seminar participants at ANU and Murdoch University for helpful comments on an earlier draft. I am responsible for all errors. Final revision accepted: June 12, 2012.

view such practices as preserving a particular Muslim identity in the face of various social changes inherent to modernization.

The second transformation of the Muslim world is the consequence of globalization and the transformation of Muslim identity (Keyman & Koyuncu, 2005; Khoo & Hadiz, 2010; Mandaville, 2001; Meuleman, 2000; Roy, 2004). Globalization in these accounts has transformed Muslim identity by changing individuals' terms of reference from the national or local community to the global or transnational community. Much like modernization and class formation, globalization can lead to the same kind of social dislocation that increases individual ties to a "deeper" or "enduring" religious identity. But globalization also increases the salience of the Muslim identity by linking it to a broader transnational religious community. Not all Muslims will respond to globalization in this way—it is just as possible that globalization will increase the salience of one's identity as a member of other global or transnational communities—but among those who do, the consequences should be visible in everyday life choices. Such internationalist approaches suggest that Muslims who identify with the global Muslim political community should be more likely to use Islamic financial products because doing so is one way to express one's identification with that community.

These arguments about the origins of social change in the Muslim world do not directly compete with one another, although they differ in how they conceptualize contemporary social change—as driven by Islamization and religious change, by modernization and class formation, or by globalization and identity change. However, when applied to the particular problem of Islamic finance, none of these approaches is based on systematic empirical research. Strikingly, we do not even know if more pious Muslims are more likely to use Islamic financial products than are less pious Muslims, as per the conventional conclusions from the marketing literature. Most such studies of Islamic banking suffer from basic problems of selection bias, for almost without exception these studies focus only on consumers of Islamic banking products (e.g. Asyraf & Nurdianawati, 2007; Metawa & Almossawi, 1998). Other individual-level research focuses only on consumers' awareness of Islamic financial products (e.g. Naser, Jamal, & Al-Khatib, 2003), or on a limited number of banks within a country (e.g. Hegazy, 1993). Without even a basic grasp of the relationship between piety and the use of Islamic financial products, it is impossible to weigh the influence of piety versus alternative determinants of individuals' choice of Islamic versus conventional banking products.

Rather than starting with the customers of Islamic banks and determining what characteristics they share, this paper starts with all potential consumers and investigating the factors that separate those who use Islamic financial products from those who do not. The result is the first comprehensive study of the individual-level determinants of the use of Islamic financial products in a majority-Muslim country, using data from an original, nationally-representative survey in Indonesia—which has both a large conventional banking industry and a large and growing Islamic financial industry. There is robust evidence supporting the class and internationalist approaches to the sources of demand for Islamic financial products: the frequency with which Indonesian Muslims report using Islamic financial products increases both as a function of family income and of respondents' views of the importance of establishing strong political ties with Saudi Arabia. In sharp contrast with the existing empirical literature—including the only existing study of consumer attitudes toward Islamic banks in Indonesia (Abduh & Omar, 2007)—there is no evidence that Islamic piety is even a partial determinant of the use of Islamic financial products in Indonesia. These findings cannot be explained by differential access to Islamic financial products among different segments of the Indonesian Muslim population, nor can they be explained simply by the ability of wealthier Indonesians to diversify their holdings across different kinds of financial products.

In the next section I provide a brief overview of Islamic finance in order to establish that for most consumers, there is little that distinguishes Islamic products from conventional ones aside from the label applied to them. In Section 3 I turn to the Indonesian case, describing the context of Islamic banking in that country, the data, and my empirical strategy. Empirical results appear in Section 4. Section 5 concludes with a discussion of the implications of these findings for the broader literatures on globalization, modernization, and identity change in the Muslim world; the literature on Islamic banking; and the narrower marketing literature on Islamic banks and bank choice.

2. ISLAMIC FINANCE: AN OVERVIEW

Warde (2000, p. 5) defines Islamic finance as, roughly, all financial practices that "are based, in their objectives and operations, on Koranic principles." This is a broad definition, but it captures the essential nature of Islamic economics as an attempt to reconcile religious principles with economic activities. This goes far beyond interest-free banking to include, for example, refusing to do business with companies that operate in morally impermissible sectors (such as gambling). That said, in the actual operations of Islamic financial institutions, and for the purposes of this paper, the essential defining feature of Islamic finance is the explicit prohibition of transactions that involve *riba* (an Arabic term usually translated into English as "interest" but which encompasses several related features of economic exchange [2]).

The prohibition of interest in Islamic economics generates fundamental problems in the operation of Islamic financial institutions. To understand why, consider one basic financial transaction: loan provision. In conventional finance, the lender (hereafter "the bank") provides funds to a borrower (hereafter the "entrepreneur") seeking to use those funds for some productive use; say, to buy a new machine for a factory. The entrepreneur agrees to pay that sum of money back to the bank at some future time plus an additional percentage of the loan's principle—interest—which reflects the time value of money and the profit that the bank expects to make on the transaction. The ability to charge interest is the essence of the bank's motivation for engaging in such a transaction. By contrast, the expectation of future profits from the new machine that exceed the interest charged on the loan is the entrepreneur's motivation for engaging in this transaction.

Islamic scholars have interpreted the ban on interest to reflect an inherent asymmetry in such transactions: the risk in this transaction is believed to fall entirely to the entrepreneur, who must pay back the loan regardless of whether she/he actually obtains profits from the productive use of the loan. Islamic scholars have held that a legitimate contract form must be one that allows risk to be borne by *both* parties to the contract. The goal of the vast body of contemporary scholarship on Islamic finance is to determine how to accomplish these and other related transactions without charging interest, that is, by sharing risk.

Complete treatments of how Islamic scholars, jurists, and bankers have recreated such transactions without explicitly charging interests appear in El-Gamal (2006), Warde (2000, pp. 132–148), and Venardos (2006, pp. 71–84). Briefly, there are two ways that Islamic financial institutions avoid interest: