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*by Ahmad Dahlan*

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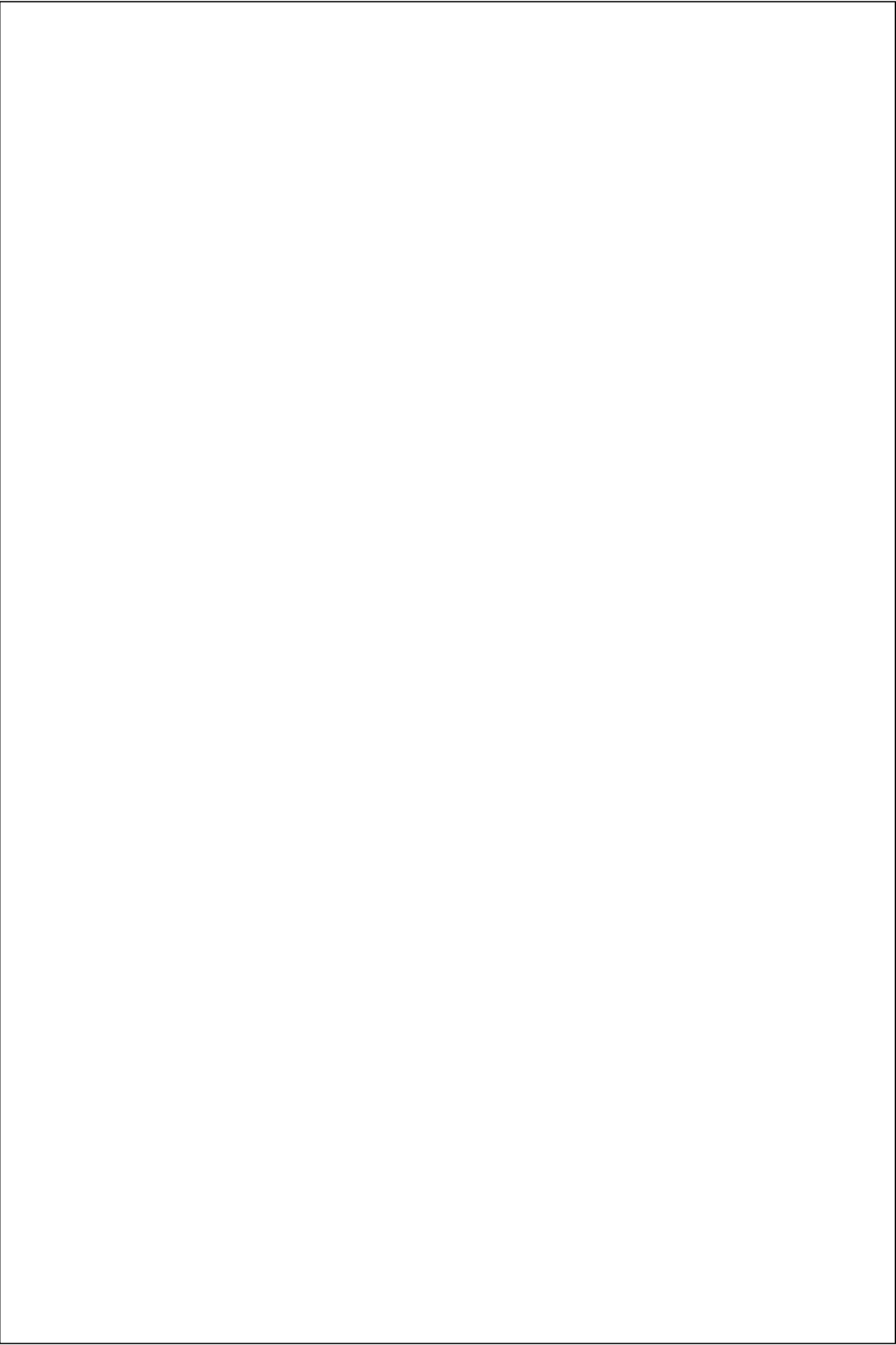
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**POLITICAL ECONOMY OF  
ISLAMIC BANKING IN  
INDONESIA**





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# POLITICAL ECONOMY OF ISLAMIC BANKING IN INDONESIA

THE POLITICAL SUPERSTRUCTURE OF  
SHARIA BANKING POLICY IN 1992-2011

Dr. Ahmad Dahlan, M.S.I.



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*Political Economy of Islamic Banking in Indonesia: The Political Superstructure of Sharia  
Banking Policy in 1992-2011*

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**Dedicated to:**

My God, Allah *Subhânahu-wa-Ta'âlây*

Prophet Muhammad *Sallây-Allâh-u-Alayhi-Wa-Sallam*

My Parents

My beloved wife (*Dunyâ Akhîrat*), Firdaus Albar

My sweet daughter, Naurah Mahaabati asy-Syafaa'

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*Bismillâh al-Rahmân al-Rahim*

I met Ahmad Dahlan at the Islamic Council of Victoria (ICV) Australia on the 17th of October 2019. We discussed the development of the Islamic economy and Islamic finance in Australia, Indonesia, and in the world.

Then I read his book manuscript, and I think it is very good. He maps the development and intricacies of sharia banking regulations in Indonesia, analyzing them with the political economics approach.

Indonesia, one of the largest Muslim countries in the world, has an economic role in the global market. It will be increasingly crucial for us to understand the opportunities and challenges of Indonesia in the development of the sharia banking that is growing in some countries.

Dahlan argued that the establishment of Islamic banking in Indonesia in the early 1990s represented a political compromise between the political superstructure and the Islamic political infrastructure, such as the Indonesian Ulema Council (MUI), the Indonesia Association of Muslim Intellectuals (ICMI), and others. The discussion was strengthened by interviews with Karnaen Perwaatmadja and M. Syafi'i Antonio (two figures of the Islamic economics movement in Indonesia).

I hope Dahlan may research Islamic banking development in Australia. I feel Australia has the most potential as a market of Islamic finance and *halâl* economic business in the Asia-Pacific.

Thank you and *Wassalâm-u-'Alaykum*

<sup>1</sup>  
Melbourne, Australia, July 2020

Almir Colan

Director at AUSCIF (Australian Centre for Islamic Finance)

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# Preface

**A**<sup>1</sup>*lhamdu-Lillâh*. All praises are to Allah s.w.t.; peace and blessings to our Prophet Muhammad s.a.w., his family and companions, and our teachers from before and during our time.

Islamic finance has grown significantly and has received worldwide attention. This book provides a qualitative overview of Islamic finance in Indonesia that will be described in three sections: the introduction, the discussion, and the conclusion.

The introduction describes several aspects of the research problem, the theoretical framework, and the literature review.

The discussion is contained in three chapters:

Chapter 1 describes the superstructure policy of Islamic banking in Indonesia within the 1992 to 2011 period. In this period, the political processes resulted in policies leading to three pieces of Islamic banking legislation: Law No. 7 of 1992, Law No. 10 of 1998, and Law No. 21 of 2008. The discussion focuses on the significant policy impacts on the elements related to Sharia banking.

Chapter 2 explains the fluctuations of the Islamic political infrastructure from 1992 to 2011. The data are analyzed by looking for various dynamics in the Islamic political infrastructure acting as a pressure group affecting policy in the political economy of Islamic banking in Indonesia. The discussion was strengthened by the interrelation of Islamic politics with the political superstructure before 1992.

Chapter 3 is a discussion of the political economy of Islamic banking in Indonesia from 1992 to 2011. The discussion is contained in six parts: First, the establishment of the first Islamic banking in Indonesia, including Islamic banking thought, and the success of the Islamic political infrastructure in establishing the first Islamic bank; Second, reform to Islamic banking; Third, the liberalization of Islamic banking; Fourth, the purifications of Islamic banking in regulations, human resources, and institutions; Fifth, the influence of sharia banking policy; and Sixth, a discussion of the political integration and religion on sharia banking policy.



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The last part is the conclusion. Some laws and regulations have been issued to drive the growth of Islamic banking in Indonesia, but up to 2011 it never reached Bank Indonesia's target of securing a 5 percent share of the financial market. The strengths of the political superstructure, such as the ICMI, are needed to encourage the policies of Islamic economics and banking regulation since the Islamic political infrastructure stopped being strategic like it was during the early 1990s.

Finally, I would like to thank Dr. Khariri, Dr. A. Luthfi Hamidi, Dr. Moh. Roqib, and Civitas Academics' State Institute for Islamic Studies (IAIN), Purwokerto, Central Java. Also my overseas brothers: Almir Colan (Director at the Australian Centre of Islamic Finance, AUSCIF), Ayman Islami (Islamic Council of Victoria, ICV), Prof. Salim Farrar (University of Sydney), Azhar Ibrahim, Ph.D. (National University of Singapore), Wan Khuzaery (Malaysia), Syekh Teguh Iskanto, Ahmad Subardja, Asroni Zubair, Novian Abu Bakar and Naufal Muhammad (Indonesian Muslim Community in Victoria, IMCV, Australia), Al-Fath (Young Indonesian Muslim Student Association, YIMSA, Australia), Tufel N. Musyaddad (Charles Darwin University), Shaifurrohman (MES Australia-New Zealand). My mentors: Jeff R. Young (Universal Publishers, Florida, USA), M. Syafi'i Antonio, Ph.D. (Tazkia Group Indonesia, Sharia Board of Islamic Development Bank [IDB], Jeddah), Karnaen Azwar Perwaarmadja (*almarhûm*), Prof. Abdul Salam Arief (UIN Sunan Kalijaga Yogyakarta), Akhsim Affandi, Ph.D. (Faculty of Economics, UII Yogyakarta), Dr. Qizam, Ak. (FEBI, UIN Sunan Kalijaga Yogyakarta). My spiritual teachers: Habib Muhammad Effendy al-'Aydarus (Tarîqat 'Alawiyat, Yogyakarta), Habib Ahmad al-'Atas (Purwokerto, Central Java). My colleagues: Dr. M. Misbah, Dr. Akh. Faozan, Agung, MT. Karyadi, Ahmad Zayyadi Pustaka Ilmu, Kompol Gusman Fitra (QytaTrans Group), Dr. Tatung (PT. Orion), and Alumni of MAPK (Madrasah Aliyah Program Khusus) Yogyakarta.

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*Wallâhu-A'lâm-u-bis-Sawâb.*

Purwokerto, Indonesia, January 2020

Ahmad Dahlan

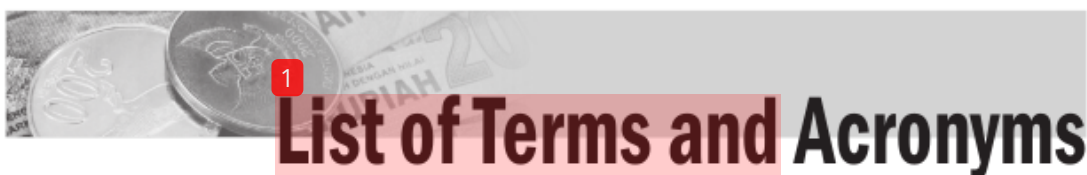


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# List of Terms and Acronyms

## Act and Regulations

Pakjun 83/Junpack 83: economic policy packages dated June 1, 1983

Pakto 88/Octpack 88 : economic policy packages dated October 27, 1988

**GR** : Government Regulation (Peraturan Pemerintah)  
GR No. 70 of 1992 concerning Commercial Banks  
GR No. 71 of 1992 concerning Rural Banks  
GR No. 72 of 1992 concerning Banks Based on Profit-Sharing Principles

Act 2008: Law No. 21 of 2008 concerning Sharia Banking

Act 99 : Law No. 23 of 1999 concerning Bank Indonesia

Act 98 : Law No. 10 of 1998 concerning Banking

Act 92 : Law No. 7 of 1992 concerning Banking

Act 68 : Law No. 13 of 1968 concerning the Central Bank

Act 67 : Law No. 14 of 1967 concerning Banking Principles

Act 53 : Law No. 11 of 1953 concerning the Principles of Bank Indonesia

## State Institutions

**DPR** : Dewan Perwakilan Rakyat/House of Representatives

**MPR** : Majelis Permusyawaratan Rakyat/People's Consultative Assembly

**ABRI** : Angkatan Bersenjata Republik Indonesia/Indonesian Armed Forces

**TNI** : Tentara Nasional Indonesia/Indonesian National Army

**POLRI** : Polisi Republik Indonesia/Indonesian National Police

**BI** : Bank Indonesia/Indonesian Central Bank

**OJK** : Otoritas Jasa Keuangan/Financial Services Authority



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### Political Parties under Old Order

Masyumi	Partai Majelis Syuro Muslimin Indonesia/Indonesian Muslim Syuro Assembly Party
Parmusi	Parsaudaraan Muslim Indonesia/Indonesian Muslim Brotherhood Party
PSI	Partai Sosialis Indonesia/Indonesian Socialist Party
Permesta	Piagam Perjuangan Semesta/Universal Struggle Charter
PKI	Partai Komunis Indonesia/Indonesian Communist Party

### Political Parties under New Order and in Reform Era

PKB	Partai Kebangkitan Bangsa/National Awakening Party
PAN	Partai Amanat Nasional/National Mandate Party
Golkar	Partai Golongan Karya/Party of Working Groups
PDI-P	Partai Demokrasi Indonesia Perjuangan/Indonesian Democratic Party of Struggle
PBR	Partai Bintang Reformasi/Reform Star Party
PBB	Partai Bulan Bintang/Crescent Star Party
PDS	Partai Damai Sejahtera/Prosperous Peace Party

### Financial Institutions

BIMB	Bank Islam Malaysia Berhad
BMI	Bank Muamalat Indonesia
DIB	Dubai Islamic Bank
IDB	Islamic Development Bank
IFSB	Islamic Financial Services Board

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### Economic Terms

3 D	(Dîn, Dunyâ, Dawla)
<i>Dîn</i>	synonym of religion
<i>Dunyâ</i>	synonym of economics
<i>Dawlat</i>	synonym of politics
EaC	Economy as Commander

MaC	<sup>1</sup> Morality as Commander
PaC	Politics as Commander
SBU	Sharia Business Units/Unit Usaha Syariah
SCB	Sharia Commercial Banks/Bank Umum Syariah
SRB	Sharia Rural Banks/Bank Pembiayaan Rakyat Syariah
LPS/IDIC	Lembaga Penjamin Simpanan/Indonesia Deposit Insurance Corporation
IDR	Indonesian Rupiah
Pertamina	Perusahaan Tambang dan Minyak Nasional/Indonesian Oil Corporation

#### Non-Governmental Organizations

MUI	Majelis Ulama Indonesia/Indonesian Ulema Council
ICMI	Ikatan Cendekiawan Muslim Indonesia/ <i>Indonesian Association of Muslim Intellectuals</i>
DPS	Dewan Pengawas Syariah/Sharia Supervisory Boards (SSB)
DSN-MUI	Dewan Syariah Nasional-Majelis Ulama Indonesia/National Sharia Board-Indonesian Ulema Council (NSB-IUC)
HMI	Himpunan Mahasiswa Indonesia/Muslim Students' Association
NU	Nahdlatul Ulama: the largest Islamic mass organization in Indonesia
OIC	Organization of Islamic Cooperation (formerly Organization of the Islamic Conference)
OPEC	Organization of Petroleum Exporting Countries







# Introduction

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## 0.1 The Background

Indonesia is a unique country in the context of the Islamic banking establishment. Socially, Muslims are the majority, and politically, Indonesia is a member of the Organization of Islamic Cooperation (OIC), an institution that encouraged the establishment of the Islamic Development Bank in 1973. However, the establishment of Islamic banks in Indonesia only started in 1992 and the long delay has left Indonesian banks far behind those in other Islamic countries, such as the Dubai Islamic UAE Bank (1975), the Faisal Islamic Bank Sudan (1977), the Bahrain Islamic Bank (1979), and Bank Islam Malaysia Berhad (BIMB) in 1983.

According to Salavrakos (University of Western Greece), in the field of economics the term “political economy” can be defined by the debate about the importance of economics for the individual, the society and the state.<sup>1</sup>

Yustika (Professor of Political Economy at Brawijaya University, Indonesia) stated that the most important aspect of the political-economic approach is the political infrastructure, or the structural power in society that may affect economic achievements. Compare this with the purely economic approach that states that structural power in a market mechanism is a *given*.<sup>2</sup> Mayntz argues to reintegrate political science and economics in the new research. That the political economy have been paralleled by a shift in the meaning of “liberalism, from a doctrine calling for a relatively passive state and an economy guided

<sup>1</sup> Salavrakos (2012).

<sup>2</sup> Yustika (2009: 2).

by the ‘invisible hand’ of the market to the view that the state should actively intervene in the economy in order to generate growth and sustain employment.<sup>3</sup>

Thus, in the political-economic study concerning the context of the delayed implementation of Islamic banking in Indonesia, it is necessary to seek the interrelation of the political superstructure vis-à-vis Islamic political infrastructure in Indonesia, for the individual, the society and the state. Some previous research, such as by Anwar (1995), Effendy (1998), Ahmad (2004), Robison (1990, 1996), Hefner (2001), and Hadiz (2011), showed that Islamic political interests were accommodated by political superstructure through several policies, especially regarding the existence of Muslims in both the executive and legislative branches in the 1990s.

Some studies from many countries show the political economy of Islamic banking has become a major interest of academic research, such as by Henry (2015) who studied it in Indonesia, Hamat *et al.* (2016) who studied it in Indonesia and Malaysia, and Okeke-Ojukwu who studied it in Nigeria (2012).

## 0.2 Theoretical Framework

### Theory of Political and Religious Integration in Economics

A theoretical concept for the political and religious integration in economics refers to previous theories: First, Mallarangeng’s theory concerning the coalition of political and economic interests. The assumption of this theory is that changes in policy reflect greater changes in society, and every policy change requires support from a coalition of various economic groups. Therefore, a policy change will occur if it is supported by a coalition of influential groups that forces the policymakers into accommodating certain policies.<sup>4</sup>

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<sup>3</sup> Mayntz (2019).

<sup>4</sup> Mallarangeng (2002: 2–5); Goldstein (1993: 10).

The theory of the coalition of political and economic interests does not emphasize the theoretical problems. So, it is used to assume that sharia banking policy may reflect greater changes in society over the need for Islamic financial institutions and the change of Islamic political infrastructure.

Second, Ayubi's theory is that politics requires a movement to reform the manifestation of the three Ds: *Dîn*, *Dunyâ*, and *Dawlat*.<sup>5</sup> *Dîn* is synonymous with the religious aspects, or Islamic Sharia. *Dunyâ* is synonymous with the economic aspects, and *Dawlat* is synonymous with the political aspects.

Third, Caporaso's and Levine's shared opinion is that the political economy is the interrelation of various aspects of economic and political institutions in economic policy.<sup>6</sup> Fourth, Yustika explains that the difference between political economy and pure economics is that political economy concludes that the political power structure influences economic achievement, while the pure economics approach considers the power structure in the market as a *given*.<sup>7</sup> Fifth, according to Effendy's research, Islam did not fully participate in the political development of Indonesia, especially in the 1970s and 1980s. The deadlock started to clear in 1992, when the state began to accommodate Islamic interests.<sup>8</sup>

The links between the above theories are analyzed as the basis for the theory of political and religious integration in the economy.

### **The Link of Political and Religious Integration in the Economy**

The political and religious integration in the economy may be described by connecting lines and nodes as in the following chart:

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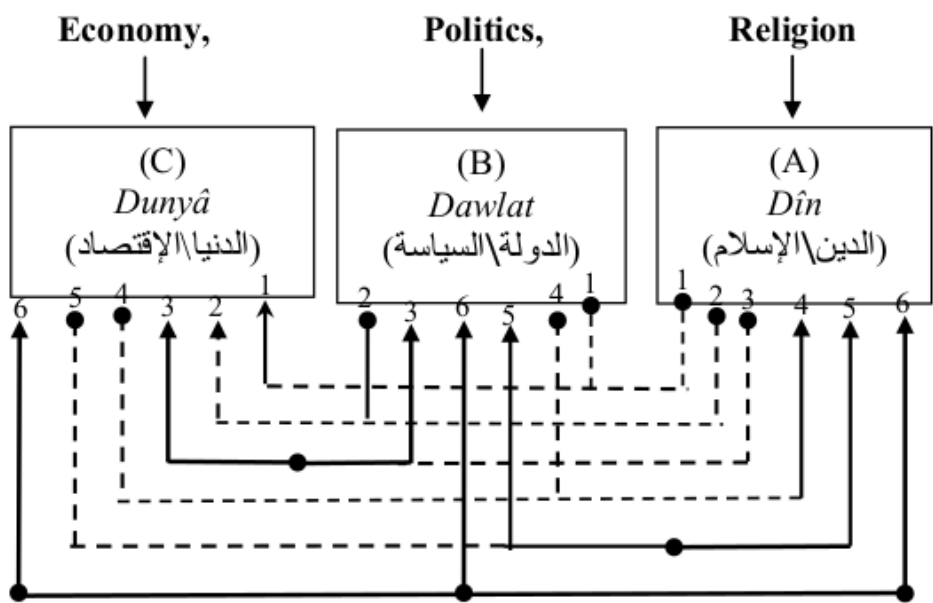
<sup>5</sup> Ayubi (1991: 63–4).

<sup>6</sup> Caporaso and Levine (1992: 3).

<sup>7</sup> Yustika (2009: 2).

<sup>8</sup> Effendy (1998: 214).

Flowchart 1.1  
The link of Political and Religious Integration to the Field of Economics



- Note:
- 1. Economic study
  - 2. Political study
  - 3. Political economics study
  - 4. Religious study to political and economic study disconnected
  - 5. Pure Islamic political study
  - 6. Islamic political economics study

Line #1: “Pure economic study (C) is not connected with politics (B). This study is influenced by the classical economic theories, especially the laissez-faire approach to market power, which still drives all economic activities (free market).”

Line #2: “Political study (B) only examines the aspects of the political superstructure and state policy, and is not integrated with any economic approach (C).”

Line #3: “The political-economic study criticizes the problem of interrelations between economic and political studies. The political-economic study grows as an interrelation study of economic and political structures (Caporaso), or economics is not only related to the market power structure but also examines a political structure or others



(Yustika). Then, the political economy constructs the interrelations of economics (C) with a political approach (B).”

In Islamic political economics, the developed critiques concern the relationship between economics and politics, plus their relationship with religion. Thus, Islamic political economy is itself a critique of the political-economic approach, which only emphasizes the connections between B and C, but not with *Dîn* (A), the religion aspect.

Islamic political economics also criticizes the religious studies (A) that do not emphasize the contemporary and practical relationships in both the political and economic fields (B+C). The religious studies are dominated by issues concerning the Hereafter, instead of the *profane* aspects.

Furthermore, Islamic political economy develops interrelations connecting aspects of the religious, political, and economic studies as a unity (A+B+C).

Line #4 shows “Religion (A) and political (B) studies basically have been connected by the cluster of political jurisprudence (*Fiqh-u-Siyâsat*). Yet the relationship is rarely formalized in the state’s constitution. There are still long-running disputes over Islamic political concepts and practice.”

Meanwhile, the relationship between religion (A) and economic (C) studies has long been a theoretical study and has been popular since 1973, when the Islamic Development Bank was established.

Line #5: “It shows that the religion and political approaches are integrated as Islamic politics (*Siyâsat-ul-Islâm*), but in practice they do not connect to the field of Islamic economics. Besides, Islamic political study is dominant in the aspects of social and political policy, but it rarely penetrates to the aspect of economic policy.”

Due to the interrupted relationship of three scientific clusters (religion, politics, and economics), the author then constructs a theory by integrating politics and religion in the field of economics as an Islamic political-economic study discourse, stressing the existence of three great sciences and ideologies, religion (*Dîn*), economics (*Dunyâ*), and politics (*Dawlat*), which are mutually integrative.

Line #6: “Islamic Political Economy Study is an analytical theory to trace the integration of *Dawlat* (politics) with *Dîn* (personified as an Islamic society, Muslim intellectual, or Islamic political infrastructure) for seeking economic (*Dunyâ*) policies by interrelating those aspects.”

### 0.3 Literature Review

Many theories, approaches, and histories of political economics are described in Caporaso and Levine (1992), Rachbini (2002), Deliarnov (2006), and Yustika (2009). All explanations begin from the theoretical frameworks of the interrelation of politics and economics in the view of classical economics scholars, Keynesians, and neo-classics. Theories of political economy describe public choice, rent-seeking, redistributive combines, and the idea of justice theory. Nevertheless, in these books, there are no explanations of the various cases or methods to apply theories of political economy in response to a country's modern economic development. The exception is Yustika's book, which describes national economic cases in Indonesia, analyzing them using the political economy approach supported by primary data. Rachbini emphasized the theory of the New Political Economy (NPE), which is a study of the phenomena and problems of non-market mechanisms, including the state's role and its interventions in the economic market.

The Islamic political economy has been described by Salleh and Rosdi (2014), and Askari, et al. (2015). Salleh and Rosdi explain the many understandings and methodologies of political-economy study. Political economy is currently an interdisciplinary study referring to economics, law, and political science to explain the symptoms of political institutions, political environment, capitalism, socialism, and mixed economic systems. It may be assumed that analysis of the interrelation of economics and politics will ensure an increase in national wealth to fulfill various social needs using interdisciplinary approaches.

In the limited number of kinds of literature, the definition of Islamic political economics is that it is a study of the economic effects of political superstructure policies in a country. It emphasizes that the micro and macro aspects of the fields of economics and politics should facilitate the functions of the Islamic economic system. The successes

and failures of Islamic banks have become clear examples of the importance of integrating the state's existence and market mechanisms in Islamic economic cases.

Askari *et al.* describe the Islamic economic system as a market-based system seen as the best and most efficient mechanism for allocating resources for production and consumption. To be efficient, a market must have rules, such as those concerning information disclosure to protect market participants, e.g., workers, producers, investors, and consumers. However, according to Islamic sharia, Allah *Ta'âlay* is the Creator of all on the Earth and his creations are given to all humans. Thus, all land and all natural resources must be used to benefit all generations equitably.<sup>9</sup>

The political superstructure policy for banking in Indonesia has been studied by Sukarman (2014) and Mallarangeng (2002). Sukarman describes the political economy in Indonesia as focusing on the policy analysis of the June 1983 Package (Pakjun 83) and the October 1988 Package (Pakto 88), compared to what was done in the five Southern Cone countries: Argentina, Brazil, Chile, Paraguay, and Uruguay. This study analyzes two important discussions: the context of the domestic and international political economies in the Pakjun 83 and Pakto 88 policies, and the impact of the implementation of these two policies on national banking development.

Mallarangeng describes the period before the 1990s when President Soeharto turned to a group of Western-trained economists at the Faculty of Economics in the University of Indonesia to design an economic-stabilization policy.

The study of Islamic politics in Indonesia was contained in Effendy (1998), Hefner (2001), Ali (2004), and Hadiz (2011). Effendy explains the difficult synthesis of Islamic politics with the Muslim country's politics after independence. Then, he develops the research in Indonesia to explore Islamic politics using various elements holistically (mutual symbiosis), and the non-monolithic (sharia) nature of the interior and exterior of Islam in the historical perspective of Islamic versus state politics. He also explains Islamic politics in the current practical

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<sup>9</sup> Askari, *et al.* (2015: 19).



dialectics occurring in Indonesia by stating that the tension between Islamic politics and the state was caused by the misunderstandings of government and Islamic thinkers.

Hefner (2001) explains that to understand Islamic political pluralism one cannot appropriately refer to a theoretical model that considers both Islamic politics and religion to be something linear. Historically, it is very clear that Islamic politics is not monolithic, like politics and culture in all major civilizations. Islamic politics is pluralistic and dynamic. Even in the early classical period of the Omayyad and Abbasid empires, there was a lively extra-religious pattern. Organizations are centered on the institution, namely Muslim clerics (*ulema*) and religious judges, but the state controls both of them.

Politically in Indonesia from 1983 to 1985, the government required mass organizations to adopt Pancasila as a single principle and often intervened in Islamic organizations. Socially, young Muslim intellectuals emerged in Indonesia campaigning to renew education, culture, democratization, and human rights as part of the discourse to promote public pluralism, public participation, and the culture of social justice.

Ali (2004) explains that the New Order government put most Islamic organizations under strict control using Patronage, especially through the establishment of the Ministry of Religious Affairs.

Indonesian Muslims have had religious movements even before Indonesia's independence, such as Muhammadiyah (formed in 1912) and Nahdlatul Ulama (1926), which are free of state intervention. These organizations have been carrying out economic activities since long before the New Order era, but their political roles were marginalized in the 1980s.

In the late 1980s, the development process of the New Order government was criticized by the public. The government prioritized the Chinese minority and marginalized micro-scale and medium-scale business development, which involved many Muslims. The government emphasized economic growth and businesses that were highly dependent on foreign aid instead of national economic endurance, such as agriculture and micro-business.

Hadiz (2011) describes Islamic politics as a response to issues of unequal power and a dream of wealth distribution in the modern era determined by Islamic ideals, terminology, images, and symbolism.

In the Indonesian case, Islamic politics may be understood through several factors. First, relations between the state and representatives of Islamic politics fluctuated, especially during the New Order regime from 1966 to 1998. Second, Islamic radicalism in Indonesia is a product of the long phase of authoritarian capitalist development under the New Order government. It is a global effect on the character of Islamic politics that has been forged by the political imperatives of the Cold War.

A brief study of the political economy of Islamic banking in Indonesia was described by Kara (2005), Choiruzzada and Nugroho (2013), Henry (2015), and Hamat *et al.* (2016). Kara (2005) analyzes government policies on Islamic banking in Indonesia. He explains that the political aspects of Islamic banking in the 1990s were an accommodation of political Islam's interests in government policy. However, he just compares the contents of Law No. 7 of 1992 and Law No. 10 of 1998.

Hamat *et al.* (2016) describe the historical development of Islamic banking in Indonesia as contained in three phases. The first was the thinking or theoretical phase that began in the 1930s. This was the most difficult time for establishing Islamic banks throughout the Indonesian archipelago because of the poor relationship between the Dutch colonial government and Muslims.

The second phase involved preparation and establishment. In the 1980s, Indonesian intellectuals and Muslim scholars re-initiated the formation of Islamic banks by citing the successes in Malaysia and other Muslim countries. However, the effort failed because the government imposed Pancasila as the sole guiding principle for all social organizations. Ideas incorporating the word "Islam", including "Islamic banks", was not allowed by the government because the word "Islam" was assumed to refer to Islamic-state movements, extremism, and Islamic fundamentalism.

In 1992, the government accommodated the ideas of Islamic organization to establish an Islamic bank. Then, the steering committee convinced the parties that were in disagreement over the use of the word “Islam” by the bank. This team succeeded in encouraging the government to enact the Banking Law of 1992 and to include the term “profit-sharing principle” in several articles.

The third stage is the maturation of the concept and setting phase. This is a unique phase of the establishment of Islamic banks in Indonesia from 1990 to 2000. Law No. 10 of 1998 provided a stronger legal basis for the establishment of Islamic banks. The law arranged to allow Islamic banks to operate dual banking systems, while conventional banks were also allowed to offer sharia products in Sharia Business Units.

Choiruzzada and Nugroho (2013) concluded that the interactions between Islamic economic movements, Islamic scholars, the state, and business actors have to lead to the building of coalitions involving Islamic economic movements and Islamic scholars in Indonesia.

Henry (2015) is a figure who gives lectures on the political economy and the development of sharia banks in several cities and provinces in Indonesia, such as Jakarta, Denpasar (Bali), Lombok, and Yogyakarta. He argues that the first Islamic bank in 1992 existed because of the major role of Bacharuddin Jusuf Habibie. He took the initiative to increase the capital for the Islamic bank’s establishment by mobilizing 87 shareholders.

Many studies have been done on the regional growth of Islamic banking related to Islamic politics in some countries, such as by Kahf (2004), Baskan (2004), Hanif (2011), Ahmad (2008), and Johnson (2013).

Kahf (2004) explained that the existence of the Islamic Bank is the phenomenon of the awakening of a new power with control over the wealth of natural resources and the rise of Islamic intellectuals, especially in the 1970s when the Dubai Islamic Bank (DIB) and the Islamic Development Bank (IDB) emerged.<sup>10</sup>

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<sup>10</sup> Monzer Kahf, “Islamic Banks: The Rise of a New Power Alliance of Wealth and Shari’a Scholarship,” in Henry and Wilson (eds.) (2004: 36).



The economic revival gained momentum when the income of oil-exporting Middle Eastern countries increased significantly because of a leap in oil prices, impacted by the Yom Kippur War, also known as the 1973 Arab-Israeli War, and Arab countries' oil embargo against Western countries around October 1973. Then, the two main reasons to establish Islamic banks were: 1) To increase the standing of the Organization of the Islamic Conference (as the OIC was then known) as a global power of political economy; and 2) To be a buffer agency for distributing financial aid from Muslim oil-exporting countries, especially the Gulf countries, to African and Asian countries.

Baskan (2004), in his research in Turkey, concluded that the development of national politics was conducive to the extent that Islamic symbolization was suitable for the opportunity to establish Islamic banks. When Islamic states became stronger it grew easier to form Islamic banks and an Islamic economic system. His research concluded that political conditions are reciprocal for the growth of Islamic financial institutions.<sup>11</sup>

Hanif (2011) explained that Islamic banking has grown fast in the last 20 years. In 2008, the volume of Islamic banking operating in more than 50 countries reached US\$951 billion. The Middle East is the center of Islamic banking, with about 80 percent of the business and the remaining 20 percent is shared by the rest of the world. In Pakistan, Islamic banks had grown extraordinarily in the previous six years, at an average annual rate of 76 percent. He identified that Islamic banking does not merely copy conventional practices. Islamic banks under the Islamic Financial Institution (IFI) have succeeded in obtaining the trust of depositors with a profit-and-loss sharing system.

Ahmad (2008) examined the developments, growth opportunities and main challenges of Islamic banking in the United Kingdom. He interviewed three different groups, namely the Banking Authority, Islamic banking customers, and non-Islamic banking customers. The study's findings indicated higher opportunities in the UK to develop

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<sup>11</sup> Filiz Baskan, "The Political Economy of Islamic Finance in Turkey: The Role of Fethullah Gulen and Asya Finance," in Henry and Wilson (eds.) (2004).

an Islamic financial system since the resident Muslim people are eager to take religion-based financial products.

Johnson (2013) researched the influence of Islamic banking on economic growth, analyzing it by quantitatively using the regression method. The analysis showed that the proportion of Muslims in a population is the strongest determinant of the spread of Islamic banks. Nevertheless, the spread of Islamic banks does not have a significant impact on economic growth.

This study revealed, first, that Islamic banks may serve to connect public and Islamic law-based institutions. Second, Islamic banks may become public institutions using Islamic law and an alternative legal system.

In the social aspects, an effect of Islamic banking is that the Muslim population is served financially. In less-developed countries, Islamic banking is a potential tool for economic growth. Despite being a relatively new institution, Islamic banks are growing rapidly and affecting the communities where they develop.

Islamic banking continues to grow appropriately in areas of Muslim population around the world, but its influence on economic-growth instruments and the deepening of previous financial systems has not become clear.

The most important indicator of the spread of Islamic banks is the Muslim population. This finding, supported by previous evidence on Islamic banking, is that they are complementary to and not a substitute for conventional banks. Therefore, the spread of Islamic banks has no significant influence on the growth of gross domestic product (GDP), but it has the power of determining other general growth variables.

# Policy of Islamic Banking Development in Indonesia

A definition by Ebrahim and Joo:

An Islamic bank is a bank that, by its own choice, opts to comply with two sets of law: the legislation of the country (state jurisdiction) and Islamic law (sharia). This is why Islamic bankers have two types of legal counsel: traditional “lawyers” and “Sharia Councils”.<sup>12</sup>

In Indonesia in 1992, Islamic banks were known as the banks using the profit-sharing principle and, since 1998, as sharia banks. The word “sharia” became more popular after the issuance of Law No. 10 of 1998 concerning Banking (Act 98) and Law No. 23 of 1999 concerning Bank Indonesia (Act 99).

In political-economics, every law as promulgated may be interpreted as the product of a policy resulting from a compromise in a debate or discourse occurring in society.<sup>13</sup>

Act 98 and Act 99 enacted the dual banking system in Indonesia, by which the Islamic Commercial Bank is treated equally to the Conventional Commercial Bank. In other aspects, the Conventional Commercial Bank may also open Islamic Business Units or offices channeling sharia business in conventional bank offices.

In the above regulation, the discussion of Islamic banking in the political superstructure policies of Indonesia from 1992 to 2011 referred to regulations issued in 1992, by which Islamic banks were allowed to practice in Indonesia. During the period of 1992 to 2011, three acts

<sup>12</sup> Ebrahim and Joo (2001: 321); Al-Bahar (1996: 1).

<sup>13</sup> Goldstein (1993: 10); Mallarangeng (2002: 4–5).



were passed to develop Islamic banking: Law No. 7 of 1992, Law No. 10 of 1998, and Law No. 21 of 2008.

## **1.1 Banking Development Before 1992**

### **Banking Development in The Old Order**

#### **a. Early Independence**

In the early stages of independence, Indonesia nationalized a number of Netherland Banks and companies, for example people's credit bank of which later became BRI (Bank Rakyat Indonesia). In 1946 the government established BNI (Bank Nasional Indonesia) to become a central bank, replacing De Javasche Bank. Some pragmatic groups did not approve of BNI as a bank of circulation and preferred to continue with the roles of De Javasche.<sup>14</sup>

In 1949, the Round Table Conference (Konferensi Meja Bundar, KMB) was held where Netherlands finally acknowledged Indonesia's independence or in the words of the Netherlands, but Netherland-owned banks were allowed to continue their tasks of which were to ensure that war compensation be paid by Indonesia. In addition, the interests of Dutch private capital were still omnipresent in the Indonesian economy.<sup>15</sup>

In the periods 1950-1959, the president Soekarno rescinded the KMB in 1951, one of the political initiatives was to nationalize the De Javasche Bank to become Bank Indonesia (Bank Central), and Sjafruddin Prawiranegara was assigned to become the first governor, where he had laid the main foundations of Indonesian banking policy.<sup>16</sup>

In the context of economic development, Sumitro Djojohadikusumo (Young Minister of Trade and Industry) took the important step of introducing economic planning in Indonesia. The Sumitro Plan stressed industrialization to reduce Indonesia's extreme dependence on exports of primary products to the world market, a vulnerability that had become particularly obvious during the worldwide depression of the 1930s.

<sup>14</sup> Sukarman (2009).

<sup>15</sup> Lindblad (2011).

<sup>16</sup> Sukarman (2009).

However, very little of the Sumitro plan was realized, at any rate, during the Sukarno period. Subsequent efforts at economic planning during the Old Order regime, in particular the Five-year Development Plan for the period 1956–1960 and the Eight-Year Overall Development Plan launched in 1959, bore even less resemblance to actual economic needs in Indonesia. However, a new elite of indigenous businessmen emerged in the 1950s.<sup>17</sup>

#### **b. Bank Central Establishment**

Sjafruddin Prawiranegara declared that the position of Bank Indonesia (BI) is equal and not under the government. The central bank views that agricultural sectors must be enhanced, in contrast to the minister of finance who considers the enhancement of the industrial sector to be of larger priority.

Sjafruddin suggested that a Monetary Board according to Law No.11 of 1953 concerning Stipulation of the Main Law of Bank Indonesia be established as a means to ease coordination. Although the minister of finance will hold the position Head of the Board, and the minister of trade as well as the Central Bank governor will become members, this does not imply that the central bank will simply submit to the demands of government actors.

The separation of authority between BI and the government in the financial and monetary sector has also not been clearly regulated. The impact since the issuance of Presidential Decree No. 6/1960, The independence (in a limited sense) of Bank Indonesia began to waver. This was due to the strength of government intervention in the duties and work procedures of Bank Indonesia as the central bank.<sup>18</sup>

The purpose of the coordination does not always proceed as it should because within the process of policy making in Indonesia's banking system, the Monetary Board frequently is used by the government to open up Central Bank esoterism. Moreover, possibilities of government actors to abandon coordination all together with other actors may occur. This occasion had taken place in 1958, when the minister of finance

<sup>17</sup> Lindblad (2011); Wie (ed.) (2003: 16–17); Robison (1986).

<sup>18</sup> Murdadi (2013).



implemented devaluation without consulting with BI, resulting in the resignation of Loekman Hakim, as a sign of protest, who was currently assigned as BI governor.<sup>19</sup>

## **Banking Development in The New Order**

### **a. Stabilization Period**

Stabilization policy is a strategy enacted by a government or central bank aimed at maintaining a healthy level of economic growth and minimal price changes. Sustaining a stabilization policy requires monitoring the business cycle and adjusting benchmark interest rates as needed to control abrupt changes in demand.<sup>20</sup>

This phase occurred in the early days of the New Order government from 1966 to 1969, when it still emphasized national stability and recovery from chaotic economics and politics.

The economic-stabilization period was the economic problem that had to be addressed immediately by the New Order government. President Soeharto of the New Order began to rise into power against the backdrop of political and economic chaos post-G30S/PKI incident in September 1966. Indonesia's external influence pursuit and various experimental political ventures during Soekarno era left its economic conditions untended. The new administration inherited hyperinflation, almost zero or negative foreign exchange reserve, unreliable exports and imports statistics, and stagnating to negative GDP growth. Foreign debt amassed up to US\$ 2.3 billion with little export performance which was only US\$ 430 billion.<sup>21</sup>

The economy had more or less stagnated since independence. Between 1960 and 1965 real GDP per capita in a desperately poor Indonesia fell by roughly 10% (World Bank, 2000). By 1965 inflation was very high (229%) and accelerating (1,195% in 1996) (World Bank, 2000). Gross domestic investment was only 6.5% of GDP and

<sup>19</sup> Sukarman (2009).

<sup>20</sup> Kenton (2019).

<sup>21</sup> Rosyadi (2017); Boediono (2016: 107–110).

falling (World Bank, 2000). Indonesia's external position was rapidly deteriorating in the face of rampant capital flight while spare parts, raw materials, profitable production had all but ceased, and food were in short supply.<sup>22</sup>

Then, President Soeharto embraced technocrats from the University of Indonesia in the Cabinet, led by Prof. Dr. Widjojo Nitisastro (Leader of Bappenas), to design and implement gradual and sustainable economic development.<sup>23</sup>

In the Indonesian context, to maintain healthy economic growth the New Order criticized the legality of the national banking system, which at that time referred to Law No. 11 of 1953 on the Principles of Bank Indonesia. This law had regulated the national banking platform since the Old Order, through the strange policies concerning Bank Indonesia, which functions as both a central bank and a commercial bank. As stated in Article 3, Paragraph 3 of Law No. 11 of 1953:

The bank may have one or more branch banks or large agent offices outside Indonesia. It may also have correspondents and representatives, as long as it is needed to carry out the bank's responsibilities properly.

The meaning of the above bank is that Bank Indonesia acts as the central bank and regulator. However, it may also open commercial branches as long as they are needed for the profitability and stability of the Indonesian economy.<sup>24</sup>

The New Order reorganized the functions of Bank Indonesia, making it solely a central bank, by enacting Law No. 14 of 1967 on Banking Principles (Act 67),<sup>25</sup> and Law No. 13 of 1968 on the Central Bank (Act 68),<sup>26</sup> as well as an amendment to Law No. 11 of 1953 on the Principles of Bank Indonesia.

<sup>22</sup> Rock (2003: 1); Bresnan (1993: 112); Winter (1996: 47)

<sup>23</sup> Alam & Sarimaya (2017).

<sup>24</sup> Djumhana (2003: 57); Margono Djojohadikusomo, "Memurnikan Perbankan Nasional Kita," in Redaksi Harian Kompas (eds.) (1981: 45).

<sup>25</sup> Law No. 14 of 1967 ratified on December 30, 1967, signed by President Soeharto and Ampera Cabinet Secretary, Sudharmono.

<sup>26</sup> Law No. 13 of 1968, containing 18 chapters and 56 articles, was ratified on December 7, 1968, signed by President Soeharto and Secretary of State Alamsjah Prawiranegara.

Act 67 explains that the main task of national banking, which is to collect public funds, is to be directed at fields that may enhance people's prosperity. This conforms to MPRS Decree No. XXI/MPRS/1966 on the renewal of policies on the basis of economy, finance, and development.

Therefore, bank loans prioritize farmers, fishermen, and small industries. However, the implementing regulations, such as Law No. 3 of 1968 on Foreign Banks, supported by Law No. 1 of 1967 on Foreign Investment, affect foreign banks, which could be reopened. They do not consider the existence of rural banks, the banking market, or village institutions.

### **b. Development Period**

Development consists of systematically inter-related growth and change processes in human societies, delimited by the boundaries of national states, but also highly interdependent on a world scale. These processes have many uniformities and predictable sequences, but also have unique characteristics in each country or society, deriving from historical patterns, cultural traits and values, territorial and population size, resource endowment, internal class structure and power relationships, place in the international system, etc.<sup>27</sup> Development as a process of evolutionary succession in stages, where human societies leave a rudimentary model until they arrive at a western industrialized civilization consumption model, which is considered unique and universal. From an economic perspective, Schumpeter (1984, 1985, 1989) used the term development as evolution, unfolding, revelation and innovation.<sup>28</sup>

In this period, entering the decades of 1970s, Indonesian economic condition began to show favorable situations. The government shifted focus from economic stabilization towards national development by initiating its Five Year Development Plan (Repelita).<sup>29</sup>

<sup>27</sup> Wolfe (1981: 61).

<sup>28</sup> Soares Jr. & Quintella (2018: 107–8).

<sup>29</sup> Rosyadi (2017).



The New Order stressed development to sustain the government by developing national economic growth with political stability at the same time. “Modernization and development” were a slogan heralded by the New Order government, called the “Development Cabinet”, during 1969–1981.

Kawamura (Associate senior research fellow, Area Studies Center, Institute of Developing Economies, Japan) describes the developmental cabinet was created with the launch of the Soeharto’s New Order in 1966. Soeharto presented “development” as a centerpiece of national goals and attempted to justify its authoritarian rule and its own hold on power through the achievement of these goals.<sup>30</sup>

The issues tackled by the development policy of the Soeharto government are expressed in the Development Trilogy (Trilogi Pembangunan). This principle was adopted when full-scale development policy began to be implemented in the second 5-year development plan (Repelita) after the first 5-year development plan starting in 1969 succeeded in stabilizing the economy. The Development Trilogy aimed:

- 1) to secure national stability,
- 2) to increase economic growth, and
- 3) to equalize the benefits of development.<sup>31</sup>

Throughout the Soeharto era, these three principles served as basic standard for the formulation of development policy.<sup>32</sup>

During the 1970s and 1980s, the New Order government undertook national economic development by consolidating state power and intervening in various aspects of social life, especially to achieve economic stability, control monetary stability and increase exports after the inflation crisis.

BI Governor, Radius Prawiro and his substitute Rachmat Saleh tried very hard to maintain the bank’s health as one of the ways to suppress inflation. The total numbers of banks were reduced and bank capital structure was strengthened, by demanding that private banks merge and not issue permits to establish new private banks in 1974.

<sup>30</sup> Kawamura (2008).

<sup>31</sup> Mohsin (2014).

<sup>32</sup> Kawamura (2008).

Government banks were implicitly guaranteed by the government when those banks were incapable of fulfilling their bonds. In other words, barrier of entry had taken place in banking. Until 1988, the total number of banks that had operated included 1 development bank, and 1 savings bank), 27 regional banks, 10 foreign branch offices, and 68 private national banks taken place in banking. Until 1988, the total number of banks that had operated included 1 central bank, 7 state owned banks (5 commercial banks, 1 development bank, and 1 savings bank), 27 regional banks, 10 foreign branch offices, and 68 private national banks.<sup>33</sup>

For one thing, the Indonesian government increased the focus on the issue of food security (especially rice security). During October and November in 1973 president Soeharto regularly met with officials from the national rice agency BULOG (Badan Urusan Logistik, the Logistics Board) and held sessions with the Economic Stabilisation subcommittee of cabinet to discuss the rice situation.<sup>34</sup>

In 1978, the government enacted a policy dated November 15, requiring the rupiah currency exchange rate to not only be applied to US dollars, but also to the currencies of several of Indonesia's main trading partner countries. Also, the government, through Finance Minister Ali Wardhana, devalued the rupiah from IDR 415 to IDR 625 per US\$1. The policy aimed to adjust the exchange rate as oil prices were increasing because of the 1973 Arab-Israeli War, and Pertamina (the Indonesian Oil Corporation) was collapsing under a debt of up to US\$10 billion, which resulted in the dismissal of Ibnu Soetowo (President Director of Pertamina) in 1976.<sup>35</sup>

The above data show that the New Order government's policies from the 1970s to the early 1980s led to better banking developments than seen in the past by the issuance of a law concerning the central bank and banking. However, it did not accommodate the establishment of the Islamic banks that developed in several countries, especially after the Islamic Development Bank was established with support from OPEC (the Organization of Petroleum Exporting Countries).

<sup>33</sup> Sukarman (2009).

<sup>34</sup> McCawley (2013).

<sup>35</sup> McCawley (2013: 274–5).

*Islamic Banking in this Period*

At present, a revival of global Islamic banking is happening, marked by the IDB's establishment in the 1970s. IDB was established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in *Dhul-Qa'dah* 1393 H/December 1973. The IDB was formally opened on Shawwal 15, 1395H/October 20, 1975. Its purpose was to foster the economic development and social progress of member countries and of Muslim communities individually and collectively according to the principles of sharia. It is headquartered in Jeddah, Saudi Arabia, and has regional offices in Rabat, Morocco (opened in 1994), Kuala Lumpur, Malaysia (1994), Almaty, Kazakhstan (1997), and Dakar, Senegal (2008).<sup>36</sup>

Ibrahim Warde writes that Pakistan, Iran, and Sudan were the pioneers of the Islamization of financial institutions that was included in their national political processes. Pakistan was the first country to implement a total Islamization program in its economic and financial systems, and its political parties promote Islamic banking.<sup>37</sup>

The establishment of the IDB faced two influential institutions, namely the International Monetary Fund (IMF) and the World Bank (WB), that worked to create a global free-market economic system. According to Bani Salamah (from Political Science Department, Yarmouk University, Irbid, Jordan), that many scholars, statesmen, and leaders of the less developed countries (LDCs) and especially the pioneers of dependency theory, argues that LDCs are impoverished and rich countries enriched by the way LDCs are integrated into the world system; the IMF and the WB are the instruments of imperialism, as the creators of those institutions want to keep the new independent nations poor and in chains. The opposite opinion, held by considerable number of Western scholars and advocates of free market economy that oppose the previous argument, believe that there is no correlation

<sup>36</sup> Islamic Development Bank (2013: 1).

<sup>37</sup> Warde (2009: 112–3); Ibrahim A. Karawan, "Monarchs, Mullas, and Marshale: Islamic Regimes?" in Butterworth and Zartman (1992: 116).



between the underdevelopment in the Third World countries and the practices and roles of the IMF and WB as financial institutions.<sup>38</sup>

Agus Subagyo explained that the IMF has a liberal-capitalist ideology. The IMF emphasizes that every country should prioritize market mechanisms, produce goods for export, reduce government subsidies in public sectors, and privatize state companies. However, the northern countries used the IMF to force its own development models through the Structural Adjustment Programs (SAPs) and force Third World Countries (TWCs) to accept them.<sup>39</sup>

In the *World Population Review* (online, 4/7/2020), Third World Countries were defined by high poverty rates, economic instability, and a lack of basic human resources as compared to the rest of the world. The term “Third World Countries” was first used during the Cold War. This term was used to describe countries that were not aligned with either the Warsaw,<sup>40</sup> led by the Soviet Union, or the *North Atlantic Treaty Organization* (NATO), led by the USA.

Moreover, the IMF’s policies frequently disadvantaged TWCs. The mechanism of the IMF’s decision-making did not use “one man to one vote,” but was based on the amount of capital deposited by each of the 250 member countries, plus one vote for every 100,000 SDR (Special Drawing Rights, the IMF’s standard currency). Thus, the IMF’s voting rights map is composed of the USA holding 19.1 percent, Britain holding 6.6 percent, Germany 5.7 percent, France 4.8 percent, Japan 4.5 percent, and Canada 3.1 percent. In combination with other developed countries, they have 57.6 percent of the voting rights, while developing countries only have a combined 34.4 percent of the voting rights.<sup>41</sup>

In 1971, the IMF’s influence was weakened during the international monetary crisis, since the USA developed a fixed exchange rate for the US dollar against gold. The IMF also played a significant role in the 1973 to 1974 world oil crisis. In 1982, it played a role in the recovery

<sup>38</sup> Bani Salamah (2016) cite to Muthee (2013); Bauer & Yamcy (1957).

<sup>39</sup> Subagyo (2003: 30–1).

<sup>40</sup> The name for the official organization of the communist bloc set up to counterbalance NATO.

<sup>41</sup> Subagyo (2003: 33).

from the global debt crisis, especially in Latin American countries, such as Brazil, Argentina, Mexico, and Chile. In 1997, the IMF became a major influence in Asia during the monetary and economic crises in Thailand, Indonesia, and the Republic of Korea.<sup>42</sup>

Therefore, the existence of the IDB and the establishment of Islamic banks are highly relevant as political-economic power that has been used by Muslim countries, which make up the majority of TWCs, and to balance the IMF’s influence on TWCs.

The European Central Bank published that Islamic banks developed quite evenly in several countries after the IDB was established, more particularly in the Middle East.

Table1.1  
Islamic Banks in Several Countries within 1970s and 1980s

Year	Banks
1971	1. Naseer Social Bank, Egypt
1975	2. Al-Amanah Islamic Investment Bank, Jeddah
1975	3. Islamic Development Bank, Jeddah
1975	4. Dubai Islamic Bank, Dubai
1977	5. Faisal Islamic Bank, Sudan
1977	6. Kuwait Finance House, Kuwait
1982	7. Qatar Islamic Bank
1982	8. Al-Baraka Group, various countries

Source: Mauro, *et al.*, European Central Bank, 2013.<sup>43</sup>

**c. Banking Deregulation Period**

There are two extreme views of regulation/deregulation, namely: Regulation is necessary in order to reduce market failure, avoid banking crises and increase financial stability. Deregulation leads to a more efficient allocation of resources.<sup>44</sup> Deregulation is when the government

<sup>42</sup> Subagyo (2003: 40–1); Gold (1980: 59–75); Komer, *et al.* (1986).  
<sup>43</sup> Mauro, *et al.* (2013: 21).  
<sup>44</sup> Mc Grath (2005).



reduces or eliminates restrictions on industries, often with the goal of making it easier to do business. It removes a regulation that interferes with firms' ability to compete.<sup>45</sup>

Banking deregulation before 1983 was aimed at encouraging economic stability and allowing banks to conduct more activities. Banking deregulation was done through policy packages on banking issued from 1983 to 1988. It occurred in two periods, from 1983 to 1988 and from 1988 to 1991.

#### *1983–1988 Period*

According to the online book, *Sejarah Bank Indonesia: Moneter Periode 1983–1997*, at the beginning of the 1982/'83 period the Indonesian economy experienced heavy pressure from the decline in oil prices on the world market and the continued recession in the world economy, which affected domestic economic activities. The competitiveness of Indonesian products decreased, the inflation rate became high, and economic growth decreased sharply because of a quite large deficit in the balance of payments.

Many monetary control policies were aimed at strengthening the structure of the Indonesian economy. The first was devaluing the rupiah exchange rate on March 30, 1983 from IDR 702.50 to 970 per US\$1. Then, the policy package of June 1, 1983, known as Pakjun 83, was enacted to encourage the independence and development of the national banks.<sup>46</sup>

The core of the policy was: (1) Freedom of state banks to set deposit rates, which was previously regulated by Bank Indonesia; and (2) Abolishing the provisions of the credit limit. Instead, the government used indirect instruments, namely the determination of mandatory reserves and open market operations.

Djumhana said Pakjun 83 initiated the banking liberalization process in the form of loan ceiling removal. Banks could freely determine the interest rates for deposits and loans, which was aimed at

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<sup>45</sup> Amadeo (2020).

<sup>46</sup> Gysimas (2014: 144–145).

increasing public-fund mobilization and reducing banks' dependence on Bank Indonesia.<sup>47</sup>

Kara argued that the banking deregulation of Pakjun 83 may have been used by banks to determine a different interest rate according to each bank. He analyzed Pakjun 83, concluding it provided an opportunity for banks to apply a zero percent interest rate and carry out economic transactions without charging interest, which is forbidden by Islamic sharia.<sup>48</sup> However, his analysis was not correct, since the government's policy expected a high interest rate so that people would deposit their capital in the banks. On the other hand, the regulation of banks' profit-making mechanisms also still referred to Law No. 14 of 1967 on Banking, specifically Article 13, item i:

Credit is a provision of money or account equivalent to it based on a loan agreement between a bank and another. Then ... the debtor is obliged to repay the debt after a certain period with a fixed amount of interest....

The article shows a policy that still specifies only one mechanism in the banking transaction system, namely the interest rate. As a focus of Pakjun 83, the government made adjustments to solve the currency chaos and speculation with indirect monetary supervision policies through Market Securities and Bank Indonesia Certificates, especially in the periods of September to October 1984 and May to June 1987.<sup>49</sup> At that time, a controversial policy was issued, known as *Gebrakan Soemarin I* (Soemarin Breakthrough). J.B. Soemarin (Minister of Development Planning/Chair of Bappenas from 1983 to 1988) made a breakthrough to monetary tightening by raising interest rates on Bank Indonesia Certificates (SBI) to encourage an increased rate of economic growth. This was due to strict restrictions on private and foreign banks affecting Indonesia's banking and financial sector, which was dominated by national banks and strictly controlled by the central bank (Bank Indonesia) and the Monetary Department.<sup>50</sup>

<sup>47</sup> Djumhana (2003: 64–5).

<sup>48</sup> Kara (2005: 104–5, 130); Poerwaatmadja (1996: 32); Basir (2009: 30–1).

<sup>49</sup> Mallarangeng (2002: 176).

<sup>50</sup> McCawley (2020).

Pakjun 83 allowed foreign banks to operate in Jakarta with strict restrictions on ownership proportion, capital, and credit provision. National private banks operate more freely, but with the same strict restrictions.<sup>51</sup> However, the deregulation of 1983 did not include either institutional aspects or a climate which would enable banks to create new products and raise efficiency of their operations.<sup>52</sup>

In principle, Pakjun 83 still limited the development of banking institutions, especially foreign private banks, and this would not change until the October 1988 Package was issued. In general, policies in this period were able to increase the rate of economic growth to 5.7 percent, exceeding the average growth of 5 percent in 1988.<sup>53</sup>

#### *1988–1991 Period*

The government issued new policies for the financial, monetary, and banking sectors through a policy package dated October 27, 1988, known as Pakto 88.<sup>54</sup> The policy was aimed at mobilizing public funds, increasing non-oil and gas exports, efficiency, and the ability to implement monetary policy, and developing a capital-market atmosphere.<sup>55</sup>

A week later, David McKendrick, an American analyst, commented: ... Pakto 88, if implemented ... the banking sector in Indonesia will become the most open sector in the Third World.<sup>56</sup>

<sup>51</sup> Mallarangeng (2002: 176); Suwandi (1995).

<sup>52</sup> Iskandar (2002).

<sup>53</sup> *Ekonomi.Bisnis.com*, February 07, 2020.

<sup>54</sup> The six policies are all dated October 27, 1998, contained in:

Minister of Finance Decree No. 1061/KMK.00/1988 on the establishment of National Private Banks and Cooperative Banks.

Minister of Finance Decree No. 1062/KMK.00/1988 on the opening of Government Bank offices, Regional Development Banks, National Private Banks, and Cooperative Banks.

Circular Letter of BI No. 21/3/BPPP on Opening of Government Bank Offices, Regional Development Banks, National Private Banks, and Cooperative Banks.

Minister of Finance Decree No. 1063/KMK.00/1988 on Opening of LKBB Branch Offices (Non-Bank Financial Institutions).

Minister of Finance Decree No. 1064/KMK.00/1988 on the Establishment and Business of Rural Banks, Presidential Decree No. 38, 1988 on People's Credit Banks.

Minister of Finance Decree No. 1065/KMK.00/1988 on Issuance of Certificate of Deposits by LKBB.

<sup>55</sup> Kara (2005: 131).

<sup>56</sup> Mallarangeng (2002:176–77). McKendrick (1989: 196).



Mallarangeng said Pakto 88 was the most liberal set of rules for the banking sector in Indonesia, stipulating that: 1) The issuance of new bank licenses, suspended since 1971, would be reopened; and 2) A foreign bank is permitted to open branches in six cities only with a core capital of IDR 10 billion. This also applies to bank licenses in the form of joint ventures between foreign banks and national private banks.

Thus, the monopoly of the state-owned banks over the State-Owned Enterprises' fund was eliminated. Some banks even became foreign-exchange banks, since there were few requirements. Pakto 88 facilitated the expansion of some banks, which made the deposit market stricter.

One of the fundamental provisions in Pakto 88 was an agreement for foreign-exchange banks that only required a bank's capital adequacy ratio (CAR) level and assets to be a minimum of IDR 100 million.<sup>57</sup>

For the first time, this policy allowed foreign banks to open branch offices in Jakarta and another six big cities, provided they distribute 50 percent of their loans to various export-oriented companies.<sup>58</sup> National private banks were also allowed up to 85 percent foreign ownership, with paid-up capital of at least IDR 50 billion.

Domestic banks were permitted to open a new bank with a minimum capital requirement of IDR 10 billion, and existing private banks could freely open branch offices. New regulations substantially reduced the requirements for capital reserves, from 15 to 2 percent, and allowed banks to increase the number of loans they issued.<sup>59</sup>

In this period, the government issued Presidential Decree No. 38 of 1988 concerning Rural Banks,<sup>60</sup> aimed at strengthening small banks' standing. However, the prevailing banking act was Law No. 14 of 1967 on Banking Principles, which did not drive the growth of small banks.

<sup>57</sup> *Tempo Magazine*, "Dari Pakto 88 Sampai Likuidasi 16 Bank," November 2–8, 1997. (<http://tempo.co.id/ang/min/02/36/utama3.htm>)

<sup>58</sup> After the Pakto 88 policy, the development of foreign banking expanded. Bank Danamon was the first foreign exchange bank in Indonesia, and it is a public company listed on the Jakarta Stock Exchange.

<sup>59</sup> Prawiro (1988); Mallarangeng (2002: 178).

<sup>60</sup> Presidential Decree No. 38 of 1988 contains five articles, ratified on October 26, 1988, and signed by President Soeharto and Minister/Secretary of State Moerdiono.

*Islamic Banking in this Period*

In 1983, Islamic banks had emerged in Southeast Asia. Malaysia was the first country to develop Islamic banks and Islamic financial institutions in Southeast Asia. Malaysia is a multicultural country made up of 13 states and has three ethnic and religious communities consisting of the *Bumiputra* (Malay) at 61 percent, the Chinese at 30 percent, and Indians at 9 percent. The Malaysian economy was controlled by the Chinese and a few Indian groups. However, the *Bumiputra* and Islam have gained political supremacy, and Malay now serves as the country's official language and Islam as the official state religion. Therefore, naturally, Malaysia developed Islamic banking far ahead of Indonesia since Islam is a priority in Malaysia.

Ibrahim Warde explains that the Malaysian government adopted the New Economic Policy in 1970. It was designed to stop discrimination, and increase the share of property owned by Malaysian corporations from 2.4 percent in 1970 to about 30 percent in 1990.<sup>61</sup>

Socially, Tabung Haji has been popular in Malaysia since 1963. In 1969 it developed the Pilgrims Management and Fund Board to manage the savings of people planning to go on the *Haji*. Tabung Haji's success strongly encouraged the establishment of Bank Islam Malaysia Berhad (BIMB) as a full-fledged Islamic commercial bank.<sup>62</sup> Tabung Haji contributed 12.5 percent to BIMB's total initial capital of MYR 80 million.<sup>63</sup>

Tabung Haji's historical records show Malaysia's political space for the Muslim *Bumiputra* or Malay, and the country establishment of Islamic banks has made Malaysia the world's country-of-reference for the development of Islamic banks.

Islamic banking also developed in the Philippines with establishment of the Philippines Amanah Bank (PAB), which works

<sup>61</sup> Warde (2009:123–4).

<sup>62</sup> BIMB (Bank Islam Malaysia Berhad) was the first Syariah bank in Malaysia, opened on July 1983; Lewis and Algaoud (2001: 6).

<sup>63</sup> Ariff (1988: 47).



without interest providing special funding to Muslim Filipinos.<sup>64</sup> It is a subsidiary of the Philippines' Central Bank, established under a presidential decree as a specialty Islamic bank without reference to the Central Bank's permission. The bank is the government's response to the demands of Muslim citizens in the southern Philippines. The PAB does not use the full-fledged Islamic bank, but two windows, or profit-sharing models, were opened by conventional banks as business units.<sup>65</sup>

The establishment of the PAB in the southern Philippines is an example of how political policy in the country accommodates Muslim interests. The southern Philippines hosts bases of Muslim fighters, such as Cotabato, South Cotabato, Lanao del Norte, Sulu, and others.

Table 1.2  
Islamic Banks in Several Countries in 1980s-1990s

Year	Bank
1983	1. Bank Islam Malaysia Berhad
1983	2. Islamic Bank Bangladesh
1984	3. Dar Al-Maal Al-Islami Trust, Geneva, Swiss
1983	4. Al-Rajhi Bank, Saudi Arabia
1989	5. AHZ Global Islamic Finance, UK

Source: Mauro, *et al.*, European Central Bank, 2013.

Engzell (Uppsala University, Sweden) found that the growth of Islamic finance in the world has increased annually by about 15 percent more than that of traditional banks.<sup>66</sup>

Until 1983, Islamic banks expanded in Europe, although they were developed only in a few countries with relatively large Muslims, like the UK. In the UK, the banks established included the Islamic Bank of Britain (IBB), formed in 2004, the European Islamic Investment Bank (EIIB), formed in 2005, the Bank of London and the Middle East

<sup>64</sup> Siddiqi (1981: 39).  
<sup>65</sup> Ariff (1988: 47).  
<sup>66</sup> Engzell (2008: 3).

(BLME), formed in 2007, the Qatar Islamic Bank UK (QIBUK) and the European Finance House, Gatehouse, both formed in 2008, and the Abu Dhabi Islamic Bank UK (ADIB-UK), formed in 2013.

Belouafi and Chachi<sup>67</sup> explained that Britain is very active in developing Islamic finance. At the 9th World Islamic Economic Forum (WIEF), October 29 to 31, 2013, British Prime Minister David Cameron announced the government was planning to make Britain the International Finance Center.<sup>68</sup> He showed empirical data that the IBB was the first bank in the UK to increase its total assets continuously since 2004.

Figure 1  
Total Assets of Islamic Bank of Britain from 2004–2007<sup>69</sup>

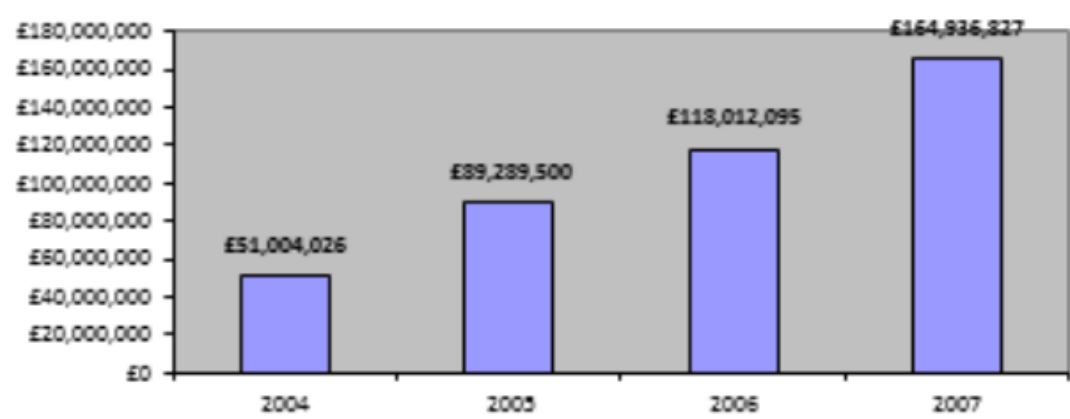


Figure 1 shows the average annually increasing assets reaching 140 percent: 175 percent in 2005, 132 percent in 2006, and 139 percent in 2007.

Wilson said the development of Islamic banks in Europe is politically a key dimension of the relationship between Arab countries and their European counterparts. The Arab banks imported most of

<sup>67</sup> Ahmed Belouafi is a Professor at the Islamic Economics Institute, King Abdul Aziz University, Saudi Arabia. Abdelkader Chachi is an Economic Researcher and Senior Training Specialist at the Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia.  
<sup>68</sup> Belouafi and Chachi (2014: 38).  
<sup>69</sup> Islamic Bank of Britain, *Annual Reports & Financial Statements*, 2005–2007. Engzell (2008: 13).

their conventional financial products from Europe in the past, but now European banks are importing *sharia*-compliant products from the Arab world, not only for their overseas Arab clients, but, more significantly, for the growing Muslim population of Europe.<sup>70</sup>

#### d. Early Banking Reform

Sumawinata described the 1990s as a period when economic growth progressed, and the capital of rich countries entered Indonesia. Politically, this situation was also occurring in East Asian and other Southeast Asian countries.<sup>71</sup>

According to Basir, banking regulations in Indonesia before the 1990s and the issuance of Law No. 7 of 1992 on Banking did not support the establishment of *sharia* banks. The banking system had controlled the interest rates since the establishment of the De Javasche Bank in 1951 under Law No. 24 of 1951 and Law No. 11 of 1953 on Bank Indonesia Principles and until the issuance of Law No. 14 of 1967 on Banking.<sup>72</sup> Since that time, the government has intervened with regulations or presidential decrees to maintain the financial stability that was influenced by strict competition between banks for determining an interest rate.<sup>73</sup>

The beginning of banking reform happened in 1992, when policy around banking took a more comprehensive and higher form, namely executive and legislative policies in the form of the collaborative issuance of Law No. 7 of 1992 on Banking as an amendment to Law No. 14 of 1967 on Banking Principles.<sup>74</sup>

<sup>70</sup> Wilson (2007: 2).

<sup>71</sup> Sumawinata (2004: 9–10).

<sup>72</sup> Law No. 11 of 1953 on Bank Indonesia Principles, which contained 43 articles, was approved by President Soekarno on May 19, 1953, and signed by Minister of Justice Loekman Wiriadinata. See Article 13, item (c), Law No. 14 of 1967 on Banking, which explained the interest system. This article has been written about in a previous explanation.

<sup>73</sup> Basir (2009: 27–8); Simorangkir (1989: 86); Perwaatmaja *et al.* (2005: 59).

<sup>74</sup> Djumhana (2003: 59–7).

## **1.2 Periods of Sharia Banking Regulation**

### **Period of Law No. 7 of 1992**

Two important sets of regulations were issued in this period, namely the government regulations issued as executive products, and a legislative product in the form of Law No. 7 of 1992 concerning Banking.<sup>75</sup>

Law No. 7 of 1992 (Act 92) was enacted in response to the national and international economic developments that had not been accommodated in the previous banking Law, namely Law No. 14 of 1967 concerning Banking Principles. Act 92 allowed banking institutions to expand,<sup>76</sup> facilitated in the refinement and simplification of bank types,<sup>77</sup> enhanced public-fund protection and increased professionalism, and encouraged Indonesian banking to be based on economic democracy. As stated in the Considerations and Articles 2, 3, and 4 of Law No. 7 of 1992 concerning Banking:

A bank is an institution to receive deposits from society to increase the equity and economic growth of national development, and stability towards improving the welfare of the people.

The above statement is very different from the bank's definition in Law No. 14 of 1967 concerning Banking Principles, as stated in Article 1(a):

A bank is a financial institution whose main business is to provide credit and services in payment transactions and money circulation.

Act 92 hardly makes an opportunity to establish sharia banks, but two months after issuance, Bank Muamalat Indonesia (BMI) was formed as the first sharia bank in Indonesia. It showed the success of the Islamic political infrastructure movement that progressed since the 1990s after a workshop on "Banking and Bank Interest" was held from August 18 to 20, 1990, in Cisarua, Bogor, West Java.

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<sup>75</sup> Law No. 7 of 1992 concerning Banking contains 10 chapters and is described in 61 articles. It was decreed on March 25, 1992, signed by President Soeharto and Minister Secretary Moerdiono.

<sup>76</sup> That is the range of services: a stronger legal foundation in the implementation, guidance, supervision and improvement of banking capabilities.

<sup>77</sup> Namely, the bank is contained in Commercial Banks and Rural Banks (BPR).



The idea was followed up on in the 6<sup>th</sup> National Conference of the MUI on August 22 to 25, 1990, in Jakarta. The National Conference's recommendation to establish an Islamic bank led to the immediate formation of a steering committee (SC) for preparing anything required for the establishment of an Islamic bank.<sup>78</sup> Then, the first Islamic bank emerged, namely BMI, which was officially established on 24 Rabi'-uth-Thani 1412 H/November 1, 1991, and was received by a Decree of the Minister of Finance on April 22, 1992, along with an operating license based on the Decree of the Minister of Finance No. 430/KMK.013/1992.<sup>79</sup> On May 1, 1992, BMI got a business license to operate.

As a politically good response, when BMI held its soft opening in its head office it was attended by the Minister of Finance and the Governor of Bank Indonesia. The peak of Islamic political economy success showed in BMI's grand opening on May 15, 1992, at Puri Agung, Sahid Jaya Hotel, Jakarta.<sup>80</sup>

Some important regulations in this period:

**a. Government Regulations**

A Government Regulation (*Peraturan Pemerintah*, abbreviated GR/PP) is a statutory regulation in Indonesia established by the president to implement a law. Three government regulations widely facilitated the establishment and practice of banking with sharia principles in 1992, namely GR 70/1992 concerning Commercial Banks,<sup>81</sup> GR 71/1992 concerning Rural Banks,<sup>82</sup> and GR 72/1992 concerning Banks Based on Profit-Sharing Principles.<sup>83</sup>

<sup>78</sup> Perwaatmadja and Antonio (1999: 84); Basir (2009: 32).

<sup>79</sup> Harahap (1997: 108); Parmudi (2005: 55–8).

<sup>80</sup> Kara (2005: 109).

<sup>81</sup> Government Regulation No. 70 of 1992 concerning Commercial Banks contains 37 articles in nine chapters, decreed on October 30, 1992, signed by President Soeharto and Minister/Secretary of State Moerdiono.

<sup>82</sup> Government Regulation No. 71 of 1992 concerning Commercial Banks contains 22 articles in seven chapters, decreed on October 30, 1992, signed by President Soeharto and Minister/Secretary of State Moerdiono.

<sup>83</sup> Government Regulation No. 72 of 1992 concerning Commercial Banks contains nine articles, decreed on October 30, 1992, signed by President Soeharto and Minister/Secretary of State Moerdiono.



First, GR 70/1992 concerning Commercial Banks stated in Article 5, paragraph 3:

A commercial bank that operates based on profit-sharing principles must expressly state that its business activity is based on profit-sharing principles in its draft articles of association and work plan.

The above article explicitly describes that commercial banks operate based on the profit-sharing principle.

Second, GR 71/1992 on Rural Banks stated in Article 6, paragraph 2:

A rural bank that conducts its business activities based on profit-sharing principles must expressly state that its business activity is based on profit-sharing principles in its draft articles of association and work plan.

Third, GR 72/1992 on Banks Based on Profit-Sharing Principles. This regulation affirmed that Islamic banks in this period were still called banks using profit-sharing principles.

GR 72/1992 generally explained the two basic principles in Islamic Bank practices in Indonesia:

- a. The products of the bank conform to profit-sharing principles,
- b. An institution advises on sharia products in the banks.

An Islamic bank should adhere to the profit-sharing principle and have a sharia supervisory board (SSB) that provides advice on sharia products in banking. This was very difficult to apply before the three government regulations were issued.

Sharia principles were only stated in Article 6, item (m) and Article 13, item (c) of Chapter III concerning Types and Businesses of Banks, Act of 1992. The two articles stated exactly the same thing:

Providing financing for customers based on the principle of profit-sharing following the provisions stipulated in government regulations.

Therefore, the above three government regulations legalized banks using the principles of profit-sharing since the Act of 1992 on banking

had not clearly explained the mechanisms and principles of sharia in banking.

### **b. Profit-Sharing Principles**

The profit-sharing principles or the profit and loss sharing is the most important difference of Islamic banks from conventional banks. Islamic law by contrast supports the theory that financial transactions should be grounded on a profit and loss sharing principle as solution in prohibition of *riba*.<sup>84</sup> On the economics of profit-sharing, Siddiqi observes that “the two ratios of profit-sharing the one between banks and depositors and the other between banks and entrepreneurs will be determined by demand and supply. The equilibrium ratios of profit-sharing will be such as to ensure a supply of savings to bank deposits sufficient to sustain a supply of investible funds to business, commensurate with the business demand, and for investible funds which will be largely a function of the expected rate of profit in productive enterprise.”<sup>85</sup>

The sharia principle is stated in Article 5, paragraph 3 of GR 70/1992 on Commercial Banks, and Article 6, paragraph 2 of GR 71/1992 on Rural Banks. The profit-sharing principle in Islamic banking systems became stronger after the issuance of GR 72/1992 on Banks Based on Profit-Sharing Principles as stated in Article 1, paragraph 1:

Banks based on profit-sharing principles are commercial banks or rural banks that conduct business activities solely based on profit-sharing principles.

The sentence “based on profit-sharing principles” is the key to legalizing banking transactions that no longer use the interest system, but instead use the profit-sharing principle based on contracts in Islamic law.<sup>86</sup>

Many contracts in Islamic law may be practiced in financial institutions. However, only a few contracts are suitable to be applied by sharia banks, such as *wadi'a*, a contract involving savings products,

<sup>84</sup> Uppal and Mangla (2014).

<sup>85</sup> Siddiqi (1983/1403H: 125).

<sup>86</sup> Pesendorfer and Lehner (2016)

*mudâraba*, a contract involving deposits and financing products, or contracts specifically applied to loan products, such as *mushâraka*, *murâbaha*, and *ijâra*.<sup>87</sup>

*Wadi'a* means leaving (*taraka*), depositing, or trusting (*amânat*).<sup>88</sup> Syamlan explains the *wadi'a* is genuinely a "deposit contract". Islamic banks in this context act as a warehouse and should not transfer the benefit of funds for the sake of making a profit.<sup>89</sup>

Islamic banks that operate in the dual banking system face competition from the conventional banks when forming a new type of savings account with the *wadi'a-yad-damânat* contract. The term *wadi'ah* is derived from the verb "*wada'a*" which means to leave, lodge or deposit.<sup>90</sup> It fundamentally commingles two contracts: the *wadi'a* (trusteeship) and *dhamânat* (guarantee).

Irregular deposits happened because of the change of *wadi'a* to *wadi'a-yad-damânat*. In the context of Indonesian Islamic banking, it is used as a current account, as well as a savings account. The main feature is that the savings provide no returns to the customer. However, banks could give a bonus (*ataya*) to the depositors based on their discretion. Herewith, Islamic banks guarantee that the money can be withdrawn at any time. In the context of the IFSB (Islamic Financial Services Board), this type of deposit is also called a "non-investment account".<sup>91</sup>

*Mudâraba* was popularized by Iraq's clerics, while the Hijâz scholars called it *qirâd* or *muqârada*, but there is no difference between the two principles. Rahman defined *mudâraba* as a form of cooperation contract based on the principle of profit-and-loss sharing, one party being the owner of the capital (proprietor, *rabb-u-mâl*) and the second running the business (*mudârib*).<sup>92</sup> This type of investment account is generally referred to as an unrestricted profit-sharing investment account (UPSIA).<sup>93</sup>

<sup>87</sup> Uppal and Mangla (2014).

<sup>88</sup> Ali and Muhdlor (2003: 207–8).

<sup>89</sup> Syamlan (2017).

<sup>90</sup> Ibrahim and Noor (2011).

<sup>91</sup> Syamlan (2017); Ibrahim and Noor (2011).

<sup>92</sup> Rahman (1979: 305–6); al-Dâbû (1997: 30); Sâbiq (1410 AH:297. Vol. 3).

<sup>93</sup> Adewale and Archer (2019: 2).



*Mushâraka* is a word of Arabic origin which literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture.<sup>94</sup> *Mushâraka* is a contract between the institution offering Islamic financial services and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of real estate or a movable asset, on either a temporary or a permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the *mushâraka* agreement, while losses are shared in proportion to each partner's share of capital.<sup>95</sup>

Muhammad Imran Ashraf Usmani, in *Islamic Markets* (online), Arshad and Ismail (2010), Naim (2011), and Mushtaq Ahmed, et al. (2016) explain that *mushâraka* is more commonly referred to as *shirkat*, which is generally seen in *Shirkat-ul-Milk* (joint ownerships) and *Shirkat-ul-'Uqûd* (partnership by contract).

*Shirkat-ul-Milk* means joint ownership of a particular property by two or more persons. This kind of *Shirkat* may come into existence in two different ways:

- 1) Optional Partnership (*Ikhtiyârî*) or voluntary co-ownership: On the option of some parties, if two or more persons purchase equipment, it will be owned jointly by both of them, and the relationship between them concerning that property is called *Shirkat-ul-Milk Ikhtiyârî*. This relationship has come into existence by their choice, as they elected to purchase the equipment jointly.
- 2) Compulsory Partnership (*Ghair Ikhtiyârî*): This comes into operation automatically without any effort or action taken by the parties. For example, after the death of a person, all his heirs inherit his property, which comes under their joint ownership as a natural consequence of the death of that person.<sup>96</sup>

<sup>94</sup> Ahmed (2016).

<sup>95</sup> Adewale and Archer (2019: iii); Ahmed (2016).

<sup>96</sup> Naim (2011); al-Kâsânâ (2000: 73); Ibn Qudâmah (n.d: 109); Ahmed (2016).

*Shirkat-ul-'Aqd* means a “partnership effected by a mutual contract”. For brevity, it may also be translated as a “joint commercial enterprise”. *Shirkat-ul-'Aqd* is further divided into three types:

- a. *Shirkat-ul-Amwâl* is a partnership in the capital for all partners involving the investment of capital into a commercial enterprise.
- b. *Shirkat-ul-Âmal* is a partnership for all partners jointly rendering some service for their customers, and the fee charged is distributed among them according to an agreed ratio.

For example, if two people agree to undertake tailoring services for their customers on the condition that the wages so earned will go into a pool, which shall be distributed between them irrespective of the amount of work each partner has done, this partnership will be a *Shirkat-ul-âmal*, which is also called *Shirkat-ut-taqabbul* or *Shirkat-usy-syanâ'i* or *Shirkat-ul-abdân*.

- c. *Shirkat-ul-wujûh* is a partnership in goodwill (*wajahat*). The partners make no investment at all. They purchase commodities on deferred prices by getting capital through a loan on the basis of their goodwill, and they sell them on the spot. The profit so earned is distributed between the partners according to an agreed ratio.<sup>97</sup>

Each of the above three types of *Shirkat-ul-'Aqd* are further divided into two types:

- a) *Shirkat-ul-Mufâwada* is when the capital and labor are shared. All partners share capital, management, profit, and risk in absolutely equal portions. It is a necessary condition for all four categories to be shared amongst the partners; if any one category is not shared, then the partnership becomes *Shirkat-ul-'Aynan*. Every partner who has an equal share is a Trustee, Guarantor, and Agent on behalf of the other partners.
- b) *Shirkat-ul-'Aynan* is a more common type of *Shirkat-ul-'Aqd* by which the equality in the capital, management, or liability

<sup>97</sup> Ahmed (2016); Raza and Azeem (2014).



might be equal in one case but not in all respects, meaning either profit is equal but not labor, or vice versa.<sup>98</sup>

In the contemporary Islamic economy, like in Islamic banking, that several *syirkat* had been simplified in *mushâraka* means a joint enterprise is formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution.

Apart from financing long-term investment projects, *mushâraka* is also commonly used for funding entrepreneurs the working capital to purchase raw materials or goods as well as transactional banking service in the form of Letter of Credit (L/C). Additionally, *mushâraka* can be used for financing imports and exports. An exporter or importer can arrange for a single transaction on the basis of *mushâraka* and share the profit with the financier according to a pre-agreed ratio.<sup>99</sup>

Simply speaking, profit sharing based on *mudâraba* and *mushâraka* are types of business partnership in which the partners share profit as per agreed ratio, while sharing loss as per the ratio of their investment. These contracts ensure distributive justice as when a loss is incurred due to any unanticipated situation beyond the control of the partners, then the loss borne by each is shared in proportion to the amount invested.<sup>100</sup>

*Murâbaha* is a sale and purchase contract, providing for an item to be delivered at the beginning, but allowing payments to be made in installments. As a consequence, the bank can take provisions (profit margins) that exceed the general price.<sup>101</sup> Abdullah al-Moosali said *murâbaha* is a resale with a stated surcharge (add-on profit).<sup>102</sup>

*Ijâra* is usually practiced in the form of an operational lease, which is the transfer of rights to goods or services through the payment of rent without a clause of transfer of ownership (*milkiyya*) of the item. However, using an *ijâra muntahiya bitamlik* contract means leasing financing with a clause that transfers ownership to the customer.<sup>103</sup>

<sup>98</sup> Arshad and Ismail (2010).

<sup>99</sup> Moriguchi, *et al.* (2016); Ahmed (2008); Usmani (1999).

<sup>100</sup> Javaid (2015).

<sup>101</sup> Syariah Financing Directorate, Minister of Finance (2011: 88); Antonio (2001: 25–7).

<sup>102</sup> Moosali (1937: 39, Vol. 2).

<sup>103</sup> Antonio (2001: 181).

Syamsul Anwar, a Professor in Islamic Engagement Acts from Indonesia, quoted Zarqa’s opinion that classified contracts into two types, namely contracts with nomenclature (*‘aqd-ul-musammâ*) and contracts without nomenclature (*‘aqd ghair-ul-musammâ*).

A contract with nomenclature (*‘aqd-ul-musammâ*) is a named contract, or one that was strictly and specifically arranged in *fiqh* (Islamic jurisprudence). Zarqa identified it in 25 contracts, including bilateral (two-party) and unilateral (one-party) contracts.<sup>104</sup>

Table1.3  
Table of contracts with nomenclature (*‘Aqd-ul-Musammâ’*)

No.	Contract Nomenclatures	No.	Contract Nomenclatures
1	<i>tabkîm</i> (arbitration)	15	<i>muzâra’a</i> (land partnership)
2	<i>‘umra</i> (home use rights)	16	<i>musaqqa</i> (land maintenance)
3	<i>kafâla</i> (underwriting)	17	<i>wakâla</i> (authorization)
4	<i>hiwala</i> (debt transfer)	18	<i>bay’</i> (sale and purchase)
5	<i>rahn</i> (pawn)	19	<i>mudâraba</i> (partnership)
6	<i>ijâra</i> (lease)	20	<i>wasiyya</i> (guardianship)
7	<i>‘idâ</i> (deposits)	21	<i>isâ</i> (appointment of delegates)
8	<i>i’âra</i> (debt)	22	<i>muwâla</i> (determination of heirs)
9	<i>hiba</i> (grant)	23	<i>bay’al-wafâ</i> (sale and purchase options)
10	<i>qismah</i> (job division)		
11	<i>syirka</i> (joint venture)	24	<i>iqâla</i> (agreement on contract termination)
12	<i>sulh</i> (peace)		
13	<i>qard</i> (soft loans)	25	<i>mukhâraja</i> (release of inheritance rights)
14	<i>zawâj</i> (marriage)		

The Compilation of Islamic Economic Law (*Kompilasi Hukum Ekonomi Syariah, KHES*) in Indonesia mentions only 14 types of

<sup>104</sup> Zarqâ’ (1968: 538, Vol. 1); Anwar (2007: 72–6); Anwar (2010: 79).

nomenclature contracts, while the *Majallat al-Ahkâm al-'Adliyya* states that *mukhâraja*, *qard*, *umra*, *muwâla*, *zawâj*, *wasiyya*, and *isâ'* are not included in the nomenclature contract.<sup>105</sup>

The contract without nomenclature (*'aqd ghair-ul-musammâ'*) is a contract without the specific nomenclature arrangements described in Islamic law or *fiqh*. The nomenclature contract can be created by the parties' needs to fulfill their desires and interests. However, an unnamed contract generally refers to the general theory of contracts (*nadhriyat-ul-'uqûd*) and the rules of contract principles (*mabda' hurriyat-ut-ta'âqud*) in Islamic jurisprudence.<sup>106</sup>

### c. Sharia Supervisory Board

The Shariah Board is the sole and exclusive interpreter of Islamic law within an Islamic bank. It alone has the power to allow or to stop a transaction or the introduction of a new type of financial product on the grounds of religious permissibility or impermissibility. The Shariah Board is essentially autonomous and unsupervised.<sup>107</sup>

The existence of a Sharia Supervisory Board (SSB) within its structure is one of the important features that distinguish an Islamic bank from a conventional bank. Every Islamic bank should have a Sharia Supervisory Board. According to AAOIFI a Sharia Supervisory Board is a body of specialized jurists in Islamic commercial jurisprudence (*fiqh al-mu'âmalat*), which is independent of the Board of Directors and has the right to be present at the Board of Directors' meetings to verify and certify the religious aspects of their decision. The SSB has supervisory as well as consultative functions; it reviews the operations of its financial institutions to make sure they comply with Sharia and issues religious edict (Fatwa) regarding the legitimacy of new modes of investment and finance and whether they are sharia compliant.<sup>108</sup>

Sharia boards have fiduciary responsibilities toward the institution's stakeholders. In theory, the role of SSB involves six areas:

<sup>105</sup> Anwar (2007: 73); Anwar (2010: 79).

<sup>106</sup> Anwar (2007: 87–8); Anwar (2010: 79).

<sup>107</sup> Morrison (2014).

<sup>108</sup> El Hussein (2018).



1. Issuing the *fatwâ* that certify permissible financial products;
2. Undertaking sharia audits to ensure products comply with guidelines;
3. Calculating *zakât* payments;
4. Disposing of non-sharia-compliant income or earnings;
5. Providing advice to the bank on the distribution of income to shareholders or depositors/investment account holders;
6. Guiding the bank on its wider social role.

In Indonesia, the SSB was known as Dewan Pengawas Syariah (DPS), which must exist in a bank employing profit-sharing principles as stated in Article 5, paragraphs 1 to 3, GR No. 72 of 1992:

- (1) A bank based on the profit-sharing principle must have a Sharia Supervisory Board assigned to supervise banking products in collecting public funds from and distributing them to the public according to sharia principles.
- (2) The Sharia Supervisory Board is established by the concerned Bank based on the results of consultations with the Indonesian Ulema Council (MUI).
- (3) In performing its duties, the Sharia Supervisory Board consults with an institution as referred to in paragraph 2.

The assertion of the SSB in the above article is of a strengthened Act 92, which does not expressly state that the banks based on profit-sharing principles must have an SSB. It becomes very important when it refers to the various contracts contained in *aqd-ul-musammâ* and '*aqd ghair-ul-musammâ*', as previously discussed in some complexity. The SSB requires broad insight, especially in the general theory of contracts and the contract freedom principles.

The development of '*aqd ghair-ul-musammâ*', or contracts without nomenclature, in Islamic banking was engineered for the multiple functions of product that would be difficult to process with a contract with nomenclature. It can sometimes only be modified with a mix of nomenclature contracts, such as *Murâbaha-bil-Wakâla* and *Ijâra Muntahiya Bittamlik*.



*Murâbaha-bil-Wakâla* is about buying and selling, whereby the sharia bank represents the purchase of the product by the customer. After it is obtained, the customer then gives it to the sharia bank.<sup>109</sup>

*Ijâra Muntahiya Bittamlik* is a loan contract of sharia banks involving ownership of a benefit or service through a rent mechanism involving a clear object within a certain period followed by a transfer of ownership at the end of the contract.

In Indonesia, *Murâbaha-bil-Wakâla* is usually used by sharia banks for financing consumptive products, while *Ijâra Muntahiya Bittamlik* is used for home-purchase financing.

#### **d. Full-fledged Islamic Bank**

A full-fledged Islamic bank is one that runs on sharia-approved policies and all the products are free of interest being paid or received (www.quara.com). In Indonesia, the institutional model of full-fledged Islamic banks is that the sharia bank operates only with profit-sharing principles, while conventional commercial banks and rural banks may use interest systems and cannot open an Islamic window or a unit with sharia principles. As stated in Article 6, GR No. 72 of 1992:

- a. Commercial Banks and Rural Banks solely based on the principle of profit-sharing are not permitted to conduct business activities that are not based on the principle of profit-sharing.
- b. Commercial Banks and Rural Credit Banks are not permitted to carry out business activities based on profit-sharing principles.

The regulations involving full-fledged Islamic banks make all Islamic banks operate under the sharia system. In the banking market sector, this regulation makes it difficult to drive the growth of Islamic banks. The establishment of Bank Muamalat was very premature if it aims to replace the hegemony of the conventional market structure with a sharia market. The support from many sharia community organizations, the Islamic political infrastructure, has not succeeded in realizing any new Islamic banks after Bank Muamalat. The existence of

<sup>109</sup> Maulidizen and Borhan (2016).

Islamic banks with full-fledged sharia did not significantly increase the total number of banks between 1992 and 1998.

This condition is in line with Chapra's opinion: Islamic banks must pay attention to social-economic, political, and moral conditions.<sup>110</sup> However, from a political perspective, the existence of Bank Muamalat provides new passion for the Islamic political model to struggle through the economic system, although, from a social perspective, it has not become an alternative system that may be carried out on a massive scale.

Referring to Robison's theory of structural determinism, which stems from a combination of class theory and state autonomy theory, the local bourgeoisie's role was crucial in the course of the New Order government's economic policy.<sup>111</sup>

It may be meant that Soeharto, as the ruler at the time, and the class leaders who were motivated by the ICMI, the MUI, and the ten Muslim ministers who participate in funding Bank Muamalat influenced the issuance of Islamic banking regulations, namely the three GRs, Nos. 70, 71, and 72 of 1992, setting forth banks with the profit-sharing principle, making Bank Muamalat more legitimate.

Liddle revealed Soeharto as a president who could maximize their power to achieve goals.<sup>112</sup> Soeharto freely moved his political interests, accommodated Ali Moertopo<sup>113</sup> and liberal economists and technocrats in the 1970s, developed national stability and forces with the Christian figure General L.B. Moerdani in the 1980s,<sup>114</sup> and optimized modern technology with B.J. Habibie, Indonesia's first aircraft creator and a representative of the Islamic political infrastructure, in the 1990s.

<sup>110</sup> Chapra (1992: 353).

<sup>111</sup> Malarangeng (2002: 28); Robison (1986).

<sup>112</sup> Liddle (1990); Robison (1996); Malarangeng (2002: 28–30).

<sup>113</sup> Ali Moertopo (1924–1984) was a lieutenant general and politician. He became Indonesian Minister of Information (1978–1983) and Deputy Head of the State Intelligence Coordinating Board (1969–1974, 1974–1978).

<sup>114</sup> Leonardus Benyamin "Benny" Moerdani (1932–2004) was the Commander of the Indonesian Armed Forces (1983–1988) who was directly involved in military operations handling the hijacking of Garuda Indonesia Flight 206 at Don Mueang Airport, Bangkok, Thailand, on March 28, 1981.

In its political aspects, the establishment of Bank Muamalat showed that the New Order delayed the development of Islamic banks in Indonesia for almost 20 years after the establishment of the IDB, and ten years from the establishment of BIMB in Malaysia, even though Indonesia was a member of the OIC, which signed onto the concept of establishing the IDB.

**Period of Law No. 10 of 1998**

Law No. 10 of 1998 on Banking (Act 98) was enacted by President B.J. Habibie on November 10, 1998.<sup>115</sup> It was an amendment to Law No. 7 of 1992 (Act 92) and had several aims.

First, it was a response to the regional monetary crisis that led to the chaotic state of the Indonesian economy and banking in 1997. At that time, national banks were seriously shaken by bank runs, when large numbers of bank customers simultaneously withdraw their deposits. Some banks collapsed, 16 banks were liquidated, several banks were acquired by the Central Bank, and the others had to merge.

Table1.4  
National Private Banks Liquidated in 1997

No.	Banks	Total Assets (IDR in millions)	Capital (IDR in millions)
1.	Bank Harapan Sentosa	4,291,625	341,177
2.	Bank Guna Internasional	449,886	59,213
3.	Bank Andromeda	1,383,377	115,297
4.	Bank Astria Raya	715,767	55,168
5.	Bank Sejahtera	2,220,045	146,849
6.	Bank Dwipa	159,305	13,411
7.	Bank Kosagraha Semesta	201,323	17,051
8.	Bank Jakarta	296,822	30,482

<sup>115</sup> Law No. 10 of 1998 contains two articles, namely Article I and Article II. Article I contain 59 articles, of which 43 articles make changes to Law No. 7 of 1992. Article II contains two paragraphs concerning credit cancellation in the Paku Alam Duchy, as well as the enactment of Law No. 10 of 1998 from the date of passage.



9.	Bank Citrahasta Manunggal	163,506	13,482
10.	South East Asia Bank	617,865	28,105
11.	Bank Pinaesaan	512,405	29,205
12.	Bank Mataram Dhanarta	305,262	15,912
13.	Bank Anrico	122,730	5,850
14.	Bank Pacific	2,276,050	190,328
15.	Bank Industri	543,901	30,636
16.	Bank Majapahit Jaya	176,001	22,841

Second, it was a response to the rapid development of the national economy, especially concerning the legal aspects of the operational systems of national Islamic banking, which still refer to GR No. 72 of 1992 and a decree of the Governor of Bank Indonesia in S.E.BI No. 25/4/BPPP/1993.<sup>116</sup>

Act 98 principally changes and adds to Act 92 regarding:

**a. Banking Secrecy**

In general terms, banking secrecy (alternately known as banking privacy, banking discretion, bank safety, bank-client confidentiality, and banker-client privilege) is a conditional agreement between a bank and its customers that all foregoing activities must remain secure, confidential, and private.<sup>117</sup>

The principle of bank secrecy aims to protect the confidentiality of the personal and financial data of a bank's customers.<sup>118</sup> Also, it builds customer trust in the bank for managing customer finances,<sup>119</sup> to maintain and enhance public confidence in the bank not to disclose the financial condition and other customer transactions as well as the circumstances of the customer concerned to the other party.<sup>120</sup>

The principle of secrecy in banking and financial institutions has been followed since the collapse of feudalism during the fight for individual rights in trade. By the middle of the 19<sup>th</sup> century, almost all

<sup>116</sup> Anshori (2010: 14).

<sup>117</sup> Anonim, "Bank secrecy". <https://amp.en.google-info.cn/33696818/1/bank-secrecy.html>; Guex (2000).

<sup>118</sup> Sutedi (2010: 145).

<sup>119</sup> Husein (2003: 145).

<sup>120</sup> Idris (2017).



governments in Western Europe had adopted the principle of banking secrecy.<sup>121</sup> The definition of bank secrecy as stated in Article 1, point 28 of Law No. 10 of 1998 is: "Bank secrecy is everything related to information about the customers' deposits."

Banks and their affiliates are required to keep confidential information regarding their customers' data, as well as the amount of deposits. The customers' data is:

- a) Name of customer;
- b) Address;
- c) Date of birth and/or age;
- d) Phone number;
- e) Name of the customer's mother; and
- f) Other information constituting personal identity connected to utilizing bank products.

Furthermore, Bank Indonesia Regulation No.7/6/PBI/2005 regarding Transparency of Information of Bank Products and the Use of Customer Personal Data stated:

Banks are obligated to ask for written approval from customers before the banks can provide and/or disseminate their customers' data to other parties for commercial purposes unless stipulated otherwise under the applicable laws and regulations.

Therefore, customer approval of a request to provide or disseminate the customers' data to another party must be signed by such a customer on a special form made for the purpose that should be valid under Law No. 11 of 2008 concerning Electronic Information and Transactions, as finally amended by Law No. 19 of 2016.<sup>122</sup> Under BI Regulation No. 2/19/PBI/2000 concerning Requirements and Procedures to Grant Written Orders or Approval to Disclose Bank Secrets, information covered by the banking confidentiality obligation can be released on the basis of:

- a) Taxation;
- b) Settling the bank's receivables that have been given to the State

<sup>121</sup> Djumhana (1996: 112).

<sup>122</sup> Rolindrawan and Mustikaningrum (2017).

Agency for Receivables and Auctions (*Badan Urusan Piutang dan Lelang Negara*) or the Committee for State Receivables Affairs (*Panitia Urusan Piutang Negara*);

- c) Cases in the criminal courts;
- d) Disputes between a bank and customer in civil court;
- e) An exchange of information between banks;
- f) The written request and approval of the customer; and
- g) The request of the valid heir of a deceased customer.

The result is that banking secrecy does not mean absolute confidentiality covering all assets and liabilities. Thus, in certain cases, for the prevention of actions like money laundering and corruption, a customer's bank account can be tracked and audited by eligible state institutions, such as the police and the Corruption Eradication Commission (Komisi Pemberantasan Korupsi, KPK).

Exceptions to the interests of justice in criminal cases were exceptions to legal compulsion subjected to the provisions of Article 43 on Act 2008 concerning Sharia banking. There are the interests of justice in a criminal case of a written request from the Chief of Police, the Attorney General, the Chief Justice of the Republic of Indonesia and the leadership of institutions authorized to conduct investigations where bank secrecy can be excluded. Police, prosecutors, judges or other investigator can ask permission to head of Bank Indonesia to obtain information from banks on deposits or investments suspect or defendant existing in an sharia bank.<sup>123</sup>

#### **b. Establishment of the Indonesia Deposit Insurance Corporation**

As described on [www.lps.go.id](http://www.lps.go.id), the monetary and banking crisis that struck Indonesia in 1998 resulted in the sharp devaluation of the rupiah, and a decline in public trust in banking institutions.

In its bid to address the crisis, Indonesia's government established a series of policies that included efforts to protect any bank's payment responsibilities, including public deposits, known as the "blanket guarantee scheme". It was endorsed under Presidential Decree No. 26

<sup>123</sup> Idris (2017).

of 1998 regarding Guarantee on Liabilities of Commercial Banks and Presidential Decree No. 193 of 1998 concerning Guarantee on Rural Banks Payment Responsibility.

Law No. 10 of 1998 on banking mandated that the LPS (Lembaga Penjamin Simpanan), known in English as the Indonesia Deposit Insurance Corporation (IDIC), should be established to protect depositors' funds.

Eventually, on September 22, 2004, the president enacted Law No. 24 of 2004 on the IDIC. Concerning the Law, the IDIC was established as an independent institution that has two functions: to guarantee bank customer deposits and to complete or handle bank failures. Every bank in Indonesia is required to become a participant and pay the guarantee premium, and the IDIC will guarantee as many customers as possible in the event of bank failure.<sup>124</sup>

In the Islamic banking context, the existence of the IDIC makes it easier for Islamic banks to expand their collection of customer funds since they are guaranteed.

On June 11, 2013, the IDIC and the Indonesian National Police signed a memorandum of understanding on the implementation of Law No. 24 of 2004 on the IDIC. Every instance of bank fraud can be reported by the IDIC to the Criminal Investigation Police in Indonesia as a financial crime.

From 2006 to 2011, the IDIC liquidated 49 rural banks (BPR) and paid customers IDR 650 billion in replacement money. Samsu Adi Nugroho, IDIC Secretary, explained that the cause of bank liquidation was the large number of cases of transaction fraud, fictitious loans, and customer savings account deposits that were accepted but not recorded.<sup>125</sup>

### **c. Dual Banking System**

The Indonesian banking system used a dual banking system, namely the parallel regulation of both sharia banks and conventional banks.

<sup>124</sup> Anshori (2010: 15); Widjanarto (2003: 53–54).

<sup>125</sup> Simamora (2013).



The dual banking system is prevailing in a number of Asian countries such as Malaysia, Indonesia, Bahrain, and Pakistan.<sup>126</sup>

The dual banking system is the framework of the Indonesian Banking Architecture (Arsitektur Perbankan Indonesia, API), the wider synergy between sharia banks and conventional banks to support the mobilization of public funds in increasing the ability to finance national economic sectors under Bank Indonesia authority.

However, some changes were made to the dual banking system in 1992 and 1998. Due to the regulation of banking in 1992, sharia banks had to be operated by full-fledged Islamic banks, as stated in Article 6, GR No. 72 of 1992:

The principle of profit-sharing may only be carried out by Commercial Banks or Rural Banks, whose business activities regard the principle of profit-sharing, rather than conventional banks.

Meanwhile, the Act 98 era allowed sharia banking to be conducted by a sharia business unit within a conventional bank. As stated in Article 1, paragraph (3) of Law No. 10 of 1998:

Commercial Banks are banks that carry out business activities regarding a conventional manner or sharia principles.

The explanatory note to Article 6, item m of Law No. 10 of 1998 on Banks states:

Commercial banks that conduct conventional business activities may also conduct sharia principles-based business activities through:

- a. An establishment of a branch office or office under a new branch office; or
- b. A conversion of a branch office or office under a branch office that conducts conventional business activities to carry out activities based on sharia principles.

The above articles show Islamic banking may be carried out by a bank that operates with full-fledged sharia system institutions like Bank Muamalat, a sharia bank that was converted from a conventional

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<sup>126</sup> Lone and Rehman (2017).



bank, and a sharia business unit of a conventional bank. Allowing the conventional commercial banks to open sharia business units ushered in a competitive market for Islamic banks, inter-sharia banks, and external markets within conventional banks.

As a result, Bank Muamalat no longer had a monopoly. The government started to get directly involved in sharia banking business by developing Bank Syariah Mandiri, supported by Bank Mandiri as a big merger of four banks (Bank Dagang Negara, Bank Bumi Daya, Bank Exim, and Bank Bapindo) on July 31, 1999, taking over Bank Susila Bakti's plan, which originally named the entity Bank Syariah Sakinah.

On October 25, 1999, Bank Indonesia approved Bank Susila Bakti to change its business activities from conventional to sharia principles and approved Bank Syariah Mandiri to replace Bank Susila Bakti, which officially began operations on Monday, 25 Rajab 1420/ November 1, 1999.<sup>127</sup>

#### **d. Profit-Sharing Replaced by Sharia Label**

Law No. 10 of 1998 was legally important for Islamic banks to achieve a stronger standing and for a new era of a bank's "sharia" label, which was previously popular with banks based on profit-sharing principles.

The changing of a bank with "profit-sharing principles" into a bank with "sharia principles" may be understood in terms of Islamic banks in Indonesia being called "sharia banks".<sup>128</sup> The word "Islam" being replaced by "sharia" influences Indonesian bank legislation, religious courts, academic activities, and mass organizations to use the word "sharia" over "Islam".

Sharia banks have had better legal standing since the enactment of Law No. 23 of 1999 concerning Bank Indonesia (Act 99).<sup>129</sup> It expressly

<sup>127</sup> Based on the Bank Indonesia Senior Governor's Decree No. 1/1/KEP.DGS/1999, October 25 1999.

<sup>128</sup> Rivai, *et al.* (2007: 733).

<sup>129</sup> Law No. 23 of 1999 on Bank Indonesia consists of 13 chapters and 79 articles, ratified and promulgated on May 17, 1999, signed by President B.J. Habibie and Minister/Secretary of State Muladi.

assigns tasks, responsibilities, and authority to Bank Indonesia to carry out its duties following sharia principles. Therefore, a sharia-bank development team was formed in April 1999 by Bank Indonesia as the Banking Research and Development of Bank Indonesia.

The article of Act 99 that strongly supports Islamic banking regulation concerns the terms of profit-sharing, as stated in Article 1, paragraph 7:

Sharia-based financing is a provision of money or billing equivalent to it based on an agreement between Bank Indonesia and Bank that obligates funded banks to return the money or bill after a certain period with a return or *profit-sharing*.

Act 99 came about after tough and long debates, especially concerning the definition of central bank independence. As stated in Article 4, paragraph 2, Chapter II of Act 99, concerning Status, Position, and Capital:

Bank Indonesia is an independent state institution and free from the interference of the government and/or any other parties, except as expressly regulated in this act.

To avoid giving BI too much independence, Law No. 23 of 1999 was amended by Law No. 3 of 2004 on Bank Indonesia.<sup>130</sup> Although the aim of the amendment, decreasing the independence of Bank Indonesia, was only emphasized by the words “in carrying out its duties and authorities”, that did not mean all matters without limitation.

Law No. 3 of 2004 concerning the institutional aspects of Bank Indonesia aimed to reduce Bank Indonesia’s independence in the monetary sector in relation to the existence of Islamic banks, as stated in Article 11:

- (1) Bank Indonesia may provide credit or financing based on Sharia Principles for a maximum period of 90 (ninety) days to a Bank to overcome the concerned Bank’s short-term funding difficulties.
- (2) Credit or financing provisions based on Sharia Principles as referred to in paragraph 1 shall be guaranteed by a receiving

<sup>130</sup> Law No. 3 of 2004 on Bank Indonesia contains 77 articles and three chapters. It was ratified and promulgated on January 15<sup>th</sup>, 2004, signed by President Megawati Soekarnoputri and State Secretary Bambang Kesowo.

Bank with high quality and easily liquidated collateral with a minimum value equal to the value of credit or financing received.

- (3) The implementation of the provisions referred to in paragraph 1 and paragraph 2 shall be stipulated in a Regulation of Bank Indonesia.

Article 11 is an example of Bank Indonesia supporting the existence of Islamic banking. In November 2003, the Sharia Banking Bureau, the work units serving sharia banks, became the Directorate of Islamic Banking (Direktorat Perbankan Syariah, DPBS) to oversee four teams, namely the Research and Development Team, the Regulatory Team, the Licensing Team, and the Supervisory Team of Islamic Banks. On August 18, 2005, after Law No. 3 of 2004 was enacted, the DPBS added three more teams, namely Supervisory Teams One and Two, and the Information Team.

The Development Team was added in response to innovations in the sharia banking industry. By January 3, 2005, it had fostered three Sharia Commercial Banks (SCB), 19 Sharia Business Units (SBU), and 93 Sharia Rural Banks (SRB), with total assets of more than IDR 18 trillion.

In the period from 1992 to 1998, only one Sharia Commercial Bank and 78 Sharia Rural Banks had operated. Law No. 10 of 1998 provided a stronger legal basis for the existence of the Islamic banking system. Law No. 23 of 1999 concerning Bank Indonesia, which was explicitly granted authority in the sharia financial field, allowed the sharia banking industry to develop faster.

### **Period of Law No. 21 of 2008**

Law No. 21 of 2008 on Sharia Banking issued on July 16, 2008<sup>131</sup> indicates that there were two pieces of legislation governing banking in Indonesia, namely Law No. 10 of 1998 on Banking (Act 98) and Law No. 21 of 2008 on Sharia Banking (Act 2008).<sup>132</sup>

<sup>131</sup> Law No. 21 of 2008 on Sharia Banking was adopted by President Susilo Bambang Yudhoyono.

<sup>132</sup> Law No. 21 of 2008 on Sharia Banking contains 13 chapters and 70 articles.



In general, the similarity of the regulations in Act 98 and Act 2008 extends to the principles, objectives, and functions mentioned, to licensing and legal forms, to the types of business activities, to bank secrecy, and to guidance and supervision. Some differences in principles concern aspects of sharia.

Meanwhile, the new regulations contained in Act 2008 include ones about governance, prudential principles, and risk management (Chapter VI), dispute settlement (Chapter IX), Sharia Banking Committees, self-liquidation, and elaboration of Bank Indonesia's supervisory authority.<sup>133</sup>

Sharia Banking Committees were described in Article 26, paragraph 4 of Act 2008:

The sharia banking committee consists of elements from Bank Indonesia, the Ministry of Religion, and neutral elements of society with expertise in the field of sharia and amounts to a maximum of 11 people.

The enactment of the Act 2008 fundamentally improved the national standing of Islamic banking, especially related to institutions. Some improved policies in Act 2008 were:

**a. The Term "Sharia" in Banking**

Sharia (also spelled shariah, or shari'a), literally translated, means "the way". Sharia is an Islamic religious act that governs not only religious rituals, but also aspects of day-to-day life under Islam.<sup>134</sup> The Shari'a have become acceptable under the provisions of freedom of religion in the Constitution, despite much widespread Islamophobia amongst the general population.<sup>135</sup>

In economics and finance, sharia establishes guidelines for investment and banking systems. Sharia provides full freedom to contract as long as certain basic requirements—that is, the prohibition of *riba*—were met. A financial transaction is considered valid if it meets the basic requirements of a valid legal contract and does not contain

<sup>133</sup> Permana and Purba (2008: 3).

<sup>134</sup> <https://www.investopedia.com/terms/s/shariah.asp>.

<sup>135</sup> Turner and Possamai (2015: 9). "Introduction: Legal Pluralism and Shari'a," in Turner, B.S. *et al.* (2015).



certain elements, such as *riba* (interest), *gharar*, *qimar* (gambling), and *maysir* (games of chance involving deception). While the prohibition of *riba* is the most critical and gets the most attention in economic activities.<sup>136</sup>

Sharia applied to the economic system emphasizes the concept of getting benefits from broader economic activities. The benefit does not only come at the end of an economic activity, but all processes of the transaction must contain the elements of *tawâzun* (equilibrium), *adâlat* (justice), and *halâl*.

*Halâl* is an Arabic word meaning “lawful” or “permitted” as prescribed in the Qur’an, Hadîth, and Islamic jurisprudence. The opposite of *halâl* is *harâm*, which means “unlawful” or “prohibited”. *Halâl* and *harâm* are universal terms that apply to all facets of life. These terms are commonly used about food products, meat products, cosmetics, personal care products, pharmaceuticals, food ingredients, and food contact materials. While many things are *halâl* or *harâm*, some things are not clear.<sup>137</sup>

The innovation of applying *halâl* or sharia to banks has two factors: First, optimizing the profitability of the corporation according to Islamic sharia; and Second, changing some shareholder rights with profit-and-loss-sharing models based on investment and several instruments based on Islamic social models, such as *zakât*, *infâq*, and *sadaqat*. Shareholder and stakeholder values are based on sharia principles in business.

In Indonesian banking, the term “sharia” was included in Article 2 of Act 2008, Chapter II (Principles, Functions, and Objectives):

In conducting business, sharia banks embody sharia principles, democratic economics, and prudential principles.

The above article shows that sharia banking institutions are more explicitly placed in the domain of the Banking Act. However, sharia banks carry more diverse aspects of Islamic law, namely *‘aqad*, in a variety of products that are open to the general public.

<sup>136</sup> van Greuning and Iqbal (2008: 6–7).

<sup>137</sup> <https://www.icv.org.au>.

*Aqd* means “binding”,<sup>138</sup> binding something real or abstract, from one or two parties.<sup>139</sup> A contract is something that represents a person’s determination to carry out a commitment, which arises from one party unilaterally taking an oath (*waqf*), or two parties bilaterally agreeing to engage in such things as buying and selling, leasing, and pawning.<sup>140</sup>

#### **b. Authority in the Field of *Fatwâ***

The authority in the field of *fatwâ* was strengthened, affecting the sharia legal principles that were only issued by the *fatwâ* authority as stated in Article 1, paragraph 12, Law No. 21 of 2008:

The Sharia Principle is an Islamic law principle in banking activities based on a *fatwâ* issued by an institution with authority to stipulate *fatwâ* in the field of sharia.

The article explicitly states that Islamic law principles are based on the authorized institution’s *fatwâ*, which is a characteristic of the development of social institutional authority, in this case the National Sharia Board-Indonesia Ulema Council (NSB-IUC/DSN-MUI) through legislation not contained in previous regulations, such as Law No. 10 of 1998 on Banking, Law No. 23 of 1999, or Law No. 3 of 2004 on Bank Indonesia.

Therefore, the DSN-MUI plays a big role and is required to be independent in the development of Islamic legal products in the field of Islamic economic systems, especially banking.

The enactment of Act 2008 affected contracting as practiced by Islamic banks that are more operational and follow the classification of sales and purchases, leasing, and lending transactions, as stated in Article 1, paragraph 25 of Act 2008:

Financing is the provision of funds or equivalent billing in the form of:

- a. Profit-sharing transactions in the form of *mudârabâ* and *mushâraka*;

<sup>138</sup> Zarqa’ (1968, I: 291).

<sup>139</sup> Zuhaili (1405 H/1985 M, IV: 80).

<sup>140</sup> Ascarya (2007: 35-6).

- b. Leasing transactions in the form of *ijâra* or hire-purchase in the form of *ijâra muntahiya bittamlîk*;
- c. Sale and purchase transactions in the form of *murâbaha*, *salam*, and *istisna* receivables;
- d. Lending and borrowing transactions in the form of *qard* receivable; and
- e. Service lease transactions in the form of *ijâra* for multi-service transactions.

The above contracts were more specific than in the previous legislation as stated in Article 1, paragraph 13 of Law No. 10 of 1998:

Sharia Principles are rules of agreement based on Islamic law between banks and other parties for depositing funds and/or financing business activities, or other activities declared following sharia, including financing based on the principle of profit-sharing (*mudârabah*), financing based on the principle of capital participation (*mushârakah*), the principle of buying and selling goods by obtaining profits (*murâbaha*), financing capital goods based on the principle of pure rent without choice (*ijâra*), by the ownership transfer of goods leased from the party bank by another party (*ijâra wa iqtina*).

The aspects of contract utilization in a product of sharia banks are simple and uncomplicated compared to the many *fatwâ* concerning complicated contracts used in non-bank financial institutions. Sometimes sharia contractual terms are even mixed into the terms of conventional transactions. For example, in Indonesia an *ijâra* (asset to be leased) contract involves the Sharia Nation Bonds Issuing Company (Perusahaan Penerbit Surat Berharga Syariah Negara, SBSN) ordering *ijâra* objects with certain government specifications for the payment of rent.

### c. Financial and Social Intermediary Institutions

Act 2008 introduced some new content and legal institutions aimed at supporting the national development of justice, togetherness, and the equal distribution of public welfare. It ensures sharia banks still serve the main function of being financial intermediary institutions,



allowing for the provision of social services according to the Islamic principles that have been included in Indonesian law.

The social system developed through Islamic banking does not restrict Islamic banks' objective of profitability. As described by Warde, an Islamic bank is not a charitable organization; its return rate must be profitable. In Iran, the Central Bank determines the maximum profit rate of sharia banking.<sup>141</sup>

However, sharia banks have other specific functions that are not contained in conventional profit-oriented banks.<sup>142</sup> Sharia banks also carry out social functions through the private Amil Zakat Institution (*Lembaga Amil Zakat, LAZ*), which receives funds from *zakât*, *infâq*, *sadaqat*, grants, or other social funds obtained from bank customers.<sup>143</sup>

Literally, the meaning of the word 'Zakat' is taken from the Arabic word *al-zakâ'* that has a few meanings, i.e. *an-namâ'* (growth), *al-toharah* (purity or purification) and *al-barakah* (blessing). It contains two meanings; giving away property and purifying the soul. *Zakât* in reference to the blessing of assets or property and purification of soul from stinginess.<sup>144</sup> As explained in *Dompét Dhuafa* (dompetdhuafa.org.au), *zakât* is enjoined in Islam on specific things: gold, silver, crops, fruits, trade goods, and livestock like camels, cattle, and sheep. *Zakât* is subject to the conditions that one full *Hijri* has passed since acquiring the wealth, that the wealth meets the minimum threshold (*nisâb*), and that it is a specific portion of wealth.

*Sadaqat* means "worshipping Allah by giving wealth" but it is not obligatory in Islamic law. *Sadaqat* is not obligatory on any kind of wealth; rather it is based on what a person can give, without any specific limits or guidelines. However, depending on the context, the word "*sadaqat*" is sometimes used to refer to obligatory *zakât* as well.

The word "*infâq*" has a very broad meaning: all kinds of expenditures for the sake of Allah made without asking for any favor or hoping for

<sup>141</sup> Warde (2009: 320).

<sup>142</sup> Warde (2009: 320).

<sup>143</sup> Sudirman (2016).

<sup>144</sup> Masroom, *et al.* (2020).



a return constitutes its general meaning. The word “*nafaqa*” comes from the same root, and it means “alimony”.

In Indonesia, many institutions have organized *zakât*, *infâq*, and *sadaqat* funding and distribution, such as the National Amil Zakat Agency (BAZNAS), the Amil Zakat Institution (LAZ) NU, LAZ Muhammadiyah, Dompot Dhuafa, etc.



## Fluctuation of Islamic Political Infrastructure in Indonesia

**F**luctuation is an unstable and inconsistent situation. In this chapter, fluctuation refers to the changing and dynamic interrelationships between Islamic political infrastructure and the political superstructure in Indonesia.

Political infrastructure is the atmosphere of people's politics, in which activities may affect political policies. Political infrastructure has various elements: political parties, interest groups, pressure groups, political communication media, community organizations, and political figures.

A political party is a group of people who are organized to win government power, by electoral or other means. Parties are often confused with interest groups or social movements. Political parties may seek political power through a general election or a revolution.<sup>1</sup>

Political Islam is a response to the inequality of power and wealth in the modern world, driven by Islamic ideas, terminology, images, and symbolism.<sup>2</sup> Political Islam as an ideological dimension regarding the role of Islam in politics that varies across individuals. At one end of the spectrum, secularist Indonesians favour a clear demarcation between Islam and the state. While these individuals may not necessarily be opposed to religious values playing some role in public life, they do not see Islam, or any other religion, as deserving of a special status in state–religion relations.<sup>3</sup>

<sup>1</sup> Heywood (2002: 248); Matlosa and Shale (2006: 4).

<sup>2</sup> Hadiz (2011: 4).

<sup>3</sup> Fossati (2019: 7).

In this chapter, political infrastructure and Islamic politics will be explained with the fluctuation of Islamic political infrastructure from 1992 to 2011, including Islamic ideas, terminology, images, and the symbolism of Islamic banking developments, and their interrelation with the state.

The study of the interrelations between Islamic political infrastructure and the political superstructure in Indonesia is always interesting. Some experts who have studied it are Anwar (1995),<sup>4</sup> Robison (1990, 1996),<sup>5</sup> Effendy (1998),<sup>6</sup> Hefner (2001),<sup>7</sup> Ahmad (2004),<sup>8</sup> and Hadiz (2011).<sup>9</sup>

Effendy stated that the relationship between Islam and the state is not simple. The state has often prevented the Islamic political infrastructure from fully participating in political developments in Indonesia, especially in the 1970s and 1980s.<sup>10</sup>

The marginalization of the Islamic political infrastructure was the reason why Indonesia's first Islamic bank was not established until 1992. The political change that accommodated the first Islamic bank in 1992 was the success of the Islamic political infrastructure movement, which allowed Muslims from various emerging economic and social sectors to influence the policy for establishing Islamic banks.

Political change in 1998 drastically changed aspects of the Islamic political infrastructure movement. Many experts and intellectuals changed their views on Islamic struggles from substantive to formalistic, especially in the field of institutions and political affairs. Then Islamic-based political parties emerged, driven by Islamic political figures who had previously prioritized Islamic values in political-social life.

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<sup>4</sup> Anwar (1995).

<sup>5</sup> Robison (1996); Robison (1990).

<sup>6</sup> Effendy (1998).

<sup>7</sup> Hefner (2001: 491–514).

<sup>8</sup> Ahmad (2004).

<sup>9</sup> Hadiz (2011: 3–38).

<sup>10</sup> Effendy (1998: 214).



## **2.1 Islamic Political Infrastructure before 1992**

### **Political Superstructure before 1992**

The term “political superstructure” is commonly used in political science. In a general sense, it refers to the structure of government in politics, consisting of state institutions and their relations with each other. Specifically, it means institutions or groups and their relationships to each other, their patterns of interaction within the political system and to political regulations, laws, and norms, in such a way that they constitute the political landscape of the political entity.

Broadly speaking, the Islamic political infrastructure in Indonesia before 1992 faced two regimes, the Old Order tended to be Marxian-socialist, and the New Order was under the influence of Western countries. Meanwhile, the Islamic political infrastructure as a political force has an interest in the sustainability of Indonesia as a unitary nation that respects Muslim society.

#### **a. Unstable Political System of Old Order**

The Old Order was the name given to Soekarno’s 1945 to 1968 government. The name was conferred by Soekarno’s successor, President Soeharto. Meanwhile, the Old Order was divided in three periods: the Presidential Government System (1945 to 1950), the Parliamentary Democracy (1950 to 1959), and Guided Democracy (1959 to 1966).<sup>11</sup>

#### *Presidential Government System*

In the early days of Indonesia’s independence in 1945, the Soekarno-Hatta administration implemented a presidential system of government in which the president is constitutionally independent of the legislature.<sup>12</sup>

Many conditions suppressed the government at that time: internally, political and economic difficulties, and unstable governmental forms; externally, the Dutch were still trying to intervene in Indonesia through the Linggadjati Agreement (1947), the Renville Agreement

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<sup>11</sup> Angel (1970); Subkhan (2018).

<sup>12</sup> Sulardi and Tegnan (2018).

(1948), and the Roem-Van Roijen Agreement (1949) until the Round Table Conference was held in The Hague, Netherland in 1949 between Dutch and Indonesian representatives of the Dutch, and from the Federal Consultative Assembly representing various states the Dutch had created in Indonesia.<sup>13</sup>

The final draft of the results of the Round Table Conference stated that Indonesia would take over the f4.3 billion worth of Dutch East Indies government debt accrued since 1945, and the word “*Serikat*” (State) was added to the country’s name to become the Republik Indonesia Serikat (RIS), or the United States of Indonesia.<sup>14</sup>

The results of the Round Table Conference (Konferensi Meja Bundar-KMB) limited Indonesia and kept it dependent on the Dutch. Therefore, on August 16, 1950, President Soekarno canceled the RIS while declaring Indonesia to be called the Unitary Republic of Indonesia (NKRI) with a Provisional Constitution (UUDS 1950) that established a form of government based on parliamentary democracy.

### *Parliamentary Democracy*

The Parliamentary Democracy period supported a state that was, in large part, similar in its neo-classical, almost laissez-faire policy to the colonial state as a result of the Round Table Conference agreement.<sup>15</sup>

The Parliamentary Democracy period or a parliamentary cabinet was used by the Indonesian government from 1950 to 1959. It was a system of government that vested the real executive power in a cabinet composed of members of the legislature who were individually and collectively responsible to the legislature, led by a prime minister who was appointed by the president. The cabinet was responsible to parliament. Parliamentarians were publicly elected through a liberal democratic process.<sup>16</sup>

Liberal democracy is a representative democracy in which the ability of elected representatives to exercise decision-making power is subject

<sup>13</sup> Subkhan (2018); Linblad (2011).

<sup>14</sup> Wardodjo (2018).

<sup>15</sup> Fakhri (2013: 98–99); Argenti and Dias (2018).

<sup>16</sup> Angel (1970: 345).

to the rule of law, usually moderated by a constitution that emphasizes the protection of the rights and freedoms of individuals, and which places constraints on the leaders and the extent to which the will of the majority can be exercised against the rights of minorities.<sup>17</sup>

The choice between parliamentary and presidential government is not just about the relationships between legislators and cabinet members, but more fundamentally about the ways in which the citizens are allowed to influence the ultimate policy outcomes that such political actors help shape.<sup>18</sup>

In the context of Indonesia, it means freedom for every citizen in a democratic system without distinguishing ethnicity and religion in a general election that is characterized by many political parties. In the 1955 general election, 172 political parties competed. However, only four parties got the largest number of votes: The Indonesian Nationalist Party (Partai Nasional Indonesia, or PNI) gained 22.3 per cent, followed by the Indonesian Modernist Islamic Party (Majelis Syuro Muslimin Indonesia, or Masyumi) with 20.9 per cent, the Indonesian Traditional Islamic Party (Nahdlatul Ulama, or NU) with 18.4 per cent and the Indonesian Communist Party (Partai Komunis Indonesia, or PKI) with 18 per cent.<sup>19</sup>

Table 2.1  
Indonesia's 1955 Elections

No	Political Parties	Votes	Percentage	Ideology
1	<i>PNI</i>	8,434,653	22.3	Nationalist
2	<i>Masyumi</i>	7,903,886	20.9	Islamic
3	<i>NU</i>	6,955,141	18.4	Islamic
4	<i>PKI</i>	6,179,914	18	Communist
5	<i>PSII</i>	1,091,160	2.9	Islamic
6	<i>Parkindo</i>	1,003,325	2.6	Christian
7	<i>Catholic Party</i>	770,740	2	Catholic

<sup>17</sup> [https://www.cs.mcgill.ca/~rwest/wikispeedia/wpcd/wp/L/Liberal\\_democracy.htm](https://www.cs.mcgill.ca/~rwest/wikispeedia/wpcd/wp/L/Liberal_democracy.htm).

<sup>18</sup> Bergman, et al. (2000: 256).

<sup>19</sup> Sulisty, H. (2002: 76), "Electoral Politics in Indonesia: A Hard Way to Democracy", in Croissant and Ebert-Stiftung (eds).



After the establishment of the Indonesian parliamentary cabinet, President Soekarno mainly had a ceremonial role. However, he was still trying to have more power than the prime minister, which contributed to political instability, along with long and serious debates between President Soekarno and Prime Minister Natsir about state and Islamic ideology.<sup>20</sup>

The debate around the ideological basis of the state happened between the Indonesian Army, the nationalists, Muslims, and the communists. For the Army, the new constitution was a major disappointment. The nationalists, represented by PNI (Partai Nasional Indonesia), or the Indonesian National Party, stressed *Pancasila* as the basis for individual and social rights.

Some Muslim representatives wanted Indonesia to become an Islamic state ruled by sharia. However, other Muslims argued that the establishment of an Islamic state would endanger the unity of Indonesia, and might trigger revolts and separatism, since Indonesia contained millions of non-Muslims.

Besides, the Indonesian Communist Party (Partai Komunis Indonesia, PKI), which had been outlawed by the Dutch colonial authorities in 1927, had been reborn and had many constituents in Central and East Java, allowing it to become one of the more popular parties in the 1959 election.

Soekarno had to find a way to unite these diverse viewpoints. This was the inspiration for Pancasila, the set of five principles that would become the foundation of the Indonesian state:

- (1) Belief in one supreme God,
- (2) Justice and civility among peoples,
- (3) Unity of Indonesia,
- (4) Democracy through deliberation and consensus among representatives,
- (5) Social justice for all the people of Indonesia.

The problem with uniting the pluralistic Indonesian society was that Muslim parties were demanding an Islamic state. Initially, a

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<sup>20</sup> Iskandar (2003).



constitutional committee agreed to add a sentence in the first part of Pancasila:

Belief in one supreme God, *with the obligation to implement Islamic sharia for its adherents.*

This addition was known as the “Jakarta Charter”. However, just before publishing the 1945 Constitution, it was dropped over fears that it might provoke resentment in the non-Muslim community.<sup>21</sup>

During this period, seven cabinets took turns rapidly and without significant progress. The Masyumi Party led the Natsir Cabinet from September 1950 to March 1951, the Sukiman Cabinet from April 1951 to April 1952, and the Burhanuddin Harahap Cabinet from August 1955 to March 1956. They also led three cabinets: the Wilopo Cabinet from April 1952 to June 1953, the Ali Sastroamidjojo I Cabinet from July 1953 to August 1955, and the Ali Sastroamidjojo II Cabinet from March 1956 to March 1957. The change of cabinets controlled by Masyumi and the PNI shows that the ideological battle in national politics between Islam and the nationalists was very strong.

In January 1957, political tensions intensified when Islamic ministers from Masyumi resigned from the PNI’s Sastroamidjojo II Cabinet.<sup>22</sup> National economic stability continued to deteriorate, resulting in President Soekarno dissolving the Constituent Assembly through a Presidential Decree on July 5, 1959, which automatically ended the liberal democratic system. The Constituent Assembly is thought to have failed to resolve the tension between the groups and failed to draft a new constitution to replace the 1950 Constitution.

Then, President Soekarno formed the Djuanda Cabinet (April 1957 to July 1959), which consisted of experts led by Djuanda Kartawidjaja. It was also called the Working Cabinet.<sup>23</sup>

Most people considered the president’s policy as unconstitutional. Masyumi opposed the move by firing one of its members who wanted to be appointed minister in the Working Cabinet. PNI and NU figures

<sup>21</sup> Boland (1982) as cited in Hakam (2017).

<sup>22</sup> Sandra (2007: 114).

<sup>23</sup> Lindblad (2011).

stated that the situation was critical, an emergency, and Bung Hatta also said he considered the president's policy unconstitutional.<sup>24</sup>

### *Guided Democracy*

Guided Democracy (from 1959 to 1966) was proposed by Soekarno as a return to the 1945 Constitution that stipulated the formation of a strong presidency with authoritarian tendencies. Soekarno had already recognized the Army as a "functional group", meaning they became agents in the political process, and with Guided Democracy the Army's role in politics was about to increase.<sup>25</sup>

In 1959, Soekarno imposed Guided Democracy by disbanding parliament and directly appointing half of the cabinet members. He relied on the support of the PKI (Partai Komunis Indonesia, Indonesian Communist Party) to counterbalance the Army's power.<sup>26</sup>

Under Guided Democracy Indonesia's foreign policy changed drastically from a fairly passive and neutral independent and active approach to a much more militaristic, aggressive, strongly nationalist approach that focused heavily on combating the evils of imperialism and neo-colonialism.<sup>27</sup>

In 1965, Soekarno severed diplomatic relations with Western countries by withdrawing from the IMF and the World Bank, meaning that much-needed foreign aid would cease to flow into Indonesia. This worsened Indonesia's economic situation, which had already reached extremely precarious levels by then.<sup>28</sup>

President Soekarno also eliminated his political opponents by accusing the opposition of various crimes. Some leaders of Islamic parties from Masyumi were jailed, such as Muhammad Natsir, Mr. Muh. Roem, Kasman Singadimedjo, and Syafruddin Prawirnegara. Some sympathizers of Masyumi were also imprisoned, like Hamka and

<sup>24</sup> Moedjanto (1992: 103).

<sup>25</sup> Sibuea, *et al.* (2020); Argenti and Dias (2018).

<sup>26</sup> Angel (1970: 442–44).

<sup>27</sup> Redfern (2010: 70).

<sup>28</sup> Redfern (2010: 3).

Yunan Helmi Nasution. Then, on August 17, 1960, through Presidential Decree Number 200/1960, the Masyumi Party was dissolved.<sup>29</sup>

The other serious problem was the militant Dâr-ul-Islâm movement, which aimed to establish an Islamic state, endangering the unity of Indonesia. Before its members surrendered in 1962, they tried to undermine the nation by using guerrilla tactics in West Java, South Sulawesi, and Aceh during the 1950s.

Many subversive movements also emerged, such as Permesta in North Sulawesi,<sup>30</sup> the Revolutionary Government of the Republic of Indonesia (PRRI) in West Sumatra,<sup>31</sup> and former members of the Royal Dutch East Indies Army (KNIL) who proclaimed the Republic of the South Moluccas in 1950. Soekarno dissolved the PRRI, Permesta, and the PSI<sup>32</sup> in 1960.<sup>33</sup>

The accommodation of NU as political Islam in the Sukarno regime in the 1950s and 1960s, have transform itself into a source of patronage by exploiting its control over important government posts. When Masyumi was dissolved, NU de facto became the sole representative of political Islam under Soekarno, and as the government became increasingly leftist, NU reaffirmed its position as a force for balance. Together with the Armed Forces and the Partai Komunis Indonesia (Communist Party of Indonesia, PKI), NU served as a pillar of power for Soekarno's government. Many observers have held that the organisation's good relations of NU with Soekarno were founded on its

<sup>29</sup> Angel (1970: 449–50).

<sup>30</sup> Permesta or *Perdjungan Semesta* (the Civil Society Struggle) is a military movement declared by Lieutenant Colonel Ventje Sumual (East Indonesian civil and military leader based in Makassar) on March 2, 1957.

<sup>31</sup> PRRI (Pemerintah Revolusioner Republik Indonesia/Revolutionary Government of the Republic of Indonesia) was a movement declared on February, 15, 1955, by Lt. Col. Ahmad Husein in Padang, West Sumatra. PRRI only demanded that broader regional autonomy and the constitution be implemented properly. However, the PRRI declaration was considered by the government as a rebellion and was dealt with by mobilizing the largest military force ever in the history of the Indonesian military.

<sup>32</sup> The PSI (Indonesian Socialist Party) led by Sutan Syahrir dominated parliament, but in the 1955 elections only got 753,191 votes (1.99%) and five seats, being among 29 election participants. The four top parties were PNI with 8,434,653 votes (22.32%, 57 seats), Masyumi with 7,903,886 votes (20.92%, 57 seats), NU with 6,955,141 votes (18.41%, 45 seats), and PKI with 6,179,914 (16.36%, 39 seats); KPU (V: 35).

<sup>33</sup> Syaukani, *et al.* (2005: 94–7).



flexibility, its ability to adapt itself to new situations, and its willingness to grant religious and symbolic legitimacy to Soekarno.<sup>34</sup>

In 1965 the PKI, which had become the major party supporting the government, attempted a coup against the Old Order government. On September 30, 1965, the PKI sadistically murdered Indonesian generals and buried them in a hole, an incident known as “Sumur Lubang Buaya” in Jakarta. That incident triggered public anger, especially among Indonesian Muslims. The Executive Board of the PKI, from central to regional levels, were murdered in revenge by Indonesian Muslims in what became a dark period of Indonesian history.<sup>35</sup> To become known, the PKI had also attempted a coup led by Moeso in 1948. They killed many Ulama, especially in Madiun, East Java, as well as East Java Governor R.M Suryo, pro-independence doctor Moewardi, and several police officers and religious figures.<sup>36</sup>

At present (2020), the purported rise of the PKI has become a hot topic of discussion in the Indonesian public sphere. Television media often broadcast news stories with various titles, like “Is PKI a ghost or real?” Children of the 1965 PKI leaders and several other figures often provoke the media, claiming that they were victims of Muslims who accused their parents of being part of the PKI.

Provocation continues to be carried out, such as by Ribka Tjitaning, who wrote a book entitled *Aku Bangga Jadi Anak PKI* (I am Happy I am a Child of PKI). Ilham Aidit, the son of D.N. Aidit, a PKI leader in 1965, often gives speeches about PKI history, and Bedjo Untung, a PKI activist, often debates with witnesses and experts who often loudly voice the atrocities of the PKI, such as General Kivlan Zein and Professor Hermawan Sulistyono.

According to Mackie,<sup>37</sup> the Old Order government maintained political stability at the expense of economic development.<sup>38</sup> The Old

<sup>34</sup> Makhasin (2017).

<sup>35</sup> Zurbuchen (2002); Syukur (2008).

<sup>36</sup> Pauker (1969: 4–6); Angel (1970: 450).

<sup>37</sup> Jamie Mackie, a professor, was one of the first Australians to do work on Indonesia since the 1950s. He is an economist at the State Planning Bureau, teaching about Indonesia at the University of Melbourne.

<sup>38</sup> Mackie (1967: 10); Mahfud (2012: 205–6).



Order government's policies, which were more dominated by political development, affected many changes in state institutions' policies. Soekarno made controversial policies, such as replacing the Presidential Cabinet (*Kabinet Presidensial*) with the Working Cabinet (*Kabinet Kerja*), establishing the Provisional People's Consultative Assembly (Majelis Permusyawaratan Rakyat Sementara, MPRS) and the Provisional Supreme Advisory Council (Dewan Penasihat Tertinggi Sementara, DPTS), and dissolving the House of Representatives (DPR), replacing it with the People's Representative Council of Mutual Assistance (Dewan Perwakilan Rakyat Gotong Royong, DPR-GR).<sup>39</sup>

#### **b. Authoritarianism of New Order**

Authoritarianism can be understood both as a political regime and an ideological construct. As a political regime, authoritarianism can be defined as a form of government that monopolizes authority over the state without guaranteeing political pluralism or defense of civil liberties and with little or no accountability to the population. To enforce an exclusive claim over power, authoritarian regimes revert to unconstitutional or illegitimate means, such as the use of force, censorship, or infusion of fear. Authoritarianism often presents democracy as negative.<sup>40</sup>

The New Order, which ran from 1966 to 1998 (32 years), is a long period that happened because of a government whose authoritarianism presented democracy negatively. It came about after the murder of the generals and the failure of the Indonesian Communist Party's coup made President Soekarno and the Old Order's governance politically uncertain. Brigadier General Soeharto, as Commander of the Army Strategic Command (Panglima Komanda Staf Angkatan Darat, Pangkostrad), took over the situation to lead and secure the nation.

Soeharto eventually got his finest moment during the transition of power when Soekarno, through the Supersemar, the Order of Eleventh March (*Surat Perintah 11 Maret*), transferred to him the mandate of power on March 11, 1966. This was done to overcome the national

<sup>39</sup> Angel (1970: 444–7).

<sup>40</sup> Vaillant (2012); Rosyadi (2017).

crisis of the demonstrations against the government for the G30S/PKI incident on October 1, 1965, when inflation reached more than 600 percent. The peak demonstrations took place on January 12, 1966, when the Pancasila Front rallied in the courtyard of the DPR-Gotong Royong building. They demanded three things, known as the *Tritura (Tiga Tuntutan Rakyat)*:

1. Disbandment of the Indonesian Communist Party (PKI),
2. Clear out of the Dwikora Cabinet the elements involved in the September 30 movement (G30S PKI),
3. Lower prices.

Then, Minister/Commander of the Army Lieutenant General Soeharto, through Brigadier General Amir Machmoed (Commander of the Kodam Jaya), Brigadier M. Yoesoef (Minister of Basic Industry), and Mayjen Basoeeki Rachmat (Minister of Veterans and Demobilization), requested that Soekarno, who was in the Bogor Palace, West Java, issue a letter to resolve the conflict and to say that Soeharto was still ready if given the trust. The Supersemar was signed by President Soekarno on March 11, 1966.

Many versions of the Supersemar circulate, but none are original. Some of the Supersemar's contents are about:

1. Taking all actions deemed necessary to ensure security and peace and the stability of the government and the Revolution, as well as to guarantee the personal safety and authority of the President/Supreme Commander-in-Chief/Great Leader of the Revolution/Mandate of the MPRS, for the integrity of the Nation and the Republic of Indonesia, and carry out with certainty the teachings of the Great Leader of the Revolution.
2. Coordinating the implementation of the orders with the Commanders-in-Chief of Other Forces as well as is possible.
3. Reporting everything related to the duties and responsibilities mentioned above.<sup>41</sup>

Based on the Supersemar, Soeharto issued many orders through Presidential Decree No 1/3/1966 dated March 12, 1966, on behalf of

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<sup>41</sup> Nailufar (2020).

the President/Supreme Commander of the Armed Forces/Mandatory MPRS/PBR:

1. Disbandment of the PKI and its mass organizations and declare it a prohibited party.
2. Arrest 15 ministers who were involved in or supported the G30SPKI.
3. Rid the MPRS and other state institutions of PKI elements and place the role of the institutions under the 1945 Constitution.

On June 22, 1966, Soekarno insisted that the MPRS session known as Nawaksara should not disband the PKI. The MPRS rejected his demand. Finally, on March 7, 1967, Soekarno resigned and was replaced by Soeharto.

Soeharto became the second president through the Session of the Provisional People's Consultative Assembly (MPRS/Majelis Permusyawaratan Rakyat Sementara) led by General A.H. Nasution on March 27, 1968. At the time, President Soeharto declared the New Order government and called Soekarno's governance the Old Order regime. In the New Order period, President Soeharto established the economic slogan, which grew more dominant than the political ones: "Politics No, Economy Yes."<sup>42</sup>

Political-economic policies of the New Order are widely discussed by experts from various fields, including economic, political, legal, and linguistic ones. The discussions refer to the New Order government, which lasted for 32 years, and the figure of President Soeharto, who was very influential and had a lot of social capital.

Masoed (Professor of Gadjah Mada University, Indonesia) explained that the New Order developed its national government using the Economics-as-Commander approach, which emphasized economic development as a process of capital accumulation and reproduction, driving private businesspersons to explore natural resources,<sup>43</sup> create pragmatic ideas, engage in *de*-ideologization and *de*-political-partying, and so on.<sup>44</sup> Political parties' room to move was highly limited, and

<sup>42</sup> Mahasin (1989) as cited in Gordon (1998).

<sup>43</sup> Masoed (1999: 30–2).

<sup>44</sup> Ali and Effendy (1984: 95).



community organizations' ideologies were placed strictly under government control.

Mahfud said the New Order's political configuration was based on economic consolidation, strong leadership and government, and national stability.<sup>45</sup> He also quoted Harahap, whose opinion was that the New Order chose economic development and high growth orientation, which were supported by technology, foreign capital, and national stability.<sup>46</sup>

Van Langenberg<sup>47</sup> stated that the New Order was a form of "state as well as state system". Since 1965/1966, the state-system ruler has built hegemony with the ideological formulation that the basis of constructing state hegemony is order, stability, and social security.<sup>48</sup>

Latif explained that the New Order's success in upholding its policies to generate a material reproductive system was that the New Order first manifested itself as a regime of interpretation and language. The New Order's cronies created a slogan using the terms "clean, stable, and orderly".<sup>49</sup>

Sudibyo said the New Order regime, as an agent of social actors, could direct policies that led to the crony capitalism structure. However, there were also external pressures that forced the New Order to selectively correct liberalization policies that raised the crony capitalism structure.<sup>50</sup>

Soeharto boosted the interpretation on the national political scene that the New Order was a new era that was clean, stable, orderly, and better than the Old Order. Then, he maximized political stability by involving the Armed Forces (ABRI, Angkatan Bersenjata Republik Indonesia) in his government's sustainability.

<sup>45</sup> Mahfud (2012: 199–205).

<sup>46</sup> Mochtar E. Harahap, *Perjalanan Orde Baru: Realitas yang Beragam (New Order Journey: Diverse Realities)*, unpublished, see Mahfud (2012: 207).

<sup>47</sup> Michael van Langenberg is a member of the teaching staff at the University of Sydney, Australia. His important article: "Analyzing Indonesia's New Order State: A Keyword Approach" (1986).

<sup>48</sup> Michael van Langenberg, "The New Order State: Language, Ideology, Hegemony," in Budiman (ed.) (1990: 121–49); van Langenberg, "Negara Orde Baru: Bahasa, Ideologi, Hegemoni," "Prolog" in Latif and Ibrahim (eds.) (1996: 225).

<sup>49</sup> Latif and Ibrahim (eds.) (1996: 31).

<sup>50</sup> Sudibyo (2004: 5).



Mallarangeng explained the New Order's policy had two phases. First, from 1966 to 1973, economic policy initiatives were designed to improve the performance of the economic system that had collapsed because of Soekarno's revolutionary economy. During this period, the technocrats, along with Soeharto and some main figures of the New Order, emerged as the new actors who were most decisive in the process of preparing economic policy.

Second, from 1974 to 1980, after the rehabilitation and liberalization policy, technocrats were widely criticized by scholars and student activists. The criticism voiced the confusion about the selective liberalization policy of the New Order that created the crony structure, especially during this period.<sup>51</sup> At the time, there was a massive demonstration known as the Malari (Malapateka Januari) or January's Havoc.

Malari was triggered by Japanese Prime Minister Tanaka Kakuei's visit to Jakarta on January 12, 1974, which faced protests from students and the members of the public. Rioting took place in Jakarta for two days, more than 2,000 cars and hundreds of buildings were burned, hundreds of people were injured, 820 people were arrested, and nine people died.<sup>52</sup>

After the Malari tragedy, the New Order government implemented some political strategies. First, consolidation. Some scholars and student figures who criticized the technocrats were imprisoned and some newspapers that didn't support government policies were banned, such as *Indonesia Raya*, *Abadi*, *Pedoman*, and eight others.<sup>53</sup> The government also accused communists of being responsible for the Malari riots.

Second, centralization of economic development. Centralism costs a lot, but the surge in world oil prices helped national economic difficulties at that time.<sup>54</sup> The government, through Pertamina, the national oil company, entered into contracts with foreign companies for oil exploration, mining, and refining in many regions. In 1967,

<sup>51</sup> Mallarangeng (2002: 75).

<sup>52</sup> Bresnan (1993: 137).

<sup>53</sup> Mallarangeng (2002: 80); Ricklefs (2007: 588).

<sup>54</sup> Mallarangeng (2002: 82).

Indonesia's total oil production increased from 505,400 barrels per day (bps) to 1,436,300 bps. Indonesia received a great fortune, a bonanza, in 1973 when OPEC imposed an embargo on the USA and Western Europe and oil prices rose from US\$2.96 per barrel in 1973 to US\$10.80 per barrel in 1974.<sup>55</sup>

Unforeseen consequences of the post-Malari centralism opened up opportunities for technocrats, with the support of the World Bank, the IMF, and the liberal paradigm, to launch various liberalization programs in the mid-1980s.<sup>56</sup>

The New Order government became an anti-criticism. The development potential of state wealth was exploited by the corporations close to the government, while traditional sector-based development became mere non-empowered subsystems. Then centralized policies become dominant in national development.

Suharto's autocratic regime was marked by state capture. His family had extensive and highly diversified business interests and is estimated to have amassed \$15-\$35 billion during his 31 years in office from 1967-1998. Cronyism was rampant, and it was well known that ingratiating oneself with the president's family was an important enabler of business success.<sup>57</sup>

## Islamic Political Tension

### a. The Nasakom of the Old Order

Nasakom is short for *Nasionalisme-Agama-Komunisme* (nationalism, religion, communism), a political concept coined by President Soekarno that became the hallmark of Guided Democracy from 1959 to 1965.<sup>58</sup>

Soekarno had conceived the basic ideas of Nasakom in 1926, when he wrote an article that was published in the *Soeloeh Moeda Indonesia* newspaper:

We try to prove that the ideas of Nationalism, Islamism, and Marxism in the colonies in some parts cover each other. These are

<sup>55</sup> Kumorotomo (2008: 117).

<sup>56</sup> Mallarangeng (2002: 35-6).

<sup>57</sup> Hallward-Driemeier (2020: 2).

<sup>58</sup> Angel (1970: 159).

the principles held by popular movements throughout Asia, which form the spirit of movements in Asia, so in Indonesia.<sup>59</sup>

Soekarno's ideas were inspired by a stream of three political movements in the colonial era of the Dutch East Indies. First, the nationalist group represented by the Indische Partij (IP), second, Muslims who were part of Sarekat Islam (SI), and third, the Indonesian Communist Party (PKI) with its Marxist ideology.

Soekarno devised Nasakom and Guided Democracy to express that Parliamentary Democracy was unsuitable for application in Indonesia. It had protected the capitalist system, and parliament was controlled by the bourgeoisie. Therefore, the people could not prosper. He also thought it could endanger the government if each person could vote or be elected, and so be able to cultivate the power to bring down ministers from their thrones.

Nasakom was created in February 1956 based on the three main factions of Indonesian politics: the Indonesian National Party (PNI), the Islamic Masyumi and NU, and the PKI-led left.<sup>60</sup>

Soekarno even stated that Nasakom was a manifestation of Pancasila and the 1945 Constitution. He spoke at the commemoration of Indonesia's Independence Day on August 17, 1961:

The someone agrees to Pancasila, must agree to Nasakom; The someone does not agree to Nasakom, actually does not agree to Pancasila.

The someone agrees to the 1945 Constitution, must agree to Nasakom; The someone does not agree to Nasakom, actually does not agree to the 1945 Constitution.

Nasakom made state power increasingly centered on President Soekarno, which impacted the *Dwitunggal* (two in one) of Indonesian proclaimers: Soekarno and Hatta broke up. M. Hatta resigned from the vice presidency because of a disagreement over Nasakom.

Soekarno continued to campaign on the Nasakom concept, even after his position had declined after the G30S PKI tragedy. In the All

<sup>59</sup> Pauker (1969: 13).

<sup>60</sup> Winata and Purwaningsih (2017).



Indonesia Five Session held at the State Palace, Jakarta, October 23, 1965, Soekarno emphasized the importance of Nasakom. He said:

*"Ik ben nationalist* [I am a nationalist], *ik ben Islamiet* [I am a Muslim], socialist. Three in one. Three in one."

The Nasakom's concepts were eventually engulfed by history when power transferred from the Old Order to the New Order led by Soeharto and became very anti-communist.

## **b. Suspicions of New Order Toward Islam**

### **1. Antagonistic Relationship**

The term "antagonistic relationship" was used by Weber to disaggregate the populism into two elements: first, the antagonistic relationship between the people and the elites, and second, the idea of popular sovereignty.<sup>61</sup> The first element is relevant in the Indonesian context. Hefner viewed the relation between religion-in this case Islam and state with democracy always antagonistic. The state during the New Order regime used various means to suppress the democratization process undertaken by civil society, especially by those who believe. To emulate the civilian Islamist group New Order to form a bloc (Islam regimes)- which are so-called the religious groups supporters of government. The state should have a major role in the development of, or acting as civilized state.<sup>62</sup>

In Indonesia, the antagonistic relationship that happened from 1966 to 1981 reflected the power of the New Order elite, which extended political ideology down to the grassroots and that was contrary to Muslim interests. This situation caused a rise in ideological conflicts and created uncertainty for Muslim politicians.<sup>63</sup> The conflict was triggered by governmental intervention in Parmusi (Partai Muslimin Indonesia/Indonesian Muslim Party).

<sup>61</sup> Weber (2015: 3).

<sup>62</sup> Hefner (2000) as cited in Muhammadiyah (2015).

<sup>63</sup> Rasyid (2013: 160).



The Muslim movement had fully supported Soeharto success gaining the national leadership after the coup attempt blamed on the PKI (Partai Komunis Indonesia, Indonesia Communist Party) had failed. The majority of Muslims hoped Parmusi would be a reincarnation of Masyumi Party (Partai Majelis Syuro Muslim in Indonesia), which had been blocked by President Soekarno during the Old Order.<sup>64</sup> This case effectively ended the political struggle of many Islamic-oriented leaders, who perhaps hoped to be rewarded by President Soeharto for their role in the struggle against communism, but that wasn't to be.

Some senior leaders of Masyumi, such as Djarwani Hadikusumo and Lukman Harun, were prohibited from becoming involved in Parmusi. In 1969, they lost their positions in Parmusi and were replaced by Jaelani Naro and Imran Kadir, two figures supported by the government.<sup>65</sup> The New Order backed Golkar (Golongan Karya, Working Group) to participate in the national elections. Golkar was a military joint secretariat established on October 20, 1966, at the end of President Soekarno's administration, in response to the PKI and its organizations and a political situation in which tensions were increasing.<sup>66</sup>

Early on, the New Order accommodated some members of Christian groups in the strategic bureaucracy and military leadership and members of Chinese groups in economic development. President Soeharto was a Javanese man of the *abangan* social class who shared the views of some Christian and Chinese groups that perceived Islam (*santri*) to be a common enemy.<sup>67</sup>

Many influential figures were behind this policy, such as Ali Murtopo, Yoga Sugama, and Sudjono Humardani. Sugama was a chairman of

<sup>64</sup> Hadiz (2011: 18).

<sup>65</sup> Mudhoffir (2015); Porter (2002: 41).

<sup>66</sup> <https://www.golkar.or.id/sejarah-partai-golkar>.

<sup>67</sup> Clifford Geertz used the terminology of *abangan*, *santri*, and *priyayi* to describe social class in Java. *Santri* is a variant of people who adhere to Islam, *abangan* is someone more loose and not too obedient to it. *Priyayi* are *bangsawan/ningrat* (nobles) who are not too obedient to Islam, more fascinated by the customs and habits that come from their ancestors. Geertz (1976).

the National Intelligence Agency (Bakin, Badan Koordinasi Intelijen Negara), while Murtopo and Humardani established the Center for Strategic and International Studies (CSIS) in 1971. CSIS was a think tank that endorsed the economic policies of the New Order, and was composed of Catholic and Chinese intellectuals who networked with Chinese groups.<sup>68</sup>

Important positions were held by Christians or Soeharto's loyalists. For example, the Deputy Commander of the Army was Lieutenant General Maraden Panggabean, a Christian from the Batak tribe in North Sumatra, and the position of the Minister of the Interior was held by Major General Basuki Rahmat, who brought the Supersemar in 1966.<sup>69</sup>

Enacting Law No. 15 of 1969 concerning General Elections and Law 16 of 1969 concerning Susduk MPR/DPR/DPRD also increased political tension. This confrontational pattern was implemented during the 1971 election. Golkar won an election unfairly and carried out systematic actions to minimize the role of non-government political parties. The legislature was filled by the executive using presidential authority.

During the election campaign in 1971, Parmusi under Naro and Imran Kadir became precisely aligned with Golkar and the military against NU and the PNI made Parmusi lose its mass base of support primarily, especially Muhammadiyah's, shortly before the election.<sup>70</sup> Parmusi only achieved 5.2 percent in the 1971 election because of intervention by the New Order regime through a special operation that was conducted by Murtopo. Even though Masyumi, as a senior party of Parmusi, was the largest Muslim party that achieved the second-highest number of votes (20 percent) in the 1955 election.

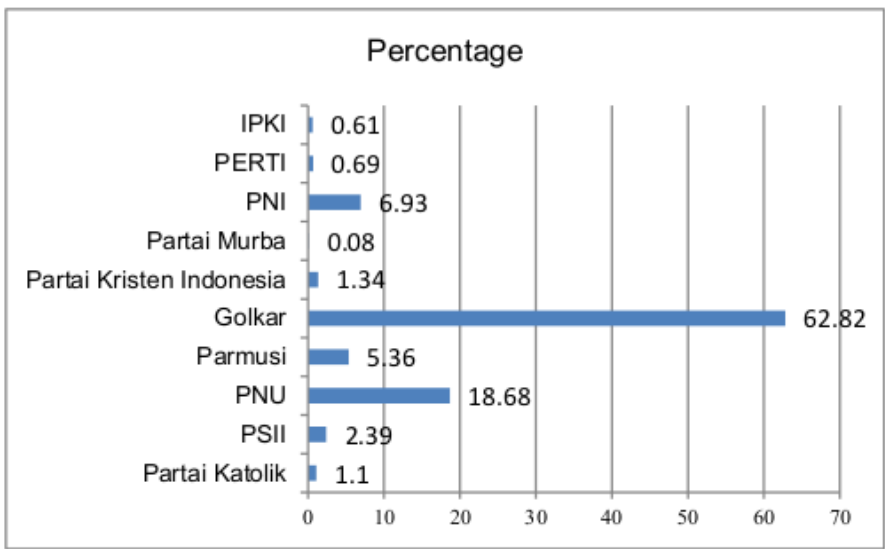
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<sup>68</sup> Mudhoffir (2015); Hadiz (2008: 642).

<sup>69</sup> Suwirta (2018).

<sup>70</sup> Mudhoffir (2015); Hadiz (2008: 642); Bertrand (2004: 81).

Table 2.2  
1971 election vote



After the 1971 election, the Islamic parties — the Nahdlatul Ulama Party, the Indonesian Muslim Party (Parmusi), the Indonesian Islamic Syarikat Party (PSII), and the Perti Islam Party — fused into the United Development Party (PPP) on January 5, 1973. Meanwhile, the Nationalist Party of PNI, Murba, the Catholic Party, IPKI, and the Indonesian Christian Party merged into the Indonesian Democratic Party (PDI).<sup>71</sup>

The concept of an election with three parties and the ABRI faction endured for five elections in 1977, 1982, 1987, 1992, and 1997, and Golkar won every election.<sup>72</sup>

In the 1980s, the New Order still accommodated the Christians. The positions of Minister of Defense, Commander of Operational Command for Restoration of Security and Order (Kopkamtib), and commander of ABRI (Angkatan Bersenjata Republik Indonesia), the Republic of Indonesia’s Armed Forces, were held by Soedomo, Maraden Panggabean, and L.B. Moerdani, who was the most influential commander of the Army.

ABRI had been exploited by the New Order to support national stability and economic development programs. ABRI was the umbrella

<sup>71</sup> Liddle (1985: 71–2).

<sup>72</sup> Thoha (2011: 138–9, 146–7).



organization of the Republic of Indonesia's Army, Navy, Air Force, and Police, which is based on Presidential Decree No. 225/Pit/I/1962. ABRI had a dual social-political function, and extensive political bargaining powers. Many ABRI personnel were appointed by regents and governors during Soeharto's era.<sup>73</sup>

After the Soeharto regime was destroyed, the dual ABRI functions were dissolved and ABRI was redivided to become the TNI (Indonesian National Army) and POLRI (Indonesian National Police).

Haryono explained that the New Order used repressive authoritarianism for building governance and used cronyism for developing the nation's economy, especially during the 1980s. It was obvious when Soeharto collaborated with General L.B. Moerdani, a Christian and the commander of ABRI, in March 1983. Political tensions spilled into the public sphere during the mass killing known as Petrus (Penembakan Misterius), and Muslim movements were restricted.

President Soeharto decided that Islam was a threat and began intimidating Muslims by prohibiting girls from wearing *hijâb* in schools, eliminating holidays during Ramadan, censoring the texts of sermons during *Eid Fitr* and *Eid Adha*, and requiring complicated permits for Islamic activities.<sup>74</sup>

In general, Indonesia's political situation in the 1980s was the same as that of other Southeast Asian countries. In Malaysia, Mahathir's political regime restricted civil-political rights and the government tended toward authoritarianism.<sup>75</sup>

Islamic politics found new forces among young intellectuals. Hefner described the emerging new modernists or young Muslim intellectuals in the late 1980s. They promoted the ultimate goal of Islamic politics, not a centralized state with a monopoly over politics and culture, but a civil society to counterbalance the state's power and empower public participation and social justice.<sup>76</sup> The presence of these intellectuals increased the bargaining power of Islamic politics. For example, the

<sup>73</sup> Kingbury (2003: 67–7).

<sup>74</sup> Kamsi (2012).

<sup>75</sup> Haryono (2010: 2); Ricklefs (2007: 610).

<sup>76</sup> Hefner (2001: 504).



enactment of Law No. 1 of 1974 on Marriage was achieved through political debate.

Hermawan explained the process of arranging Law No. 1 of 1974 on Marriage was full of political debate. After the Old Order era, the Draft Act on Marriage faced a deadlock; the New Order government also proposed a Draft Act on Marriage, which considered unification, uniformity, and homogeneity in the marriage act.<sup>77</sup>

The draft marriage act created controversy and debate, motivated by the issue of the secularization of marriage and the abolition of the Ministry of Religious Affairs' competence over the marriage act.

Minister of Religious Affairs Abdul Mukti Ali (1923 to 2004) argued that the draft marriage act did not follow sharia, especially regarding the possibility of interfaith marriages and monogamy.<sup>78</sup> In the end, Law No. 1 of 1974 was ratified after various revisions were made to follow sharia, as stipulated by President Soeharto on January 2, 1974, and has remained valid until the present.

## 2. Reciprocal Relationship

The term "reciprocal relationship" has been used in many fields, such as by sociologists McAdam and Tarrow (2010), and by psychologists Hughes and Gullone (2010).

In this session, a reciprocal relationship meant the relationship between the New Order, with Muslim society in national policies. The government and Muslims understood each other and reduced their suspicions. The state realized Muslims constituted the majority of the population and were a determining factor in the success of development. Muslims realized too that the Islamic struggle could not only to be undertaken through politics, but it can also be through culture, education, values, and civil society.

Thaba said the New Order created a reciprocal relationship with the Islamic political infrastructure movement between 1982 and 1985, by which the relationship moved toward mutual understanding. This policy started from the political test on Pancasila being the single set

<sup>77</sup> Sairin and Pattinasia (eds.) (1994: 205); Hermawan (<http://file.upi.edu>).

<sup>78</sup> Lev (1996: 331–4); Hasan (1987: 192).

of principles for politics and mass organizations in Indonesia.<sup>79</sup> Hefner explained that from 1983 to 1985, the government enforced that policy and often intervened in Muslim organizations.<sup>80</sup>

In the context of Islamic banking, in the 1980s many Indonesian Muslim intellectuals and scholars attempted the establishment of Islamic banks in Indonesia. Their desire was motivated by the success of Malaysia and other Muslim countries in establishing Islamic banks. However, their efforts failed because of political tensions.

At that time, the government forced Pancasila to be the only set of principles for social organizations because of the government's phobia over the word "Islam" as it has been associated with Islamic state ideology, extremism, and fundamentalism.<sup>81</sup>

This shows that until the 1980s, the overall direction of the political superstructure policy of the New Order was not good for Islamic symbols in any form of mass organization. The pattern of relationships between the political superstructure and the Islamic political infrastructure was disharmonious and the two tended to be in conflict with each other. However, there was also a reciprocal relationship and understanding of each other.

The New Order regime intervened in structuring the Pancasila ideology for social-economic forces and mass organizations in the 1980s.<sup>82</sup> It started from President Soeharto's statements before the plenary session of the House of Representatives of the Republic of Indonesia on August 16, 1982. Then, in the general assembly of the People's Consultative Assembly in 1983 he decreed that Pancasila was to be the only set of principles for political parties and mass organizations.

Anwar said Pancasila policy was Soeharto's realization of a state ideology. He interpreted Pancasila as not being a religion, and said that religion would not be replaced by the Pancasila ideology. He also reduced the political forces that wanted religion as an alternative to the state ideology. Besides, this policy was the beginning of the decline of the influence of Islamic ideology, still referred to as the *Jakarta Charter*

<sup>79</sup> Thaba (1996: 240–2).

<sup>80</sup> Hefner (2001: 505).

<sup>81</sup> Hamat, *et al.* (2016: 179–81).

<sup>82</sup> Anwar (1995: 110–11).

on June 22, 1945, which claimed that Islamic sharia could be followed by its adherents as stated in Pancasila's first point.<sup>83</sup>

The main point of the political accommodation started from the decreasing pressure from the Islamic political infrastructure to receive the New Order's policy that the Pancasila ideology would be the sole set of principles for society. The government responded well to the mass Islamic acceptance of Pancasila, especially when the largest Islamic mass organization, NU, led the way to accept, which was formalized by an organizational meeting.

The NU's Ulama met in Situbondo, East Java, in December 1983, to decide NU to go back to Khittah 1926. It means they reset NU's policies back to those it held in 1926 or NU withdrew from political affairs and from the United Development Party (PPP), and accepted Pancasila as the sole set of principles.<sup>84</sup> The NU's decision caused debate and friction, especially with Idham Cholid (1921 to 2010), who was a prominent figure and an Ulema of Nahdhatul Ulama, versus the NU youth group pioneered by Abdurrahman Wachid (Gus Dur), a grandchild of NU founder Hasyim Ashari.<sup>85</sup> The NU's acceptance of the Pancasila indirectly constituted the greatest success of the New Order government in de-Islamizing social organization, considering that NU is the largest Islamic political infrastructure in Indonesia.

In 1985, the New Order government enacted Law No. 8 of 1985 (Act 85) on Mass Organizations, which, among other things, stipulated the necessity to include Pancasila as the single set of principles for social organizations. As stated in items *c* and *d* of Act 85:

Item *c*:

That the Social Organization as a means to channel opinions and thoughts for members of the community, Citizens of the Republic of Indonesia have a very important role in increasing the active participation of all levels of society in realizing the Pancasila community based on the 1945 Constitution in the framework of ensuring the consolidation of national unity, guaranteeing the

<sup>83</sup> Anwar (1995: 111).

<sup>84</sup> Muhammadiyah (2015: 104)

<sup>85</sup> Masyhuri (2016).



success of national development as a practice of Pancasila, and at the same time guaranteeing the achievement of national goals.

Item *d*:

That given the importance of the role of social organizations as referred to in item *c*, also in line with the efforts to strengthen the appreciation and practice of Pancasila in society, nation, and state life in ensuring the sustainability of Pancasila, Community Organization needs to make Pancasila its only principle.

The above considerations created room for Islamic political movements to empower Islamic social organizations. Then the substance of Islam was a more realistic alternative idea for realizing social and party organizational systems, which may present Islamic values.

In a difficult situation, Muslim movements succeeded in realizing an Islamic formalism that went through political processes, such as in terms of Law No. 7 of 1989 concerning Religious Courts (Act 89), or the stipulations of Presidential Instruction (Inpres) No. 1 of 1991 on the Compilation of Islamic Law (KHI).<sup>86</sup>

Act 89 indicated that the religious court's authority would be independent and equal to the civil court, even though it's still limited to marital matters, inheritance issues, *hibah* (grants), *waqâf* (benefactions), and *sadaqat* as stated in Article 49, paragraph 1, marking the success of the Islamic political infrastructure in the House of Representatives.

Ma'arif said the Religious Courts Law was a success of Muslim political history held down for a long time during the New Order government. Amidst the lack of Islamic political ideals, it presented constitutional products with Islamic characteristics.<sup>87</sup>

For a long time, the Catholics and other Christians, and a small number of nationalists, strongly opposed the text of the Religious Courts Law. They said it was discriminatory, influenced by the *Jakarta Charter*, and contrary to the archipelago's culture.

<sup>86</sup> Law No. 8 of 1985 consisting of 20 articles in nine chapters, ratified and promulgated on June 17, 1985, signed by President Soeharto.

<sup>87</sup> Ma'arif (1995: 130–1).



However, the government had a sure case. Munawir Sadzali,<sup>88</sup> the Minister of Religious Affairs, said that parliamentarians who had names that ended with the letter “o” (usually Javanese names like Cahyono, Maryono, Moeldiro), and who were especially from the ABRI parliamentary faction, had strongly supported passing the Religious Courts Act into law.<sup>89</sup>

The Religious Courts Law had been developing the relevant context to respond to the growth of the Islamic economic system in the field of financial institutions. The religious courts’ competence was to help resolve sharia business disputes, as stated in Article 49 of Law No. 3 of 2006 on Religious Courts:

Religious courts are approved to resolve, decide, and settle cases among Muslims in the fields of: a. marriage; b. inheritance; c. wills; d. grants; e. endowments; f. *zakât*; g. *infâq*; h. *sadaqat*; and i. the sharia economy.

## 2.2 Islamic Political Infrastructure after 1992

### Political Accommodation

McHugh referred to Lijphart’s (1968) use of the term “accommodation” to mean “...settlement of divisive issues and conflicts where only a minimal consensus exists.” Political accommodation refers to “... the process, the outcome of the spirit of mutual conciliation.”

McHugh used the term “political accommodation” to encompass the objectives, arrangements, and outcomes of the mutual conciliation of people’s competing political interests and perspectives.<sup>90</sup>

In the New Order period, the political accommodation of the political superstructure with the Islamic political infrastructure occurred from 1985 to 1990. Referring to McHugh’s definition, it is the settlement of divisive issues and conflicts with only minimal consensus,

<sup>88</sup> Munawir Sjadzali (1925–2004) was Minister of Religion in the Development Cabinet (1983–1993). He was also the Chair of the first Human Rights Commission in Indonesia.

<sup>89</sup> Ma’arif (1995: 130–1).

<sup>90</sup> McHugh (2016: 3); Lijphart (1968).

namely the antagonistic relationships connected to previous policies in Indonesia.

The political accommodation increased the government's political testing of Muslim political movements, especially in implementing Pancasila. In this political test, the state considered Muslims to have "passed the exam" by understanding that the policies that were implemented by the state were kept at a distance from Islamic sharia and they applied secular organization is not violating with Islam.<sup>91</sup>

Political accommodation by the New Order was marked by President Soeharto to authorize establishing the ICMI in the 1990s. He appointed Muslims from among the ICMI's administrators to be ministers in the Development Cabinet VI from 1993 to 1998, filling about 87 percent of the positions with them. Only five out of the 38 ministers were non-Muslims: Coordinating Minister for Politics and Security Soedomo, Coordinating Minister for Economy Radius Prawiro, Minister of Defense and Security L.B. Moerdani, Minister of Finance J.B. Soemarin, and Minister of Manpower Cosmas Batubara.

In Bahtiar Effendy's analysis, Deliar Noer and Gus Dur argued that the government moved close to Islamic figures and accommodated Muslim interests but this did not reflect true accommodation. The New Order remained non-inclusive and always tried to depoliticize Islam to maintain power, as could be viewed in the election of parliamentary candidates in 1992.<sup>92</sup>

However, Gus Dur respected the political maneuvers of Muslims and argued the New Order's social, economic and political configuration still sought to dominate over all community elements, rejected criticism, and opposed demonstrations by those who wanted a power change in the political superstructure.<sup>93</sup>

The political accommodations ran very smoothly for arranging the relationship between the political superstructure and the political infrastructure of Islam. Islamic elements were involved in government,

<sup>91</sup> Thaba (1996: 240–2).

<sup>92</sup> Effendy (1998: 348).

<sup>93</sup> Effendy (1998: 349–50).

and many non-Muslim figures were no longer involved in the government.

President Soeharto and the New Order's fear of the Islamic movement began to fade, and they came to understand that the Islamic community was an important part of national development.

Among the military elite, after the ousting of L.B. Moerdani, Islamization got great support from Soeharto, including for the establishment of Yayasan Amalbakti Muslim Pancasila (YAMP, Pancasila Muslim Charity Foundation), a foundation that established 38,476 mosques in all regions of Indonesia from 1988 to 1993. The government also sponsored 1,000 preachers (*dâ'i*) to work in many Christian-populated areas. As a result, this Islamization policy was perceived as a threat to Christian groups, which worried that Indonesia would be transformed into a religious state.<sup>94</sup>

### Substantive Political Islam until 1998

The definition of "substantive", as stated by the *Cambridge Dictionary* (online), is "having real importance or value". Therefore, substantive Islamic politics can be understood as involving Islamic political intellectuals who prioritize the political movement as having real importance or value for religion in society, rather than for religious formalism.

Anwar explained that substantive thought is the accentuation of substance or meaning of faith and that worship is more important than formalism and symbolism in religion. The universal meanings of the Quran and the Hadîth were reinterpreted based on the dynamics of the Muslim generations, since substantially developing countries were economically, politically, culturally, and socially far different from the Arabia of Prophet Muhammad's period.<sup>95</sup> In the Indonesian context, referring to Effendy, the model of substantive Islamic thought represented the mainstream of Islamic politics during the New Order.<sup>96</sup>

<sup>94</sup> Mudhoffir (2015); Bertrand (2004: 87).

<sup>95</sup> Anwar (1995: 155); Muchtarom (1988: 3).

<sup>96</sup> Bahtiar Effendy, "Politik Islam Pasca Orde Baru: Sintesa antara Substansialisme dan Simbolisme?," *SKH Republika*, November 15-16, 1999. Zahra (ed.) (1999: 39). Ahmad (2004:120).



Nurcholis Madjid revealed that the jargon of the Islamic struggle in the 1970s, like the substantive Islamic political “Islam Yes, Islamic Party No” response to the national political situation of the New Order, indicated a marginalization of the Islamic movement. The statement of “Islam Yes, Islamic Party No” was apparently intended to entertain the New Order government whose strategy was to depoliticize Muslim society.<sup>97</sup>

When the United Development Party (Partai Persatuan Pembangunan, PPP) still managed to get 29.29 percent of the votes in the 1977 general election, the New Order regime increasingly stepped up its efforts to marginalize Islam as a political opposition force. The government insisted that Pancasila become the basic ideology of the country’s social and political organizations.

In the 1980s, the substantive movement of the Islamic struggle continued to grow, especially since 1985 with the New Order government’s policy of positioning Pancasila as the sole set of principles for social organizations.

The policy of Pancasila being the sole set of principles affects Muslim development, religious activities, and community organization in an erratic situation. Dawan Rahardjo and his friends responded to it by holding discussions and studies in the Pasar Minggu area of Jakarta. The discussion was attended by many intellectuals and senior Muslim thinkers of the time, such as Harun Nasution, author of influential contemporary Islamic books like *Philosophy of Religion/Filsafat Agama* (1973), and *History of Islamic Thought and Movement/Sejarah Pergerakan dan Pemikiran Islam* (1975). The discussion initiated by Rahardjo was also represented a political attitude toward the dualism of the views of the Muslim struggle. First, some underground Islamists continued to fight for the establishment of an Islamic state, including the *tarbiyah* (development, personal growth, and education) groups in several universities such as Gadjah Mada University (UGM) in Yogyakarta and the University of Indonesia (UI) that adopted the Ikhwân-ul-Muslimîn (Muslim Brotherhood) movement of Hasan al-Bana and

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<sup>97</sup> Zarkasyi (2008).



Sayyed Qutb of Egypt. Rahardjo and his friends did not approve of this movement.

Second, Rahardjo and friends chose to build and develop civil society, to achieve justice, equality, and prosperity. So, they remained independent and did not become one of the Islamic groups that was quietly co-opted by the authoritarian regime and joined in support of the New Order government policy.

The movement of Rahardjo and friends in Pasar Minggu became motivated after it had stagnated for a long time. Theology is a science that builds on the study of religion, and the philosophy that critically examines issues was excluded from Islamic studies. As a result, intelligent and profound ideas about Islamic thought do not appear. This led to the birth of the Institute for the Study of Religion and Philosophy (LSAF), which will be discussed in the next section of this book. The LSAF was the embryo of the ICMI, which was very instrumental in encouraging the authorities to issue policies that supported the founding of the first Islamic bank in Indonesia in 1992.

## **2.3 Islamic Politics in the Reform Era**

### **Economic and Political Crisis in 1998**

Indonesia underwent a political and economic crisis in 1997. The political crisis was a situation of the Indonesian nation, which was hit by a national leadership crisis in 1998. It began when various issues were raised in the media ahead of the legislative and presidential elections in 1997.

First, Soeharto's leadership had lasted for 31 years, but he wouldn't resign. Negative situations worsened because of the Soeharto government's protection of corruption, collusion, and nepotism (CCN/*KKN*).<sup>98</sup>

Second, the symbols of a stable government decreased. The ABRI's dual functions had created militaristic governance and eliminated civil society. The positions of ministerial officials, governors, and heads of regional governments were almost exclusively filled by active military

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<sup>98</sup> Ekatjahjana, *et al.* (2002: 5).

officers. The People's Consultative Assembly ironically reappointed Soeharto as the president on March 10, 1998. Demonstrations and cries for reform, which were originally initiated by students, extended into major cities like Jakarta, Yogyakarta, Semarang, Surabaya, Surakarta, Bandung, and Makassar.

The public began to engage in demonstrations because the crisis had raised the prices of various necessities and much money was lost in the goods market because of a regional monetary crisis in Southeast Asia, which affected Indonesia.

The economic crisis started as the exchange rate of the rupiah against the US dollar continued to weaken. Bank Indonesia implemented various policies, such as a free-floating exchange rate, on August 14, 1997, but was unable to strengthen the IDR exchange rate. The rupiah started at IDR 2,432 per US\$1 in July 1997 and weakened to about IDR 17,000 per US\$1 by January 1998.<sup>99</sup>

The financial crisis affected Indonesia's economy profoundly. The economy shrank by over 13% of GDP in 1998. Government debt rose dramatically in 1997 and 1998 and reached almost 100% of GDP in 1999, reflecting the cost of providing liquidity and eventually the take-over of the banking system.<sup>100</sup>

In the presence of members of the MUI in February 1998, President Soeharto stated that the government would implement a Currency Board System (CBS) to shut down currency speculators.<sup>101</sup>

Two days later, IMF Managing Director Michele Camdessus<sup>102</sup> sent a warning letter to Indonesia's government about the planned cancellation of IMF assistance if Indonesia did not implement the IMF's Letter of Intent.<sup>103</sup> The financial crisis triggered political upheaval in Indonesia.

<sup>99</sup> Habibie (2006: 2); Syafa'at (2011: 229).

<sup>100</sup> Blöndal, *et al.* (2009: 2).

<sup>101</sup> Exchange rate policy instruments can be in the form of several alternatives, including a fully determined market system, managed floats, fixed exchange rate policy, and foreign exchange control. Didik J. Rachbini, "Krisis Ekonomi dalam Sistem Moneter Global," on Tim Kahmi Jaya (1998: 247).

<sup>102</sup> Michel Camdessus is Managing Director the International Monetary Fund (IMF) 1987–2000.

<sup>103</sup> Subagyo (2003: 55–6).

The uncertain politics and economic crises, especially the rising prices of basic goods, resulted in the demonstrations becoming brutal and anarchic. The demonstrations led to riots in various regions on May 13 and 14, 1998. This was a reaction to a demonstration on May 12, 1998, near Tri Sakti University in Jakarta, where four students died after being shot by a mysterious sniper. They were Mulia Lesmana (born 1978), Heri Hertanto (born 1977), Hafidin Royan (born 1976), and Hendrawan Sie (born 1975). Finally, on May 18, 1998, students and other members of the public occupied the House of Representatives and the People's Consultative Assembly Building.

During riots on May 13 and 14, 1998, 501 bank offices and 220 automatic teller machines (ATMs) were looted, as described by B.J. Habibie, according to Sjahril Sabirin.<sup>104</sup> All government offices and shops were closed, and Bank Indonesia suspended clearing operations until things returned to normal on May 18, 1998.<sup>105</sup>

On May 21, 1998, Soeharto officially resigned as president and was succeeded by Vice President B.J. Habibie.<sup>106</sup> As stated in Article 8 of the 1945 Constitution:

If the president dies, stops, or cannot carry out his obligations within his term of office, he would be replaced by the vice president.

The Indonesian crisis in 1997 and 1998 was a failure of the New Order's capitalist market-driven development projects, which created poverty and uneven economic development.<sup>107</sup> The reforms that were originally about national leadership developed into a comprehensive reformation of various political and economic aspects. It was caused by centralization during the New Order era under Soeharto.

<sup>104</sup> Syahril Sabirin was the Governor of Bank Indonesia from 1998–2003. He was appointed Governor of Bank Indonesia replacing Sudrajat Djiwandono when Indonesia experienced a monetary crisis in 1998.

<sup>105</sup> Habibie (2006: 13).

<sup>106</sup> Syafa'at (2011: 230–1). Kumorotomo (2008: 229).

<sup>107</sup> Pontoh (ed.) (2005: xi).



### **Political Reform**

The idea of political reform was initially only about the succession of national leadership. However, the regional economic crisis that began in 1997 continued to worsen into 1998. The national leadership that was transferred from Soeharto to B.J. (Bacharuddin Jusuf) Habibie marked an anticlimax of the New Order's glory.

Habibie replaced Soeharto in 1998. At first, many people were doubtful of him, considering his closeness to Soeharto. He had been a key person in Soeharto's political patronage system, was involved in the New Order government, and was an organizer for Golkar, a party of the status quo.

Habibie overcame the doubt, becoming the third president of Indonesia and dispelling the New Order label, replacing it with his government's Development Reform Cabinet (Kabinet Reformasi Pembangunan). He said the main reform policies decided in the Monday, May 25, 1998 Cabinet Session were:

First, the main task of the Development Reform Cabinet is to overcome the economic crisis with two objectives: the availability of foodstuffs and basic needs, and national economic stability. Second, constitutional reform for democratic elections. Third, economic reform, acceleration of the completion of regulations that eliminate monopoly and oligopoly practices and improve the economy to make it more equitable for public welfare. Fourth, review the Anti-Subversion Law, and ratify the UN's [Universal Declaration of] Human Rights.<sup>108</sup>

Habibie had no option other than to launch reform programs. During his government, many laws approved by the People's Consultative Assembly (MPR) were characterized by their fundamental differences with the New Order, such as:

1. Introduction of freedom of the press,
2. Allowing the establishment of new political parties and unions,
3. Release of political prisoners,
4. Decentralization of power to the regions, and

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<sup>108</sup> Habibie (2006: 118–20).



5. Limiting the presidency to two terms of five years by Constitutional amendment.

Yusril stated that the amendments to the 1945 Constitution, which was often interpreted in the powerholder's interest during the Old and New Orders to maintain the status quo,<sup>109</sup> were to prevent anyone having unrestricted power, especially the item regarding the maximum length of a president's term of office.

The General Session from October 14 to 21, 1999, resulted in amendments to crucial articles of the 1945 Constitution of the Republic of Indonesia,<sup>110</sup> including the articles on the president and vice president's terms of office as stated in Article 7 of the 1945 Constitution:

The president and vice president hold their positions for five years and can be re-elected afterward.

The above article was amended to become:

The president and vice president hold their positions for five years and can be re-elected afterward for the same position, only for one term.

The original article was interpreted by the Old Order and New Order to perpetuate power over the president's position by allowing continual re-election. The first two presidents were appointed repeatedly: Soekarno for a total of 22 years and Soeharto for 30.<sup>111</sup> However, the reforms not only discussed the president's term of office, but also many other aspects that had been manipulated by people close to the power holders during the New Order.

Frances explained that the broader meaning of reformation contained three aspects: general reformation, political development, and economic

<sup>109</sup> Yusril Ihza Mahendra, "Tiada Reformasi Tanpa Amandemen Konstitusi," in Saydam (ed.) (1999: 349).

<sup>110</sup> There were nine changes to the 1945 Constitution, namely articles 5, 7, 9, 13, 14, 15, 17, 20 and 21.

<sup>111</sup> Soeharto (1920–2008) served as national leader, starting as a presidential official, from 1967–1973. Then, he was accompanied by several vice presidents, Hamengkubawana IX (1973–1976), Adam Malik (1978–1983), Oemar Wirahadikusumah (1983–1988), Try Soetrisno (1988–1993), B.J. Habibie (March 1998 to May 21, 1998).

development. General reformation included changes in democratic values and orientation toward society's interests. Reformation in political development included government empowerment of regional parliaments to foster regional autonomy. Reformation in economic development included the handling of domestic and foreign debts.<sup>112</sup>

In the People's Consultative Assembly Decree No. X/MPR/1998 on the Principles of Development Reform in the Context of Saving and Normalizing the National Life as the State Policy, one of the policies in the political sector was the enforcement of popular sovereignty. Its agenda was to respect the diversity of principles or characteristics, aspirations, and programs of social and political organizations that do not conflict with Pancasila, as stated in Chapter IV, Political Field, point 2, item b:

The implementation of reform in the political field is aimed at upholding popular sovereignty as a way of solving national crises in all fields, with priorities scaled.

The article mentions the duties to:

- a. Uphold popular sovereignty by empowering the supervisory role of the state, political, and community institutions.
- b. Respect the diversity of principles and characteristics, aspirations, and programs of social and political organizations that do not conflict with Pancasila.

The article, especially point b, is the policy most different policy from the New Order requiring social organizations to accept Pancasila as their sole set of guiding principles. The policy's direction was to eliminate that. Political parties that were previously obligated to solely use the set of principles of Pancasila were allowed to have diverse principles, characteristics, or aspirations, as long as they did not conflict with Pancasila.<sup>113</sup>

The elimination of Pancasila's function as the sole acceptable set of principles grew in various fields, including in Islamic economics and banking regulations. Habibie supported the development of Islamic banks in Indonesia by enacting Law No. 10 of 1998 concerning

<sup>112</sup> Frinces (2009: 195–96).

<sup>113</sup> Syafa'at (2011: 232).

Banking, passing it on November 10, 1998, about six months after he officially became president.

### The Success of Reform

Post-Habibie, the reforms were continued by presidents Abdurrahman Wachid,<sup>114</sup> Megawati Soekarnoputri,<sup>115</sup> and Soesilo Bambang Yudhoyono.<sup>116</sup> The three presidents implemented the same policy about government controls to reduce unrestricted power by applying distribution of power, supervisory rights, and the eradication of corruption, collusion, and nepotism.

#### *Distribution of Power*

Distribution of power is a constitutional system using a “separation of powers”, referred to as a popular idea of Montesquieu called *trias politica* (horizontal separation of powers).

O. Hood Phillips argues separation of powers as “the distribution of the various powers of government among different organs”. In other words, the word separation of power is identified with the distribution of power depending on the context of the understanding adopted.<sup>117</sup> It is the philosophy that there has to be a strict separation between three independent powers in every nation: for legislative, administrative, and judicial functions.

<sup>114</sup> Abdurrahman Wachid or Gus Dur (1940–2009) was president from October 20, 1999, to July 23, 2001, assisted by vice president Megawati Soekarnoputri. He became president as a member of the National Awakening Party (PKB), supported by Islamic parties, in the first election in the Reform Era in 1999. Gus Dur dramatically won the presidential election by defeating presidential candidate Megawati, with the Indonesian Democratic Party of Struggle (PDI-P) as the party winning the 1999 legislative elections.

<sup>115</sup> Megawati Soekarnoputri (b. 1947) was president from July 23, 2001, to October 20, 2004. She became president after elected president Abdurrahman was impeached by the People’s Consultative Assembly (MPR) led by Amien Rais. During her presidency, Megawati was accompanied by Vice President Hamzah Haz.

<sup>116</sup> Soesilo Bambang Yudhoyono or SBY (b. 1949) was president from 2004–2009. SBY and Vice President M. Jusuf Kalla (JK) became the first president and vice president pairs to be elected directly by the people. The SBY-JK pair, carried by the Democratic Party, defeated the Megawati-Hasyim Muzadi pair carried by the Indonesian Democratic Party of Struggle (PDI-P). SBY, who was paired with Boediono, was then re-elected as president in the October 20, 2009 for the 2009–2014 period.

<sup>117</sup> As cited in Nasution (2020).



In other opinion, distribution of power does not mean separation of power because there are still mutual influences between bodies that control each pillar of the political supra-structure, and each works within certain limits.<sup>118</sup> Deliar Noer said to properly resolve human life and the problems of the state, the three pillars of power should act according to the rule of law.<sup>119</sup>

In the Reform Era, the distribution of power was realized by an amendment to the 1945 Constitution. In the New Order, President Soeharto controlled national power with the chaotic state administration. There was no separation between the executive branch and the legislature; many ministers were members of the legislature, while the president had control over legislative power without any opponents. The power distribution during the New Order was known as “executive-heavy” since power was dominated by the executive, in this case President Soeharto.

During Reformasi, the power policy changed from “executive heavy” to “legislative heavy”, meaning power tended to be dominated by the legislature, especially after the amendment of the 1945 Constitution. The amendment meant a change, modification, shift, or exchange of circumstances. A change in the constitution may mean a constitutional amendment or constitutional reform, but not in the sense of change.<sup>120</sup>

After the 1945 Constitution, the legislative-heavy situation had a strong foundation: First, the DPR had the authority to propose to the People’s Consultative Assembly (MPR) the dismissal of the president and vice president by first submitting a request to the Constitutional Court and so on (Article 7b); Second, the DPR had the power to enact laws (Article 20, paragraph 3); Third, if President does not ratify a draft act passed by the DPR, the law will nevertheless remain in effect and must be promulgated (Article 20, paragraph 5); and Fourth, every member of the People’s House of Representatives had the right to submit a proposal for a draft act (Article 21, paragraph 1).<sup>121</sup>

<sup>118</sup> Suseno (1991: 225–26); Syam (2010: 146).

<sup>119</sup> Noer (1999: 136).

<sup>120</sup> Maksudi (2012: 98–101).

<sup>121</sup> Maksudi (2012: 173).



During the Reform Era amendments were implemented four times, in 1999, 2000, 2001, and 2002. These amendments were meant to create a balanced policy arrangement between the executive and the legislature.

### *Supervisory Rights*

The legislature has the supervisory rights to inquiry, interpellation, and questionnaires, as stated in Article 20a, paragraph 2 of the 1945 Constitution:

In executing its functions, in addition to the rights stipulated in other articles of this constitution, the legislature has the right to interpellate, inquiry, and to ask for an opinion.

Supervisory rights became apparent after the enactment of Law No. 22 of 2003 on the Structure and Position of the People's Consultative Assembly, People's Representative Council, Regional Representative Council, and Regional People's Representative Council.<sup>122</sup>

The Third Section concerning positions and functions stated in Article 25:

The legislature has the functions of:

- a. Legislation;
- b. Budget; and
- c. Supervision.

The legislature also has the rights to interpellation and inquiry. Interpellation means requesting information from the government regarding policies, as stated in Law No. 22 of 2003 Article 27:

The legislature has the functions of:

- a. Interpellation;
- b. Questioning; and
- c. Expressing opinions.

According to Article 27, letter a, the right of interpellation is the right of the People's Legislative Assembly to request information from

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<sup>122</sup> Law No. 22 of 2003 consisting of 114 articles in 12 chapters, was ratified and promulgated on July 31, 2003, signed by President Megawati Soekarnoputri and Minister of State Secretary Bambang Kesowo.

the government regarding important and strategic government policies that have a broad influence on society and the state's life.

According to letter b, the right of questioning is the right of the DPR to investigate the government's important and strategic policies that have a broad influence on society and the state's life, but which are allegedly contradictory to legislation.

According to letter c, the right to express an opinion is the right of the House of Representatives to express an opinion on government policies. It concerns extraordinary events that occur in the country or international situations that need recommendations for resolution. It also concerns inquiries into any allegations that the president or vice president has violated the law by betraying the state, committed corruption, bribery, or other serious crimes, or is no longer qualified for the position.

Maksudi said the right of the DPR to inquiry means the right of members of the legislative body to make inquiries to the government about some matter, orally or in writing. The right to questioning means the right of the legislature to conduct an investigation, the results of which would be expected to have the government's attention.<sup>123</sup>

The supervisory right, if interpreted politically, confers more power to the legislature, making government "legislative-heavy". The supervisory right needed to avoid the executive-heavy structure that allowed the New Order's power to run wild without legislative supervision.

The legislature exercised its supervisory rights when the MPR/DPR impeached President Gus Dur. Gus Dur's impeachment from his presidential position was initially related to a corruption case known as Buloggate and a graft case from Brunei Darussalam known as Bruneigate.

However, in the subsequent process, Gus Dur's disputes with the legislature continued when he dismissed Bimantoro from his position as the National Police Chief on July 20, 2001, and replaced him with

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<sup>123</sup> Maksudi (2012: 178).

Chairuddin Ismail without the DPR's approval. Gus Dur was criticized based on MPR Decree No. VII, 2000 on the role of the TNI and the Indonesian National Police as stated in Article 7, paragraph 2:

The National Police Chief is under the president ... The National Police of the Republic of Indonesia is headed by the Head of the National Police of the Republic of Indonesia who is appointed and dismissed by the President with the approval of the House of Representatives.

The results stipulated that the National Police Chief's dismissal should have been brought to the DPR for approval. According to Gus Dur, the need for the dismissal was urgent. The dispute between President Gus Dur and the legislature ended with the removal of Gus Dur as president on July 23, 2001. According to other opinions, during the Reform Era the legislature tended to have more power than the executive or the government.

#### *Corruption-Collusion-Nepotism Eradication*

The practice of corruption, collusion, and nepotism (CCN) was a disease that destroyed the New Order and Soeharto's power. The reforms promoted the idea that control of all state institutions should be free from CCN. However, it remains a very striking phenomenon in the Reform Era. The move to regional autonomy was originally aimed at distributing state funding throughout the region equally, but many budgets were manipulated by individuals in the regional administrations, from the executive and legislative circles. Consequently, many officials were arrested by the Corruption Eradication Commission (KPK).<sup>124</sup>

Data released by the chief of the Police Public Information Bureau, Brigadier Jenderal Boy Rafli Amar at the Indonesian National Police Headquarters to the mass media reported that 766 cases of corruption were handled in 2011 and a further 885 cases by September 2012.

<sup>124</sup> The Corruption Eradication Commission (KPK) was formed in 2003 to address, overcome, and eradicate corruption in Indonesia. This commission was established based on Law No. 30 of 2002 concerning the Corruption Eradication Commission.



From these cases, the state losses were estimated to be IDR 2.7 trillion in 2011, and IDR 1.67 trillion in 2012.<sup>125</sup>

## The Dynamics of Islamic Political Infrastructure

### a. Developing Islamic politics

The development of Islamic politics began with the idea of Islamic political formalization. In simple terms, it is an Islamic struggle manifested in practical politics or with Islamic symbols that are more vulgar and formal.

Anwar explains that the formalist typology in Muslim scholars' reasoning shows a thinking mode that emphasizes strict strengthening of and adherence to Islamic teaching formats.<sup>126</sup>

Some opinions disagreed. Effendy said excessive Islamic symbolization has weaknesses and will have an adverse effect on the lives of Muslims.<sup>127</sup> Hidayat and Masudi also disagreed with Islam being subordinate to a political party that prioritizes the interests of a certain group. Islam will become excessively symbolic and may lead to Muslims who do not join a political party being labeled less Islamic.<sup>128</sup>

In the political context, formalist thinking shows concern for an orientation that tends to sustain imagined forms of Islamic political society, such as an Islamic party, Islamic cultural, social, and political idioms, symbolic expressions, and experiments with a system of Islamic state administration. The formalists strongly emphasized the ideology or politics that led to formal religious symbolism.<sup>129</sup>

This strong enthusiasm created resistance to domination or ideological-political and cultural influences thought to weaken Islam's potential. Consequently, they reinforced their ideology and culture to counterbalance Western ones.<sup>130</sup>

<sup>125</sup> *Kompas* (online), "Polri Beberkan Kasus Korupsi 2011-2012," Monday, October 15, 2012 (<http://nasional.kompas.com>).

<sup>126</sup> Anwar (1995: 144).

<sup>127</sup> As cited in Ahmad (2004: 120).

<sup>128</sup> Anwar (1995: 83).

<sup>129</sup> Anwar (1995: 144-5); M. Sirajuddin Syamsuddin, "Religion and Politics in Indonesia's New Order," *Dissertation* (Ph.D.), University of California, Los Angeles, 1991, 199-204.

<sup>130</sup> Anwar (1995: 145).



In articulating their social-political ideas, the formalists strongly maintained the authenticity of revelation and were highly effective toward spiritualism, with a very literal and textual approach. Although they had Western educations, many of them continued to use traditionalist and fundamentalist arguments.<sup>131</sup>

Nurcholis Madjid (Cak Nur), the initiator of the slogan “Islam Yes, Islamic Party No!”, had changed his mind. He argued that politics is the most appropriate form of expression, especially after the New Order.<sup>132</sup>

Cak Nur’s opinion was a reflection of the thinking of the Islamic political infrastructure over realizing Islamic ideals in national development through political activities that provide direction and guidance to Muslims.

#### **b. Islamic Struggle Based on Political Parties**

As stated in the *Encyclopedia Britannica* (online), a political party is a group of people organized to acquire and exercise political power. Many Islamic political parties in the reform period were established by the Islamic political infrastructure that criticized the New Order’s political policies in the pre-reform period, such as Gus Dur of the Partai Kebangkitan Bangsa (PKB), Amin Rais of the Partai Amanah Nasional (PAN), and Yusril Ihza Mahendra of the Partai Bulan Bintang (PBB).

The political parties of the Islam-based Islamic political infrastructure grew during the period of Liberal Democracy in the Old Order. Two major Islam-based parties competed with each other, namely the NU Party and Masyumi. The NU Party used the motto “National-Islamic Cooperation” to refer to the ideal of *Izz-ul-Islâm wa-l-Muslimîn* (the glory of Islam and its adherents). Meanwhile, Masyumi had the slogan: “Fair and prosperous state with Allah’s full blessing.” Many interpreted Masyumi’s slogan as calling for an Islamic state.<sup>133</sup>

<sup>131</sup> Anwar (1995: 145).

<sup>132</sup> Ahmad (2004: 127); Nurcholish Madjid, “Partai Keadilan Nanti Muncul Sebagai Partai Penting,” in Salim (ed.) (1999: 193–5).

<sup>133</sup> Fealy (2003: 182).

At the 1957 Constitutional Assembly, Islamic figures from various groups criticized Pancasila's role as the state's basic philosophy. Muhammad Natsir, a spokesperson for Islamic parties, firmly stated that Pancasila was secular and not suitable for Islamic ideology. He and his friends idealized theistic democracy, which would be the realization of an Islam-based state or an Islamic democracy.

The above idea was opposed by both the nationalist and the communist parties, such as the PKI, PNI, PSI, PARKINDO, and other groups that disagreed with Islam being the state's basic principle.<sup>134</sup>

Ma'arif said that several Islamic figures had long called for the state or political power to accommodate and implement Islamic teachings in collective life. The argument was that according to the power relation theory explained by Ibn Taymiyyah in *Siyâsat-u-Shar'iyyat*, political organization is the most important religious necessity for human or collective life, and without political support, religion will not stand firm.<sup>135</sup>

In the Reform Era, the development of Islamic political parties as an embodiment of the Islamic political system proceeded quite diversely. In the reality of national politics, however, of the many Islamic parties, only a few were competitive in every legislative election. This can be described in the development of Islamic political parties since the 1999 elections.

### *1999 Election*

The first election in the reform period was held on June 1, 1999, under Law No. 3 of 1999 on Elections.<sup>136</sup> The Indonesian people waited for 44 years after the 1955 elections to participate in free and fair elections. In the election of 1999 people voted for a political party, not for an individual. Forty-eight parties participated in the elections of 1999.

<sup>134</sup> Anwar (1995: 146).

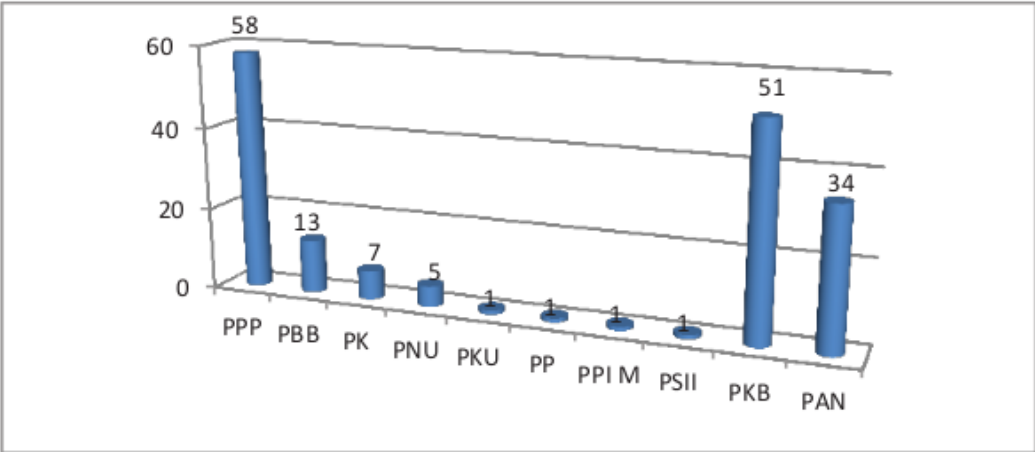
<sup>135</sup> Ma'arif (1995: 162); Ibn Taimiyyah (1966: 138).

<sup>136</sup> Law No. 3 of 1999 concerning General Elections, consisting of 86 articles in 16 chapters, was ratified and promulgated on February 1, 1999, signed by President B.J. Habibie and State Secretary Akbar Tandjung.

In the 1999 elections, 13 parties used Islamic principles (26.75 percent), namely the PK, PSII, UN, PNU, PUI, PKU, US KAMI Party, PP, New Masyumi Party, Masyumi Islamic Political Party, PAY, PSII 1905 and PP. Eight national parties (16 percent) used Islamic symbols, namely the PKB, PAN, PCD, SUNI Party, PUMI, PID, PIB, and PKM.<sup>137</sup>

Of the above 29 Islam-based political parties (42.75 percent) in the 1999 elections, only nine Islamic parties acquired legislative seats.

Chart 3.1  
Islamic Parties' Acquisition of Legislative Seats in the 1999 Elections



<sup>137</sup> The list of 48 political parties participating in the 1999 elections: 1. Partai Indonesia Baru, 2. Partai Kristen Nasional Indonesia, 3. Partai Nasional Indonesia - Supeni, 4. Partai Aliansi Demokrat Indonesia, 5. Partai Kebangkitan Muslim Indonesia, 6. Partai Ummat Islam, 7. Partai Kebangkitan Ummat, 8. Partai Masyumi Baru, 9. Partai Persatuan Pembangunan, 10. Partai Syarikat Islam Indonesia, 11. Partai Demokrasi Indonesia Perjuangan, 12. Partai Abul Yatama, 13. Partai Kebangsaan Merdeka, 14. Partai Demokrasi Kasih Bangsa, 15. Partai Amanat Nasional, 16. Partai Rakyat Demokratik, 17. Partai Syarikat Islam Indonesia 1905, 18. Partai Katolik Demokrat, 19. Partai Pilihan Rakyat, 20. Partai Rakyat Indonesia, 21. Partai Politik Islam Indonesia Masyumi, 22. Partai Bulan Bintang, 23. Partai Solidaritas Pekerja, 24. Partai Keadilan, 25. Partai Nahdlatul Ummat, 26. Partai Nasional Indonesia - Front Marhaenis, 27. Partai Ikatan Pendukung Kemerdekaan Indonesia, 28. Partai Republik, 29. Partai Islam Demokrat, 30. Partai Nasional Indonesia - Massa Marhaen, 31. Partai Musyawarah Rakyat Banyak, 32. Partai Demokrasi Indonesia, 33. Partai Golongan Karya, 34. Partai Persatuan, 35. Partai Kebangkitan Bangsa, 36. Partai Uni Demokrasi Indonesia, 37. Partai Buruh Nasional, 38. Partai Musyawarah Kekeluargaan Gotong Royong, 39. Partai Daulat Rakyat, 40. Partai Cinta Damai, 41. Partai Keadilan dan Persatuan, 42. Partai Solidaritas Pekerja Seluruh Indonesia, 43. Partai Nasional Bangsa Indonesia, 44. Partai Bhinneka Tunggal Ika Indonesia, 45. Partai Solidaritas Uni Nasional Indonesia, 46. Partai Nasional Demokrat, 47. Partai Ummat Muslimin Indonesia, 48. Partai Pekerja Indonesia.



The data show that the reforms provided the power of the Islamic political infrastructure only to mass organizations or to political figures, which then led to Islamic parties and those using Islamic symbols to acquire 170 seats (37.22 percent) of the 500 seats in the People's House of Representatives.<sup>138</sup>

Reforms stimulated Muslim enthusiasm for practical politics and the Islamization of political parties, although in elections the Islamic political parties' vote-acquisition rate was still below that of the nationalist parties. In comparison, the PDI-P, a nationalist party, acquired 35,689,073 votes (33.74 percent) and 153 seats as the winning party, followed by Golkar with 23,741,758 votes (22.44 percent) and 120 seats.

From the perspective of the votes acquired by Islamic parties, the PKB was the highest, in third position nationally with 13,336,982 votes (12.61 percent), exceeding the PPP's 11,329,905 votes (10.71 percent).

However, since the PKB's vote acquisition was very predominantly in East Java, the PPP acquired 58 seats in the legislature, more than the PKB's 51 seats. PAN took the fifth position with 7,528,956 votes (7.12 percent).<sup>139</sup>

The analysis of the 1999 election is that Islamic parties (the PKB, PPP and PAN) acquired more than 10 percent of the votes and became the five largest parties after the established parties (PDI-P and Golkar), which showed that the changes in Islamic politics from substantivity to formalism had a positive response from Muslim people.

The harmonization of the Islamic parties continued until the formation of the Central Axis (*Poros Tengah*) that made Gus Dur the fourth president of Indonesia and the first president elected by the People's Consultative Assembly (MPR) in the Reform Era.

<sup>138</sup> Ahmad (2004: 134–7).

<sup>139</sup> *Komisi Pemilihan Umum* (online), "Pemilu 1999" ([http://www.kpu.go.id/index.php?option=com\\_content&task=view&id=42](http://www.kpu.go.id/index.php?option=com_content&task=view&id=42)).

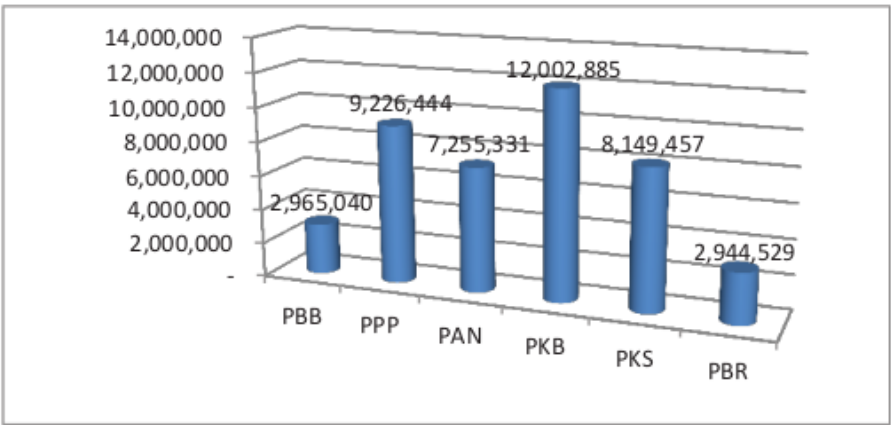


2004 Election

The 2004 parliamentary elections were held on April 5, 2004, and 24 political parties participated.<sup>140</sup> Only 16 political parties acquired seats in the People’s House of Representatives, mostly nationalist parties (PNMI, PPDK, PD, PKPI, PPDI, PKPB, PDIP, PDS, Golkar, and PP) and six Islamic parties, namely the PBB, PPP, PKB, PAN, PKS, and PBR.

The votes Islamic parties acquired may be viewed in the following chart:

Chart 3.2  
Islamic Parties’ Vote Acquisition in the 2004 Elections



Of the Islamic political parties, two parties shockingly acquired a considerable number of votes, including the Prosperous Justice Party (Partai Keadilan Sejahtera/PKS), which won the equivalent of 45 seats in parliament with 8,149,457 votes (7.2 percent), although it only acquired seven seats in parliament in the 1999 election. The PKS achieved the largest increase, boosting its votes by 450 per cent from

<sup>140</sup> List of election parties based on serial number: 1. Partai Nasional Indonesia Marhaenisme, 2. Partai Buruh Sosial Demokrat, 3. Partai Bulan Bintang, 4. Partai Merdeka, 5. Partai Persatuan Pembangunan, 6. Partai Persatuan Demokrasi Kebangsaan, 7. Partai Perhimpunan Indonesia Baru, 8. Partai Nasional Banteng Kemerdekaan, 9. Partai Demokrat, 10. Partai Keadilan dan Persatuan Indonesia, 11. Partai Penegak Demokrasi Indonesia, 12. Partai Persatuan Nahdlatul Ummah Indonesia, 13. Partai Amanat Nasional, 14. Partai Karya Peduli Bangsa, 15. Partai Kebangkitan Bangsa, 16. Partai Keadilan Sejahtera, 17. Partai Bintang Reformasi, 18. Partai Demokrasi Indonesia Perjuangan, 19. Partai Damai Sejahtera, 20. Partai Golongan Karya, 21. Partai Patriot Pancasila, 22. Partai Hamatkat Indonesia, 23. Partai Persatuan Daerah, 24. Partai Pelopor.

1999 to 2004, and also became the most successful party in the megacity of Jakarta.<sup>141</sup> The other party was the Reform Star Party (Partai Bulan Bintang/PBR) led by Zainuddin MZ, which acquired 2,944,529 votes (2.6 percent) or the equivalent of 14 seats in parliament.

However, the leading parties were still dominated by the party with a nationalist ideology. Golkar, which was a legacy of the New Order, took first position with 24,461,104 votes (21.62 percent), or the equivalent of 128 seats in parliament, followed by the PDI-P with 20,710,006 votes (18.31 percent), equivalent to 109 seats in parliament. A new nationalist party also exceeded the Islamic parties (only under the PPP), namely the Democratic Party, which acquired 8,437,868 votes (7.46 percent), equivalent to 55 seats in parliament.

The only Islamic party that did not acquire any seats in the DPR was the Indonesian Nahdlatul Ummah Party, which won 890,980 votes (0.79 percent). The other parties were nationalist parties: the Social Democratic Workers' Party with 634,515 votes (0.56 percent), the Freedom Party with 839,705 votes (0.74 percent), the New Indonesia Association Party with 669,835 votes (0.59 percent), the Bull National Independence Party with 1,228,497 votes (1.09 percent), the Pancasila Patriot Party with 1,178,738 votes (0.6 percent), the Indonesia Sarikat Party with 656,473 votes (0.6 percent), and the Regional Unity Party with 656,473 (0.58 percent).

### *2009 Election*

The 2009 election for the House of Representatives was held on April 9, 2009, and 38 national parties and six local political parties participated in Aceh. Out of the 38 national political parties in the 2009 elections, only nine achieved the 2.5 percent vote threshold, and the other 29 parties were eliminated.

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<sup>141</sup> Hidayat (2010) as cited in Woischnik and Müller (2013: 66).

Table 3.2  
List of Political Parties vis-à-vis the 2.5 Percent Vote Threshold

No.	Political Party	Votes	Percent (%)	Legislative Seats	Percent (%)
1	Democratic Party	21,703,137	20.85	125	25.35
2	Golkar	15,037,757	14.45	91	18.46
3	PDIP	14,600,091	14.03	87	17.65
4	PKS	8,206,955	7.88	51	10.34
5	PAN	6,254,580	6.01	42	8.52
6	PPP	5,533,214	5.32	35	7.10
7	PKB	5,146,122	4.94	26	5.27
8	Gerindra	4,646,406	4.46	22	4.46
9	Hanura	3,922,870	3.77	14	2.84

Some political parties that acquired seats in the 2004 elections did not achieve the 2.5 percent vote threshold in the 2009 elections, such as the Crescent Star Party (Partai Bulan Bintang, PBB), the Reform Star Party (Partai Bintang Reformasi, PBR), the Prosperous Peace Party (Partai Damai Sejahtera, PDS), the Indonesian Justice and Unity Party (Partai Keadilan dan Persatuan Indonesia), the Democratic Nationhood Unity Party (Partai Persatuan Demokrasi Kebangsaan), the Pioneers' Party (Partai Pelopor), and the Indonesian Democratic Enforcement Party (Partai Penegak Demokrasi Indonesia).<sup>142</sup>

Of the above parties, of course, it is surprising that the Bulan Bintang Party (PBB) and the Bintang Reformasi Party (PBR), seemingly well-established Islamic parties in the 2004 elections, were unable to compete and meet the 2.5 percent vote thresholds in the 2009 elections. A Christian party, the Prosperous Peace Party (Partai Damai Sejahtera, DPS), was also unable to meet the 2.5 percent vote threshold.

The results of the legislative elections in the Reform Era from 1999 to 2009 saw the Islamic political parties grow rapidly. However, only four parties have strong mass support and always acquire places

<sup>142</sup> *Pemiluindonesia* (online) (<http://www.pemiluindonesia.com/pemilu-2009/kpu-tetapkan-hasil-pemilu-legislatif-2009.html>).



among the top-ten number of legislative seats, namely the Prosperous Justice Party (PKS), the National Mandate Party (PAN), the United Development Party (PPP), and the National Awakening Party (PKB).

The phenomenon of the rise of Islamic political parties with an increased number of parliamentary seats from 1999 to 2004 suggests that the claim of neo-modernist liberal Muslim figure Nurcholish Madjid in early 70s “Islam yes Islamic party no” is no longer tenable.<sup>143</sup>

PAN and the PKB, although not led by central figures like Amien Rais in PAN and Gus Dur in the PKB, remain a solid part of the government and the ruling coalition.

From the three elections, the Islamic political parties stand without suspicion between power holders and Islam, marking the end of the “cold war” between the government and Islam during Soekarno’s and Soeharto’s governments.

Bachtiar Effendy, in his dissertation, writes that the tension between Islam and the state in Indonesia was a phenomenon of the time after 20<sup>th</sup> Century colonialism, like those in Turkey, Egypt, Sudan, Morocco, etc.

In Indonesia, Islamic political parties are considered potential competitors for power, which may overthrow the nationalists’ power. However, Islamic political parties are defeated constitutionally, physically and bureaucratically in every election, or symbolically.<sup>144</sup>

On the other hand, Islamic activists are suspicious of the state, while the state seeks to eliminate Islamic political maneuvers. The state allows Islamic rituals to grow, but Islamic politics are not allowed to develop.<sup>145</sup>

The 1999 elections resulted in a structure of legislative and executive leadership, according to Thohari and supported by Bustaman-Ahmad, which was a manifestation of the *santri* state thesis. The *santri*, in general, is a term for someone who follows Islamic education and stays in a *pesantren* (Islamic boarding school) until graduation. In this context, a *santri* is a person who is an expert in the religious sciences.

<sup>143</sup> Zarkasyi (2008: 357).

<sup>144</sup> Effendy (1998: 1–2).

<sup>145</sup> Effendy (1998: 1–2).



Thohari explains that the positions of Abdurrahman Wachid as President, Amien Rais as Chairman of the People's Consultative Assembly, and Akbar Tanjung as Chairman of the People's House of Representatives were representative of the reasons for justifying the *santri* state thesis. The figures represented Indonesia's biggest Islamic communities and political parties, as Abdurrahman Wachid belonged to Nahdhatul Ulama (NU) and the National Awakening Party (PKB), Amien Rais to Muhammadiyah and the National Mandate Party (PAN), and Akbar Tanjung to the Islamic Students' Alumni Association (KAHMI) and Golkar.<sup>146</sup>

However, the Islamic parties' harmonious relations lasted for less than one year and nine months (October 20, 1999, to July 23, 2001). The Central Axis (Poros Tengah), or the axis of Islamic parties, did not run smoothly. Even Mathori Abdul Jalil, as General Chairman of the National Awakening Party (PKB), who appointed Gus Dur as president, was involved in throwing Gus Dur out of the presidential office.

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<sup>146</sup> Hajriyanto Y. Thohari, "Negara Santri: Menengok Tesis Cak Nur," in Mu'nim (ed.). (2000: 26); Ahmad (2004: 143).



## Discussion of Political Economy of Sharia Banking in Indonesia 1992–2011

**A** discussion of the political economy of Islamic banking in Indonesia from 1992 to 2011 is contained in an analysis of policies in the field of Islamic banking, an analysis of the process and movement of the Islamic political infrastructure for influencing the political superstructure to accommodate Muslim struggles.

The political Islam of the main political infrastructure fluctuated during the New Order, which had hegemony, allowing it to apply pressure and intervene in all fields. Therefore, Islamic banking could only start in 1992.

Many political superstructure policies and regulations in the banking sector pre-1992 maintained the status quo, especially Law No. 14 of 1967 on Banking Principles. Twenty-five years ago, Law No. 14 of 1967 didn't adapt to national and international economic developments.

Since 1992, the national banking regulations were changed by the issuance of law No. 7/1992 on Banking, which aimed to accommodate economic development, which always moved rapidly, along with broadening challenges. This law was an important historical landmark in Indonesian Islamic banking. At the time, it was known as “banks with profit-and-loss-sharing principles”.

The collapse of the New Order replaced by the Reform Era in 1998 affected political Islam and sharia banking policy by allowing them to be more open and liberal.

Besides, the Islamic political infrastructure has grown in several fields of Islamic organization and become stronger in driving the growth of the Islamic economic system in Indonesia. However, a big question is: Why wasn't Indonesia's national Islamic banking market share able to exceed 5 percent in 2011? It is still too low, considering Indonesia has a large amount of Islamic political infrastructure.

### **3.1 Establishment of the First Islamic Bank in Indonesia**

#### **Islamic Banking Thought**

The historical aspects showed the ICMI was the leading Islamic political infrastructure in the influence of government policy and capital funding for establishing the first Islamic bank in Indonesia in 1992.

However, in the perspective of the struggle of intellectuals to initiate an Islamic economic system, the LSAF (Lembaga Studi Agama dan Filsafat, Institute for the Study of Religion and Philosophy) has emerged in the Islamic and economic fields since the 1980s.

The LSAF is a forum for the study and communication of religious, cultural, philosophical, and social issues. It was formed by the Foundation for the Study of Religion and Philosophy (Yayasan Studi Agama dan Filsafat) and lead by Amin Aziz, M. Dawam Rahardjo, Zacky Siradj, and friends at Jl. Empang Tiga (now known as Jl. Kalibata Timur), No. 31A, Pasar Minggu, Jakarta, on December 6, 1983. It is evidence of the progress of Muslim intellectual thought that it has made Islamic breakthroughs deeply and comprehensively.<sup>1</sup> Some Muslim intellectuals, such as Komaruddin Hidayat, Fachry Ali, and Bachtiar Effendy, were LSAF products through the Islamic discourse on developmentalism.

The LSAF's existence was part of an important intellectual process in the development of the Islamic economic system and Islamic banks in Indonesia. In the 1980s, Rahardjo was the LSAF founder who explicitly argued that bank interest is an addition to usury, long before the ICMI encouraged the formation of the first Islamic bank

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<sup>1</sup> Ma'arif (1995: 129).



in Indonesia.<sup>2</sup> As an economist, he often included Islamic elements or values in his opinions in newspapers, books, or journals.

The LSAF's intellectual development was actuated in the *Ulumul Qur'an Journal*, in which intellectuals, scholars, and technocrats expressed their highly comprehensive and constructive Islamic ideas and thoughts, including about Islamic financial systems and institutions. For example, the *Ulumul Qur'an Journal*, Vol. II, 1990/1411 H, specifically discusses various views of business or management ethics in Islam, like "The Islamic View of Work Ethics" by Sayyid Hussein Nasr, "Islamic Values and Corporate Culture" by Ahmad S. Adnanputra, and "Monotheism and Work Motivation" by Muhammad Imaduddin Abdulrahim.

The LSAF has barely discussed the development of Islamic banks or other sharia financial institutions in Indonesia. This is because the LSAF is a forum purely for intellectual movements without elements that are close to political power. On the other hand, the ICMI is an institution that is very close to political power; thus its existence is more visible and massive.

### **Islamic Political Infrastructure of the First Islamic Bank**

The MUI and the ICMI were two organizations that could bring up ideas from the Islamic political infrastructure about the Islamic economic systems and the establishment of Islamic banks that have developed from the 1980s. The MUI and ICMI held the fourth MUI National Conference in Jakarta on August 22 to 25, 1990, which resulted in a mandate for the establishment of a working group to start the Islamic banking projects in Indonesia.

The Indonesian Ulema Council was established on the 7 of *Rajab*, 1395 H/26 of July 1975, in Jakarta. The MUI is a non-governmental organization run by *ulema*, *Zu'ama*,<sup>3</sup> and Islamic scholars in Indonesia to guide, foster, and protect Muslims throughout Indonesia.

While the ICMI is a Muslim intellectual organization that was formed on December 7, 1990, in Malang, East Java. Its establishment was a measure taken to combine anthropocentrism and theocentrism

<sup>2</sup> Rahardjo (1991: 50).

<sup>3</sup> Leaders of the organizations, governments, and so on.

(having God as the central interest and ultimate concern) or to unite spiritual intellectuals.<sup>4</sup>

The idea of the ICMI was originated by several students in 1987 while they were discussing Muslim leadership polarization.<sup>5</sup> They were Erik Salman, Ali Mudakir, Mohammad Zaenuri, Awang Surya, and Muhamad Iqbal from the Faculty of Engineering, Brawijaya University, East Java. Then, in February 1990, they continued their discussions at the mosque of Brawijaya Malang University, exploring the desire for unification of the intellectual communications and activities in Paramadina Jakarta, Salman Bandung, West Java, Salahuddin Gadjah Mada University Yogyakarta, and Al-Falah Surabaya, East Java to become an Islamic intellectual organization.<sup>6</sup>

Some scholars responded to the discussion, particularly Z.A. Akhmadi as Rector of Brawijaya University, and A. Malik Fadjar as Rector of Malang Muhammadiyah University, as well as several Islamic intellectuals such as Imaduddin Abdulrachim from Bandung, West Java, and M. Dawam Rahardjo from Yogyakarta. They suggested the five students meet B.J. Habibie. The meeting resulted in Habibie being willing to lead an institution of intellectuals, which was supported by President Soeharto during a meeting at his house on September 27, 1990.

The ICMI was officially formed at the “National Symposium on Muslim Intellectuals: To Build the XXI Century People” on December 6 to 8, 1990, in Malang, East Java.<sup>7</sup> The idea to include the term “intellectuals” in the ICMI’s name was B.J. Habibie’s. Previously Nurcholis Madjid had named it the Indonesian Muslim Scholars Association (ISMI).<sup>8</sup>

Saiful Mujani explained that Hefner, an anthropologist from Boston University, suspected that Soeharto’s support for the establishment of the ICMI was strategic and opportunistic. He observed positive changes

<sup>4</sup> Diro Aritorang, “Institusi Membuat Cendekiawan Muslim Steril?” *Pikiran Rakyat*, December 21, 1990, in Muhammad (1991: 152).

<sup>5</sup> Anwar (1995: 255).

<sup>6</sup> Rahman and Hazis (2018).

<sup>7</sup> Muhammad (ed.) (1991: 5).

<sup>8</sup> Rahardjo (1996: 23).

in Islamic people during the 1990s, especially in the intellectual middle class.<sup>9</sup>

Nakamura, an anthropologist from Chiba University, Japan, argued that the ICMI's stand is the proceed of the Indonesians' government transparency to Islam. It helped bring the multiple social and political interrelations and the revival of a middle class of Islamic scholars. This condition was a sign that Indonesia is moving toward becoming a highly developed Muslim nation.<sup>10</sup>

However, disagreement on the ICMI's presence is not always negative or Islamophobic. Gus Dur was a Muslim figure who did not agree with the ICMI, since he did not develop the formalization of Islamic politics during the New Order. He placed Islam as a foundation for the ethical values of modern society, especially since Indonesia is a multi-ethnic and multi-religion country.<sup>11</sup>

Importantly, the ICMI was welcomed by national businesspersons such as Fahmi Idris and Fadel Muhammad. They announced the need for a more balanced distribution of economic wealth and criticized the economic power of Indonesian citizens of Chinese descent.<sup>12</sup> As Robison and Hadiz observed:

For many people, the ICMI's establishment marks a new era in which Islam finally "arrives" as a social and political force.

In a state of euphoria, some opinions regard the ICMI as a tool to attack anyone considered responsible in the past for the oppression of Muslims, including the military circle.<sup>13</sup>

The ICMI's establishment was the most important milestone in accommodating relations between Islam and the state, since this organization had many Islamic leaders among bureaucrats and non-bureaucrats acting as a kind of alliance.<sup>14</sup>

<sup>9</sup> Saiful Mujani, "Kultur Kelas Menengah Muslim dan Kelahiran ICMI: Tanggapan Terhadap Robert W. Hefner dan Mitsuo Nakamura," in Fauzi (ed.). (1995: 76–7).

<sup>10</sup> Mitsuo Nakamura, "The Emergence of Islamizing Middle Class and the Dialectics of Political Islam in New Order of Indonesia: Prelude to Formation of the ICMI," *Paper*, 1993. In Fauzi (ed.) (1995: 76–7).

<sup>11</sup> Arif Budiman, "Indonesia Yang Sedang Menunggu," in Fauzi (ed.) (1995: 110).

<sup>12</sup> Hadiz (2011: 18–20).

<sup>13</sup> Hadiz (2011: 18–20).

<sup>14</sup> Rahardjo (1996: 23).



In the political context, the ICMI's establishment relieved the tension between the rulers and the Islamic political infrastructure. The ICMI became an organization of state bureaucrats from Muslim political groups who had previously criticized the government.<sup>15</sup>

President Soeharto hoped some Muslims would participate in carrying out the responsibilities of intellectuals, not only in terms of religion, knowledge, and science, but also in political matters. He appointed some Muslim ministers who were *santri* and good Muslims, such as Foreign Minister Ali Alatas, Transportation Minister Azwar Anas, Finance Minister Marie Muhammad, Manpower Minister Abdul Latif (an Islamic businessperson), and Religious Affairs Minister Tarmizi Taher (an Islamic scholar and *ulema*).

Karnaen said some Muslims from the ICMI who were also ministers had provided the strategic means to reopen discussions about an Islamic banking system operating without interest.<sup>16</sup>

The ICMI smoothly served as a banking reform axis under the leadership of B.J. Habibie, who was serving as the Minister of Research and Technology, and as the Head of BPPT (Technology Research and Application Body),<sup>17</sup> and was highly trusted by Soeharto.

Clement W. Henry says the first Islamic bank was established in 1992 thanks to the big role of B.J. Habibie.<sup>18</sup> The ICMI proved its political strength in fundraising for the first Islamic bank's capital. At the signing of the Deed of Establishment of BMI at Sahid Jaya Hotel in Jakarta on November 1, 1991, the Steering Committee was chaired by ICMI members such as M. Amin Aziz, while the funds collected from the commitments to purchase shares totaled IDR 84 billion.<sup>19</sup>

<sup>15</sup> Hadiz (2011: 3–38).

<sup>16</sup> Karnaen Perwaatmadja, *Interview*, Jakarta. Sentence editor is processed by the author. A more complete process of Karnaen's steps to meet M. Natsir, a very influential Islamic figure, look Ismail, *et al.* (2013: 177–5).

<sup>17</sup> The BPPT (Agency for the Assessment and Application of Technology) is a Non-Departmental Government Institution under the coordination of the State Ministry of Research and Technology that has the task of carrying out government duties in the field of technology assessment and application. The process of forming the BPPT began with an idea former President Soeharto conveyed to Prof. Dr. Ing. B.J. Habibie on January 28, 1974.

<sup>18</sup> Henry (2015).

<sup>19</sup> Sudarsono (2005: 31); Basir (2009: 32–3).



The committee met with President Soeharto at the Bogor Palace in West Java on November 3, 1991, and obtained additional capital of IDR 116 billion from the president, vice president, and ten Ministers of Development Cabinet V, as well as from PT. PAL,<sup>20</sup> PT. Pindad,<sup>21</sup> Purna Bhakti Perwira, and several foundations formed by President Soeharto, namely YABMP,<sup>22</sup> Dakap,<sup>23</sup> Supersemar, and the Dharmais foundations.<sup>24</sup>

### *Intellectual Movement*

Generally, an intellectual movement is the reasoning process behind the establish of an authoritative system of aesthetics, ethics, government, and even religion, which would allow human beings to obtain the objective truth about the whole of reality.<sup>25</sup>

Specifically, the Muslim intellectual movement discusses the reasoning for establishing Islamic banking in Indonesia. In the 1930s, Mas Mansur conveyed the idea that Islamic banks may operate without interest since bank interest is illegal (*harâm*) and incorporates extortion. His idea caused debate among *ulema* and socialists. According to the socialists, conventional bank interest results from a voluntary agreement between two parties, so it does not incorporate extortion or coercion, and the amount charged is fair.<sup>26</sup>

<sup>20</sup> PT. Penataran Angkatan Laut (PAL) Indonesia in Surabaya: Main activities are producing warships and commercial vessels (<http://www.pal.co.id>).

<sup>21</sup> PT. PINDAD (Perindustrian Angkatan Darat) was an inheritance from the Dutch during the period of the RIS government when it was named 1950 Arms and Munitions Factory (PSM)(<http://www.pindad.com>).

<sup>22</sup> YAMP (Yayasan Amalbakti Muslim Pancasila) was established in 1992 to develop the social and religious infrastructure of Muslims. YAMP once initiated the "Program 1000 Da'i" to be placed in remote areas that are vulnerable to Christian missionaries. Kara (2005: 172–3), Sadjzali (1993: 30).

<sup>23</sup> DAKAB Foundation (Dana Abadi Karya Bakti) was, at the beginning, founded to help the extended families of Golkar members. Since 1998, the Dakab Foundation has changed its aim to help alleviate poverty in vulnerable areas (<http://www.dakab.or.id>).

<sup>24</sup> Dharmais Foundation was founded in 1975 by Soeharto, Soedharmono, and Bustanil Arifin to overcome social problems, improve people's welfare, and foster inadequate citizens (<http://www.yayasandharmais.or.id>).

<sup>25</sup> [brewminate.com](http://brewminate.com).

<sup>26</sup> Hamat, *et al.* (2016: 179–81).

In 1969, the idea to establish Islamic banks reappeared after the OIC conference in Kuala Lumpur, Malaysia. However, the New Order's political policies were still associated with the issue of an Islamic state, and positioned Islam solely for worship, emphasizing that religious ideology wasn't included in Indonesia's constitution.<sup>27</sup>

In 1982 there emerged some Muslim intellectuals who had influence in the Islamic economic field, such as Abdillah Thoha,<sup>28</sup> Adi Sasono,<sup>29</sup> Amin Aziz,<sup>30</sup> A.M. Saefuddin,<sup>31</sup> and M. Dawam Rahardjo.<sup>32</sup>

They established the Center for Agribusiness Development (Pusat Pengembangan Agribisnis, PPA) to discuss the grand designs for economic projects and the Islamic economy movement. Amin Aziz led the study group to discuss the ideas of the Islamic economy movements independently in some universities, and he succeeded in putting on the First National Islamic Economic Conference in Bandung in 1983.

<sup>27</sup> Hamat, *et al.* (2016: 179–81).

<sup>28</sup> Abdillah Thoha, Publisher Commissioner Mizan, alumni of the Faculty of Economics and Commerce, University of Western Australia (1966), and the Asia Pacific Center for Security Studies (APC-SS), Honolulu, Hawaii.

<sup>29</sup> Adi Sasono (1943–2016), alumni of Indutri Wedding Philips Las Centrum, Utrecht in the Netherlands (1974). In 2005–2009 he was on the board of directors of the International Co-operative Alliance (ICA) for Asia Pacific, Geneva, Switzerland.

<sup>30</sup> M. Amin Aziz, Ph.D. at Iowa State University, USA (1978). He was the initiator and leader of the PINBUK (Small Business Incubation Center) in 1995, founder of LPPOM-MUI (Institute for Food, Drug and Medical Studies).

<sup>31</sup> Ahmad Muflih Saefuddin (b. 1940) was a professor and was Rector of the Bogor Agricultural Institute (1962–1995), Ibn Khaldun University Bogor (1983–1986), and the University of Djuanda Bogor (since 2000), West Java. He is also a senior politician from the United Development Party (PPP), having served as a Minister of Food and Horticulture in the era of President B.J. Habibie (1998–1999).

He earned a doctoral degree in a Western country, but he is very qualified in the discourse of gloom. He is a figure who has a strong vision of the Islamic struggle, and has developed a culture for the Islamization of science.

<sup>32</sup> Dawam Rahardjo (1942–2018). He said: "If political Islam is eliminated, Indonesia will collapse and fall to pieces." Alumni of American Field Service (AFS) and Borach High School, Idaho, United States. He is known as an economist, a cultural person who has served as chairman of the ICMI, leader of the *Ulumul Qur'an; Science and Culture Journal*, and chair of the Institute for the Study of Religion and Philosophy. He had worked as a Bank of America Credit Department staff member when he was 27 years old. Two years later, Dawam joined the research staff at LP3ES (Institute for Social-Economic Development and Research). Institute for Social Sciences, Institute for Development Studies (LSP), Center for Agricultural Community Development (PPMA), and Institute for the Study of Religion and Philosophy (LSAF).

The PPA was very influential in the public discourse about the Islamic economy movement.

The intellectual movement for establishing Islamic banks was furthered by Islamic students in Bandung, West Java. A trial of Islamic financial institutions was conducted by *jamaah* (worshippers) of the Salman Mosque at the Bandung Institute of Technology (ITB) to build the Koperasi Jasa Keahlian Teknosa as Baytut-Tamwil Teknosa in 1984.<sup>33</sup> The top leaders of the MUI followed this up by deepening the concepts of Islamic finance in Indonesia.

The campaign of the Islamic economy movements that initiated Islamization of the economic system, and their criticism of economic practices, such as those of conventional banks, triggered controversy and were very influential on the Indonesian people. *Tempo* magazine described the economic Islamization campaign's success in attracting public attention and inviting responses from some people.

The idea of establishing Islamic banks moved quickly in 1984. First, Malaysia's regional socio-political influence allowed it to develop an Islamic bank, the BIMB, successfully. Second, referring to Hefner in the 1980s, new modernists or young Muslim intellectuals had emerged to campaign for education and culture with global discourse democratization and human rights, which advanced modern Islamic issues like the Islamic economy and justice in political Islam.<sup>34</sup>

The Islamic economy movements in Indonesia are not merely efforts to realize an Islamic legal tradition in social-economic relations, as stated by Hefner (1996). On the contrary, it is driven by the hope of creating a just and equal economic system, which is related to *Maqâsîd-u-Sharî'a* (sharia objectives) rather than to the formalism of Islamic jurisprudence and interpretation.

*Maqâsîd-u-Sharî'a* revealed the dignified view of Islam, which has to be observed entirely, not partially, as Islam is an absolute and integrated pattern of life and its purpose includes a complete life, personal and public, in this world and the Hereafter. Islamic economics, or Islamic

<sup>33</sup> Choiruzzad, *et al.*, "Indonesia's Islamic Economy Project and the Islamic Scholars," in Utama (ed.) (2013: 959).

<sup>34</sup> *Kompas.com* (online), "Rumah Harta untuk Semua," Business & Finance, November 26, 2008 (<http://ekonomi.kompas.com>).



banking, is the way to realize and integrate both worldly activities and the Hereafter.

The signs of Islamic activity, in general, started in the middle-class movement involving Islamic identities in Southeast Asia, such as *Kurung* and *Mini Telekung* for contemporary Muslim women's religious costumes and trends incorporating the veil.<sup>35</sup>

However, the developing ideas of the Islamic economic system and the trends of Islamic identity, especially with the middle class, were unable to bring Islamic financial institutions to Indonesia. The New Order's political relations with Islam, at that time, were still highly antagonistic; the power holder was still suspicious of any Islamic symbolization and imposed Pancasila's single set of principles.

Islamic banking reappeared in 1991 when the Rural Bank Dana Mardhatillah and the Rural Bank Berkah Amal Sejahtera were established by the Institute for Sharia Economic Development (ISED) in Bandung, West Java.<sup>36</sup> The presence of the two rural banks was quite influential from the political perspective, formally obtaining the legality to be a bank institution run according to banking regulations, and informally popularizing the sharia system.

Some of the above articles show that the intellectual movement in the field of Islamic economics developed in Bandung, West Java. National persons played a major role directly in the establishment of Islamic banks, such as Karnaen A. Perwaatmada, A.M. Saefudin, M. Amin Aziz, Sukamdani Sahid Gitosardjono, Ginandjar Kartasmita, Adi Sasono, Fadel Muhammad, Fahmi Idris, and M. Syaff'i Antonio.

Even Karnaen campaigned on Islamic banking issues with the slogan "Bank without interest" and he defended himself from Islamophobia, directly supported by Dr. Ahmed Mohammed Ali Al-Madani (President of the Islamic Development Bank). Karnaen had experience as the executive director of the IDB from 1988 to 1990.<sup>37</sup>

<sup>35</sup> Indrastomo (2016: 63–4); Rahman and Hazis (2018).

<sup>36</sup> Ascarya, *et al.* (2005: 44).

<sup>37</sup> Ismail, *et al.* (2013: 171).



### 3.2 1992: Islamic Banking Reform

The word “reform” originates from Latin: *re* (back) and *formare* (forming). It was first used by Pope Gregory VII, who aspired to the reformation of the *orbis otius*, the reform of all world orders.<sup>38</sup> This created a drastic improvement in the economy, politics, of a society or country.<sup>39</sup> Reform was used by Naqvi in observing the development of the profit-and-loss-sharing (PLS) system in Pakistan in 1979.<sup>40</sup>

Reform can mean a revision of a single regulation, the scrapping and rebuilding of an entire regulatory regime and its institutions, or the improvement of processes for making regulations and managing reform.<sup>41</sup>

Reform in the context of Islamic politics is a change from the substantive to the formalist. Formalism makes practical political struggles a formal way of devoting the struggle and strength of Islamic resources.<sup>42</sup> If his opinion is analogous to Islamic banking reform, it occurred from 1992 to 1998. The Muslim struggle for the Islamic economic system was not only substantial, but through a formal institution, namely the Islamic banks or, at that time, “banks with the profit-sharing principle”.

Some opinions are that the banking reform period was from 1998 to 1999. This author’s opinion is that it was strongly influenced by the trend of political change at that time for using the word “reform”.

#### Regulatory Reform

The term “regulatory reform” is used by the OECD (the Organization for Economic Co-operation and Development) to refer to changes that improve regulatory quality, that is, enhance the performance, cost-effectiveness, or legal quality of regulations and related government formalities.<sup>43</sup> In the banking field, it means the

<sup>38</sup> Soetandyo Wignjosebroto, “Reformasi Kehidupan Bermasyarakat dan Bernegara Bangsa,” in Soemardjan (2000: 86).

<sup>39</sup> Tim PKPB (2007: 939).

<sup>40</sup> Naqvi (2003: 203).

<sup>41</sup> stats.oecd.org.

<sup>42</sup> Ahmad (2004: 120).

<sup>43</sup> OECD (1997: 11).

change from what was previously impossible to what is now possible in the establishment of Islamic banks based on the legality of regulations and government formalities.

Banking regulatory reform was marked with the enactment of Law No. 7 of 1992 on Banking, which reformed the previous banking regulations that referred to Law No. 14 of 1967 on Banking, allowing for changes in regulations regarding the establishment of banks for the first time in 25 years.

On December 17, 1990, Bank Indonesia designated the Basic Pattern of Bank Supervision and Guidance. Bank Indonesia issued a policy package, dated February 28, 1991, on the Improvement of Bank Supervision and Guidance, initiating 204 precaution signs referring to international banking standards that include such terms as “Minimum Capital Requirements” and “Establishment of Allowance for Productive Assets”.

This Decree facilitated banking regulation reform in Indonesia as stipulated by Law No. 7 of 1992 on Banking (Act 92), an amendment to Law No. 14 of 1967 on Banking Principles. Act 92 expanded the structure of banking institutions, refined and simplified the types of banks, increased protection of public funds, and increased the professionalism of Indonesia’s banking based on economic democracy. As stated in Chapter III, Article 6 (item m) and Article 13, item c, Act 92 especially created an opportunity for the establishment of a bank operating with profit-sharing principles, a new regulation that had not been included in the previous act.<sup>44</sup> That banks only serve business and economic transactions was stated in Article 1, item a, of Law No. 14 of 1967 on Banking Principles:

A Bank is a financial institution whose main business is to provide credit and services in terms of payment and circulation of money.

Generally, banking regulatory reform is a long series of policies that cannot be separated from previous policies, especially the deregulation packages in the monetary and banking sectors from early 1983 until 1988. The banking deregulation package dated June 1, 1983, was the

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<sup>44</sup> Basir (2009: 27–8).

basis for allowing banks to determine the interest rate differentials with others according to the condition of each bank.

Some opinions state that this policy may allow banks to impose transactions with a zero percent interest rate. Since the bank interest is uncertain and the government has no control over it, that is within the authority of the respective banks. It creates the opportunity to establish a bank that does not charge interest, a sharia bank, even if it is politically impossible to do.

The Pakto 88 deregulation policy didn't maximize results, especially regarding the imposition of taxes on deposit interest, which caused some depositors to withdraw their funds. This policy led to the withdrawal of up to an estimated IDR 1 trillion in deposits within 18 days.<sup>45</sup>

The series of deregulation packages in the banking sector was influenced by Indonesia's underdeveloped banking performance. For a long time, Law No. 14 of 1967 on Banking Principles was not affirmative, especially in opening branch offices, and the government intervened too much in the banking business.

Restrictions over opening branch and cash offices widely influenced banking services. Many lower-income people in rural areas were unable to access banks and made transactions with cooperatives and loan sharks.<sup>46</sup>

Table 3.1  
Bank Growth in Indonesia 1988–1992

Years	National banks			Private banks		
	Head	Branch	Growth	Head	Branch	Growth
1988	7	852		104	876	
1989	7	922	8%	141	1,656	89%
1990	7	1,018	10%	164	2,545	54%
1991	7	1,044	3%	185	3,203	26%
1992	7	1,066	2%	201	3,341	4%

Source: Bank Indonesia's Statistics of Indonesia's Economy-Finance, July 1993.

<sup>45</sup> Prasetyanto (1990: 89).

<sup>46</sup> Budisantoro and Triandaru (2006: 74–5); Arthesa and Handiman (2006: 48); Basir (2009: 29–30).



Table 3.1 shows the growth of national banks in terms of the number of offices was slowing down after the Pakto 88 deregulation, both state-owned banks and private banks. Especially from 1990 to 1991, the state-owned banks decreased by 7 percent, and private banks increased by 28 percent, but that dropped dramatically, by 22 percent, and it grew only 4 percent in 1992.

Basir said the reasons for the national banks' slowed growth was their dependence on the Central Bank and the difficulty of the government not being able to control the national banking interest rates.<sup>47</sup>

Since various banking services could not be provided to the public and banking liquidity was beyond the government's control, banking reform was needed, including reform involving the opening of Islamic banks.

Reform of the regulations to run an Islamic economic system were used by the founder of Ikhwân-ul-Muslimîn, Hasan al-Banna.<sup>48</sup> In 1947, he sent a letter to leaders of Arab and Muslim states to request they reform their banking systems according to Islamic sharia. The reform requests were supported by Sayyid Qutb,<sup>49</sup> who strongly criticized usury in his writings, declaring it to be identical with modern banks acting "like eaters of debtors' flesh and bones".<sup>50</sup>

In the Indonesian context, regulatory reform was part of the Islamic political infrastructure's thinking process toward regulations that could establish the legality of Islamic banking systems. This reform was manifested in several articles mentioning the Islamic-based economic system in Law No. 7 of 1992 on Banking and three government regulations: Nos. 70, 71, and 72 of 1992.

This period was when the Islamic political economy was realized through the policy reform of banking institutions from being

<sup>47</sup> Basir (2009: 29).

<sup>48</sup> Hasan Al-Banna (1906–1949) wanted to revive the *khilâfah*, which was destroyed in 1924. He was an Islamic thinker who accepted Western progress but condemned Western moral decadence. Wahyudi (2010: 74–89).

<sup>49</sup> Sayyid Qutb (1906–1966) with Gamal Abdul Nasser overthrew the Egyptian government. However, under Nasser's power Qutb was imprisoned for writing *Ma'âlim fi-t-Tariq*, which according to Nasser was insulting to Muslims. Wahyudi (2010: 88–92).

<sup>50</sup> Saeed (1996: 9).



conventional toward being Islam-based, which at that time used the term “banks with profit-sharing principles”.

Regulatory strengthening was needed in response to the establishment of sharia banks and sharia rural banks with profit-sharing principles, especially with Bank Indonesia as the central bank with authority and responsibility in the various aspects related to Islamic banking. The establishment of Islamic banks or banks with profit-sharing principles, was still decided by a Finance Ministerial Decree, and the regulation was only supported by government regulations. While Bank Indonesia still operated referring Law No. No. 13 of 1968 on the Central Bank, it was still part of the executive under the Minister of Finance and had no authority to issue permits for establishing Islamic banks.

The reform process to realize regulatory strengthening took place in the next period with an amendment of Law No. 23 of 2009 on Bank Indonesia. This period shows that Bank Indonesia, as the banking regulator or central bank, had full authority over the development of Islamic banking regulations, from the Director's Decree to Bank Indonesia's Regulations (PBI) until the opening of Bank Indonesia's Directorate of Sharia Banking.

### **Institutional Reform**

Generally, institutional reform is the process of reviewing and restructuring state institutions so that they respect human rights, preserve the rule of law, and are accountable to their constituents.<sup>51</sup> By incorporating a transitional justice element, reform efforts can both provide accountability for individual perpetrators and disable the structures that allowed abuses to occur.

Institutional reform can include many justice-related measures, such as vetting, structural reform, oversight, transforming legal frameworks, disarmament, demobilization, reintegration, and education.<sup>52</sup>

<sup>51</sup> ICTJ (n.d). “Institutional Reform,” <https://www.ictj.org/our-work/transitional-justice-issues/institutional-reform>.

<sup>52</sup> [www.ictj.org](http://www.ictj.org)

Specifically, institutional reform of banking is the process of reviewing and restructuring banking institutions so that they respect Islamic banking institutions. By incorporating Islamic principles, reform efforts can change banking institutions from conventional to sharia-based and strengthen regulations that support Islamic banks.

Banking institutional reform may be traced from when the process of establishing Islamic banks in Indonesia started on July 5, 1990, at a meeting with Commission VII of the DPR.

The government confirmed that banks following Islamic law principles could be established. As long as the banks operated in compliance with the banking and health standards stipulated by Bank Indonesia regulations there was no obstacle.<sup>53</sup>

Karnaen, who accompanied J.B. Soemarlin (Minister of Finance, Development Cabinet V, March 23, 1988, to March 17, 1993) in the meeting with the DPR, and Hussein Naro, a Member of Parliament from the United Development Party (PPP), explicitly asked about the discourse over the establishment of interest-free banks or Islamic banks. He answered that the government was ready for the regulation and establishment of interest-free banks.<sup>54</sup>

On that basis, in August 1990, Ulama, Muslim scholars, and banking practitioners compiled a program to establish sharia rural banks. In the initial period, sharia rural banks emerged in Bandung, namely the BPR Dana Mardhatillah, the BPR Berkah Amal Sejahtera, and the BPR Amanah Rabaniah,<sup>55</sup> as well as the BPR Hareukat in Aceh, established on November 10, 1991.<sup>56</sup>

The process of establishing sharia rural banks was also encouraged by Karnaen, at that time serving as the Secretary-General of the

<sup>53</sup> Soemitro (2004: 127).

<sup>54</sup> Perwaatmadja, *interview*. Sentence editor was processed by the author.

<sup>55</sup> BPR Dana Mardhatillah, BPR Berkah Amal Sejahtera, and BPR Amanah Rabaniah received permission-in-principle from the Indonesian Minister of Finance on October 8, 1990. On August 19, 1991 BPR Mardhatillah began operations with the permission of the Minister of Finance No. Kep.20/KM.13/1991, BPR Berkah Amal Sejahtera with the permission of the Minister of Finance No. Kep-200/KM.13/ 1991, and BPR Amanah Rabani with the permission of the Minister of Finance No. Kep-281/KM.13/1991.

<sup>56</sup> Widyarningsih (2005: 50).

Monetary Division of the Ministry of Finance, when scholars asked about the regulations and rules. He answered:

Like football, the ball is already in front of the goal; thus it just needs to be kicked into the goal.<sup>57</sup>

The sharia rural banks' existence was part of the institutional reform of the establishment of Islamic banks. Also, it was fundamental in opening the political issue that banks may be operated by the sharia principle.

### **Social Reform of Islamic Banks**

Social reform refers to any attempt that seeks to correct any injustices in society. People who are involved in social reforms do so intending to improve the quality of life. Social reform is a kind of social movement that aims to make a gradual change, or change in certain aspects of society, rather than rapid or fundamental changes.<sup>58</sup>

Soerjono Soekanto defines reform in the social field as a limited and gradual social change.<sup>59</sup> Social reform in the Islamic banking context is:

- 1) A social movement that aims to make gradual changes in the Islamic banking principles so they may be understood by people.
- 2) A limited social change of the people moving away from using conventional banks and migrating to Islamic banks, or reform of the people's view of the "profit-sharing principle" system, which was previously unknown.

The social reform of Islamic banks in the 1990s was the reform of people's views on Islamic banking to be more positive and constructive. It is commonly known that most Indonesians are Muslims, and many organizations and institutions with Islamic attributes or symbols should contribute to the social capital to realize or support the establishment of

<sup>57</sup> Perwaatmadja, interview, Jakarta.

<sup>58</sup> International Conferences, *Social Reform*, [www.conferenceseries.com](http://www.conferenceseries.com)

<sup>59</sup> Soekanto (1993: 421).



Islamic banks in Indonesia.<sup>60</sup> However, in the 1990s that social capital could not do it.

For example, NU, which is the largest Islamic social organization in Indonesia, established banks in Jakarta in 1950 and in Semarang, Central Java in 1960. They still operated with the interest system.<sup>61</sup>

In 1990, NU, led by Abdurrahman Wahid, collaborated with Bank Summa of the Astra Group, which is owned by the Soerjadjaja family (the members of which are Christian and Indonesian citizens of Chinese descent), on a program to help small entrepreneurs and farmers. They succeeded in opening nine rural banks named NU-SUMMA Banks based on the interest system.<sup>62</sup>

In support of Islamic banks at the time, NU and several other Islamic organizations should have studied a lot about bank interest and usury and reform them in the Islamic banking system.

### 3.3 1998: Liberalization of Islamic Banking

There were some dissenting voices about the political economy of Islamic banking in 1998, who use the term “recognition” to explain the period from 1998 to 2008.

Liberalism is the doctrine that advocates the greatest possible use of markets and the force of competition to coordinate economic activities and achieve the most efficient way to distribute resources. This could be considered to be the stance closest to the neoclassical approach in modern economics. In the banking context, the role of the government is to ensure banking stability and guarantee free economic activities through deregulation, trade liberalization, and the establishment of the legal framework on national banking. It is irrelevant for the government whether the actors in Islamic banking activities are domestic private enterprises, foreign enterprises or ethnic Chinese enterprises, as long as

<sup>60</sup> Social capital is the ability of organizations, social networks between citizens and social institutions to control and form social exchanges. Moyers, *et al.* (2014: 82).

<sup>61</sup> Supriyanto (1990: 12–3); Basir (2009: 27).

<sup>62</sup> Thohir (2019).



the enterprises that survive competition drive the economy and create jobs.<sup>63</sup>

Surbakti described some features of liberalism. First: democratic discourse. Second: full intellectual freedom. Third: the restriction of government interventions in social life.<sup>64</sup>

Toynbee<sup>65</sup> stated that the tradition of liberalism led to capitalism. It sacrificed the social justice principle of individual freedom, ignored moral values, and prioritized self-interest in life and market competition.<sup>66</sup>

Fukuyama, in his economic manifesto, explained liberalism as an acknowledgment of the rights to conduct free economic activities and economic exchanges based on private ownership and markets.<sup>67</sup>

From the above definitions, banking liberalization is any method by which governments and private interests conduct free economic activities in the Islamic banking field that is supported by regulatory and institutional liberalization.

## **Regulatory Liberalization**

### **1. Regulations to Open Sharia Banks**

The regulations over sharia banks concerning opening, expansion, and share or ownership distribution have been liberated. The regulatory liberalization means the existence of sharia banks is an expression of every citizen's freedom and rights to establish, own, or run them as long as they do not violate rules or regulations.

Compared with the previous regulations, sharia banks must engage in full-fledged Islamic banking. From 1992 to 1998, the opening of a sharia bank was free, but only Muslims established sharia banks and rural banks. Implicitly, the existing regulations in 1992 created sharia banks that just belonged to Muslims, like Law No. 1 of 1974 concerning marriages that were valid only for Muslims.

<sup>63</sup> Kawamura (2008: 8).

<sup>64</sup> Surbakti (1993: 45).

<sup>65</sup> Arnold Joseph Toynbee (1889–1975) was a controversial British historian, the author of *A Study of History* (written over 27 years from 1934 to 1961), who analyzed the world wars and totalitarianism that almost destroyed Western civilization in the middle of the 20<sup>th</sup> Century.

<sup>66</sup> Toynbee (1971: 141); Perry (1982: 59); Ma'arif (1995: 78–9).

<sup>67</sup> Fukuyama (2003: 75–6).

Since 1998, after Act 98 was passed, the regulation of Islamic banking windows stated that Islamic banks may be operated by an SBU of a Conventional Commercial Bank, which means that banking liberalism occurred. It is referred to by Article 6, item m of Law No. 10 of 1998 on Banking:

Financing and/or conducting other activities based on sharia principles, following the provisions stipulated by Bank Indonesia.

Self-competitiveness of liberalization as stated by Toynbee occurred in the development of sharia banks in this period, but not to aid the Islamic mission. Nor did it incorporate religious elements, but it was as a pure profit-oriented business.

The policy of Act 98 affecting sharia banks developed from various institutions. The government, through the State-Owned Enterprises Ministry, established sharia commercial banks (SBC), and many national private conventional banks opened Islamic banks through their SBUs. Even some overseas banks opened SBU branches in Indonesia.

Compare this with the period of 1992 to 1998, or the period of Act 92, with sharia banks owned and applied for by Muslims. It relates to the regulation of GR 72/92 at that time, which led to the establishment of sharia banks that are purely Islamic institutions with full-fledged Islamic systems, not a Sharia Business Unit of a conventional bank.

## **2. Replacing the Regulator**

Referring to the third point of liberalism described by Surbakti, that the government cannot unduly intervene in people's lives,<sup>68</sup> in 1998 (in the period of Law No. 10 of 1998 on Banking) the government's role in the opening and controlling of many banks was transferred to Bank Indonesia.

This is different from 1992 to 1998, or in the period of Act 92, because when the first Islamic bank was established the administrative aspects and regulations were under the Minister of Finance. Reducing the role of the government became clearer after Law No. 23 1999 on Bank Indonesia (Act BI 99) was enacted.

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<sup>68</sup> Surbakti (1993: 45).

Since the enactment of Act BI 99, the central bank of Indonesia has gained independence from the government, in particular in conducting monetary policy. Such independence has been deemed necessary for the central bank to assure the accomplishment of the single objective of maintaining the stability of Rupiah.<sup>69</sup>

Aulia Pohan, a former Deputy of Bank Indonesia, stated that Act BI 99 was passed after tough and long debates, especially regarding the definition of the central bank's independence.<sup>70</sup> As stated in Article 4, paragraph 2 of Chapter II, concerning Status, Position, and Capital:

Bank Indonesia is an independent state institution, free from government intervention and/or other parties, except as expressly regulated in this act.

To eliminate the friction of interests between the government and Bank Indonesia, Act BI 99 initiated drastic changes in banking policy, such as:

- a) Putting authority in the banking sector under Bank Indonesia.
- b) Establishing the Deposit Guarantee Institution (Lembaga Penjamin Simpanan, LPS).
- c) Establishing a temporary body (Badan Khusus Sementara) for the restructuring of banks.
- d) Establishing the partnership principle for a foreign party holding ownership in a bank.
- e) Developing sharia banks.

The two crucial points were d and e. Point d was the beginning of national banking liberalization, especially in the foreign ownership of a national private bank, including a sharia bank.

A few days before the passing of Act BI 99, GR No. 29 of 1999 on the Purchase of Commercial Bank Shares was issued.<sup>71</sup> As stated in Article 3:

<sup>69</sup> Kasiyanto (2017).

<sup>70</sup> Pohan (2008: 195–6).

<sup>71</sup> GR No. 29/1999 concerning the Purchase of Commercial Bank Shares consisting of nine articles, stipulated and promulgated in Jakarta on May 7, 1999.



The amount of the bank's share ownership by a foreign citizen and/or foreign legal entity obtained through direct purchase or stock exchange is a maximum of 99% (ninety-nine percent) of the concerned bank's total shares.

Point e fostered sharia banking development. In 2002, Bank Indonesia published the "Blueprint of Sharia Banking Development in Indonesia" as a guideline for sharia banking's stakeholders. It referred to various aspects of the actual conditions of the international and national sharia banking industry, related devices, and development trends. It also dealt with the more macro-financial system frameworks, such as the Indonesian Banking Architecture (Arsitektur Perbankan Indonesia, API) and the Indonesian Financial System Architecture (Arsitektur Sistem Keuangan Indonesia, ASKI), as well as international best practices such as the IFSB, AAOIFI,<sup>72</sup> and IIFM.<sup>73</sup>

The development of sharia banks also referred to the API's and ASKI's strategic plans, the National Medium Term Development Plan (Rencana Pembangunan Nasional Jangka Menengah, RPNJM) and the National Long Term Development Plan (Rencana Pembangunan Nasional Jangka Panjang, RPNJP).<sup>74</sup>

### **Institutional Liberalization**

Chapra asserted that neoclassical liberalization: 1. Reduces the government's role in the economy, 2. Let's the market play its role, and 3. Allows foreign trade.<sup>75</sup> Then it is modified in the two aspects below:

#### **1. Reducing the Government's Role**

The government no longer fully concentrates on Bank Muamalat, like in the 1990s. It still has a role in Islamic banking, but it is also

<sup>72</sup> The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an international Islamic non-profit business entity that prepares accounting, audit, governance, ethics, and sharia standards for Islamic and industrial financial institutions (<http://aaoifi.com>).

<sup>73</sup> The IIFM (International Islamic Financial Market) was established in 2002 by the IDB, the Monetary Authority of Brunei Darussalam, Bank Indonesia, Bank Negara Malaysia, Bahrain Central Bank and Sudan Central Bank (<http://www.iifm.net>).

<sup>74</sup> Bank Indonesia (online), "Sekilas Perbankan Syariah Di Indonesia" (<http://www.bi.go.id>).

<sup>75</sup> Chapra (1989: 56).



involved in the banking industry through the establishment of sharia banks under the State-Owned Enterprises Ministry (BUMN), such as Bank Syariah Mandiri, BRI Syariah, BNI Syariah, and BTN Syariah. All banks of region-owned enterprises also opened sharia business units.

The Islamic banks' development has moved under-market interest so that all aspects of Islamic banks developed, the SCB, SBU, and Channeling Office. Sharia outlets even opened in several conventional financial institutions, for example in the post office and pawn shops.

Law No. 10 of 1998 on banking, which provided opportunities for conventional banks to open SBUs, was a major source of bankers' success in dominating sharia financial markets.

Many capitalists that have power in the banking market did not open sharia banks between 1992 and 1998. The regulatory and institutional liberalization in 1998 gave many conventional banks the economic power to open sharia business units.

Bank Indonesia was made the sole authority over national bank licensing and supervision under Law No. 23 of 1999 concerning Bank Indonesia, which led to the strengthening of the institutional liberalization of Islamic banks.<sup>76</sup>

As a result, the sharia banking space was entered by sharia commercial banks and sharia business units were developed by conventional banks.

Table 3.2  
Number of Islamic Banks 2004–2008

Banks	Year				
	2004	2005	2006	2007	2008
Sharia Commercial Banks	3	3	3	3	5
Sharia Business Units	15	19	20	26	27

Source: *Indonesian Banking Statistics*, Vol. 8, No. 1, Dec. 2009, 103.

<sup>76</sup> Law No. 23 of 1999 of Bank Indonesia only mentioned sharia in Article 1, paragraph 7 of financing with sharia principles. Article 11, paragraph 1 of liquidity loans under 90 days can be implemented with sharia principles, and Article 11, paragraph 2 credit guarantees with sharia must be minimum high value according to credit value.

The data show abnormalities in the development of sharia business units in Indonesia after 1998. In 2004 to 2008 the number of SBUs was 27, which increased at an average of seven banks per year, which was better than the increase of two sharia commercial banks per year. Compared to before 1998, conventional banks did not respect sharia banking business.

Regulatory liberalization affected the position of the first sharia commercial bank, BMI, the opening of which was strongly supported by the political superstructure and the Islamic political infrastructure. The ICMI, an Islamic political infrastructure that at its establishment was close to BMI, was no longer in the same situation, especially after B.J. Habibie was no longer a political power and the new power holder had different policy priorities.

BMI, as the pioneer of sharia banks in Indonesia, accelerated slowly, which may be observed in the difference of capital between BMI and BSM (Bank Syariah Mandiri), which was only established in 1999.

Table 3.3  
Asset Comparison between BMI and BSM

Banks	Years		Remark
	2010	2011	
BMI	IDR 16.02 trillion	IDR 21.4 trillion	Total Asset
		33.53%	Growth
BSM	IDR 28.05 trillion	IDR 43.51 trillion	Total Asset
		55.12%	Growth

Table 3.3 shows that the political change from the New Order to the Reform Era led to more open competition in sharia banking markets. Conventional banks becoming the major banks for sharia banking markets was an inevitable situation. From 1998 to 2008 there was a battle over the economic space. The growth of Islamic banks was dominated by economic actors with the capital power of conventional banks and the political power of state-owned banks.

In the colonial history of banking, the large and small banks' interests in market control efforts, with large banks against small banks,

were referred to in G.H.A. Prince’s research on the position of Bank Jawa in the Colonial Period (1875 to 1914). The conflict began when the Nederlandsche Bank assumed the rights over Bank Jawa’s activities managing the currency. In 1894, the conflict ended with the enactment of a law stipulating that the Dutch East Indies would use the Dutch guilder. Bank Jawa had the authority to act as the bank that issued money and was consequently responsible for the distribution of paper money in the colony of the Dutch East Indies.<sup>77</sup>

This conflict of interest in the context of market fairness was important for sharia banks’ accountability and stability. As explained by Ansori, a sharia bank should be truly independent, with its various instruments being nationally recognized parts of banking.<sup>78</sup> The data show that sharia banks develop offices more aggressively than sharia business units supported by conventional banks.

Table 3.4  
Number of Offices of Sharia Banks within 2004–2008

Banks	Year					Average, Percent
	2004	2005	2006	2007	2008	
Sharia Commercial Banks	263	301	346	398	576	
Additional Number of Offices		38	45	52	178	78
Growth per year		12.6%	13%	13.1%	30.9%	17.4%
Sharia Business Units	74	133	163	170	214	
Additional Number of Offices		59	30	7	44	35
Growth per year		44.4%	18.4%	4.1%	20.6%	21.7%

Source: *Indonesian Banking Statistics*, Vol. 8, No. 1, Dec 2009, 103.

Table 3.4 shows that the growth of sharia commercial banks was higher in terms of the number of offices than sharia business units

<sup>77</sup> G.H.A. Prince, “Monetary Policy in Colonial Indonesia and the Position of the Java Bank,” in Lindblad (2002).  
<sup>78</sup> Anshori (2012: 16).

with the average number of offices increasing by 78 per year, with the highest increase of 178 offices reached in 2007 to 2008.

The number of sharia business units increased by an average of 35 offices per year. The least was in 2006 and 2007 with only seven additional offices. However, in terms of average growth from 2004 to 2008, the sharia business units did better at 21.7 percent than the sharia commercial banks at 17.4 percent.

## 2. Foreign Sharia Bank

Foreign sharia bank is regulation that liberate to foreign bank to open sharia branches in Indonesia. Not more than two years after the passing of Act 98, foreign banks started to enter the Indonesian Islamic banking market. Maybank Syariah Indonesia was one of the hybrid foreign banks that pioneered conversion from conventional to sharia after October 1, 2010, with its shareholders being Malayan Banking Berhad (99 percent) and PT. Prosperindo (1 percent).<sup>79</sup>

### 3.4 2008: Islamic Banking Purification

Purification is the removal of impure elements,<sup>80</sup> or it is a cleaning, the operation of separating and removing from anything that is not good so as to make it better. In the context of Islamic banking in Indonesia, purification is the process of separating sharia business units from their parent conventional banks, or of removing the bad elements from Islamic banking to make it better.

Karnaen explained that Islamic banking purification reflected the hope that Indonesian Islamic banks would develop as part of a modern business framework and system and would remain on the track of an Islamic economic system.<sup>81</sup>

<sup>79</sup> Maybank Syariah began in January 1995, namely the operation of the first Indonesian-Malaysian joint venture bank, PT Bank Maybank Indocorp. In 2010, PT Bank Maybank Indocorp was converted in a Sharia Commercial bank and changed its name to PT Bank Maybank Syariah Indonesia (Maybank Syariah) (<http://maybanksyariah.co.id>).

<sup>80</sup> [www.vocabulary.com](http://www.vocabulary.com).

<sup>81</sup> Perwaatmadja, *interview*.



Meanwhile, the purification of sharia banking in this discussion means the purification of various aspects of policy in the era of Law No. 7 of 1992 (the banking reform period) that changed in the period of Law No. 10 of 1998 (the banking liberalization period) and were then purified or returned to the original regulations of Law No. 7 of 1992.

Some aspects of policy for the purification of sharia banking 15 years after 2008, heading into 2023, involve the purification of regulations, human resources, and institutions.

### **Regulatory Purification**

Regulatory purification means the purification of regulations related to sharia banking. It starts with the enactment of independent legislation, namely Law No. 21 of 2008 on Sharia Banking (Act 2008).

Politically, the passing of Act 2008 was supported by nine factions.<sup>82</sup> The Prosperous Peace Party (Fraksi Damai Sejahtera, F-PDS) was the only faction to reject it based on the consideration that it did not follow the basic principles of Pancasila, and was instead based on a certain religion.<sup>83</sup>

At the Plenary Meeting of the DPR on June 17, 2008, Rena Rosmanita Sitomorang, the PDS faction's spokesperson, stated:

Among the reasons for its rejection of Law No. 21 of 2008 is that the Act violates Pancasila and the 1945 Constitution as stated in Article 7, paragraph 1:

All citizens have equal status before the Law and in government and shall abide by the Law and the government without any exception.

However, the PDS faction's rejection was unable to prevent the Sharia Banking Act to be passed into law by the DPR on July 16, 2008. The contents of Act 2008 support regulatory purification, such as:

<sup>82</sup> 1) Working Group Faction (F-Golkar), 2) Indonesian Democratic Party of Struggle Faction (F-PDIP), 3) United Development Party Faction (F-PPP), 4) Democratic Party Faction (F-PD), 5) Faction National Mandate Party (F-PAN), 6) National Awakening Party Faction (F-PKB), 7) Prosperous Justice Party Faction (F-PKS), 8) Reform Star Party Faction (F-PBR), 9) Party Faction Star of the Pioneer of Democrats (joint faction of the Crescent Star Party and several other small parties in the DPR).

<sup>83</sup> Hasan (2009: 10–1).

First, sharia banks were obligated to use the word “sharia”, as stated in Article 5, paragraph 4, except for sharia banks that had operated before Act 2008 was passed.

Conventional commercial banks that operated sharia business units (SBUs) were required to include the phrase “Sharia Business Unit” after the name of the bank (Article 5, paragraph 5).

Second, controlling shareholders who do not pass the fit and proper test from Bank Indonesia must be sanctioned with a reduction of their share ownership to a maximum of 10 percent (Article 27, paragraph 2). If they reject this, as stated in Article 27, paragraph 3:

- (1) Their voting rights cannot be counted in the RUPS (Rapat Umum Pemegang Saham/General Meeting of Shareholders);
- (2) They only get a maximum dividend of 10 percent;
- (3) The names concerned are published in two mass media with broad reach.

Third, Bank Indonesia formed the Sharia Banking Committee consisting of elements from Bank Indonesia, the Ministry of Religious Affairs, and members of the public to formulate the *fatwâ* authority regulations.

Fourth, guidance and supervision of Islamic banks and Islamic business units were to be carried out by Bank Indonesia. While sharia compliance in Islamic banking and finance is its authority on MUI through SSB. The SSB was appointed at the General Meeting of Shareholders (Rapat Umum Pemegang Saham/RUPS) based on the MUI’s recommendation (Article 32, paragraph 2).<sup>84</sup>

Bank Indonesia supported Act 2008 by focusing on sharia banking development to improve positioning, differentiation, and branding by referring to the “Sharia Banking Market Development Grand Strategy in 2009–2012”.

Ramzi A. Zuhdi, a member of the Sharia Banking Committee, Director of the Directorate of Sharia Banking, Bank Indonesia, explained that the grand strategy was the new imaging program, a market segment development program, a product development program, a service improvement program, and a universal and open

<sup>84</sup> Maskur (2009).

communication program. Some of these programs led to Islamic banking's objective of mutually benefitting both parties and being more than just a bank.<sup>85</sup>

The above discussion shows that the regulation purification of banking in the political process does not always run smoothly because of opposition from certain political parties that still consider Islamic banking regulations in legislation as contradicting the principles of Pancasila and the 1945 Constitution. This case is similar to the process behind the promulgation of Law No. 1 of 1974 concerning Marriage, which was debated during a trial in the DPR, as was discussed in the previous chapter.

### **Human Resources Purification**

Human resources (HR) purification means the purification of the main HR of Islamic banks, from commissioners to directors, including the SSB, and the Dewan Pengawas Syariah/DPS, to follow various rules that support the realization of the ideal Islamic bank in the aspects of the Islamic banking and service systems.

#### **1. Fit and Proper Test**

The Fit and Proper Test as part of human resources purification based on Bank Indonesia Circular No. 12/6/DPbS dated March 28, 2010, on the Fit and Proper Test of Sharia Banks and SBU.

This provision is a technical implementing rule of Bank Indonesia Regulation No.11/31/PBI/2009 on the Fit and Proper Test of Sharia Banks and Sharia Business Units as enacted on August 28, 2009.

One technical rule regulated in the circular that strongly supports the sharia banking purification regulations is the Fit and Proper Test on the Sharia Bank's Controlling Shareholders (SBCS, Pemegang Saham Pengendali/PSP), members of Board of Commissioners (BoC, Dewan Komisaris), directors, and executive officers.

The Fit and Proper Test on a sharia business unit's director and executive officers assesses the involvement and/or relatedness of the concerned parties or is a clearance test for violations or irregularities,

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<sup>85</sup> Ramzi A. Zuhdi, "iB (ai-Bi) Melaju dengan Strategi Baru" (<http://www.bi.go.id>), 1–4.



including acts of fraud, or embezzlement, and/or swindles, as per the following factors:

- (1) The financial integrity and feasibility of a Sharia Bank's Controlling Shareholders;
- (2) The financial integrity, competence and reputations of members of the Board of Commissioners, members of the Board of Directors, and/or Executive Officers of Sharia Banks and a Sharia Business Unit's Director and/or Executive Officers.

Many Sharia Bank's Controlling Shareholders, members of their Board of Commissioners, members of their Board of Directors, and executive officers, and a sharia business unit's directors and executive officers have to learn about various sharia contracts and sharia transaction systems commonly practiced in Islamic banking.

The Fit and Proper Test is also applicable to candidates for the Sharia Supervisory Board (SSB/DPS). At the request of sharia banks, the DSN-MUI conducts Fit and Proper Tests on candidates for the SSB/DPS at a Bank Indonesia location in the area of the Islamic bank.

During the period of the Financial Services Authority (OJK) in 2011, the functions of the Sharia Supervisory Board (DPS) were:

- 1) Sharia supervision,
- 2) Advisory functions regarding sharia contracts and services.
- 3) Provision of members with the qualifications as sharia auditors to serve as a sharia bank's internal and external auditor.<sup>86</sup>

## 2. Good Corporate Governance

Good Corporate Governance (GCG) is the art of directing and controlling an organization by balancing the needs of the various stakeholders. This often involves resolving conflicts of interest between the various stakeholders and ensuring that the organization is managed well—meaning that the processes, procedures, and policies are implemented according to the principles of transparency and accountability.

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<sup>86</sup> *Financial Services Authority, Otoritas Jasa Keuangan* (online), "Perbankan Syariah dan Kelembagaannya" (<http://www.ojk.go.id>).



GCG for sharia commercial banks and sharia business units was regulated by Bank Indonesia Circular No.12/3/DPbS dated April 30, 2010, on the Implementation of Good Corporate Governance for Sharia Commercial Banks and Sharia Business Units.<sup>87</sup>

The first point is about the purification of the respective party's involvement in a sharia bank, especially in the position of president director of a sharia business unit that must be independent, not under the influence of the Islamic bank's commissioner.

The second point is about an urgent aspect of the national Islamic bank's institutional structure. The Sharia Supervisory Board's existence tends only to complement the organization of Islamic banks and complement regulatory requirements, not as playing an important part in supervising the implementation of sharia principles with banks.

Some of the Sharia Supervisory Board's human resources, especially the SSB on sharia rural banks, are not experts on banking. They were never involved in the sharia bank contracts in the field, and the relationship between them and a sharia bank is only ceremonial for a certain session. Therefore, the SSBs are equipped with clear working papers so that they may improve the ability of sharia banks to implement sharia principles properly.

The third point is that banks must conduct periodic self-assessments that cover at least 11 factors to evaluate GCG implementation, namely:

1. Implementation of the duties and responsibilities of the Board of Commissioners;
2. Implementation of the duties and responsibilities of the Board of Directors;
3. Completeness and implementation of the duties of the Committee;
4. Handling conflicts of interest;
5. Application of the compliance function;

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<sup>87</sup> This provision is a technical implementing rule of Bank Indonesia Regulation (PBI) No.11/3/PBI/2009 on Sharia Commercial Banks, PBI No.11/10/PBI/2009 on Sharia Business Units, and PBI No.11/33/PBI/2009 on the Implementation of Good Corporate Governance for Sharia Commercial Banks (SCB) and Sharia Business Units (SBU).

6. Implementation of the internal audit function;
7. The application of the external audit function;
8. The application of risk management, including the internal control system;
9. Provision of funds to related parties and large exposures;
10. Transparency of the Bank's financial and non-financial conditions, GCG implementation reports and internal reporting; and
11. Bank's strategic plan.

Sharia banks must implement the GCG principles, such as transparency, accountability, responsibility, independence, and fairness.<sup>88</sup> These principles may not be much different from a conventional bank's GCG, but sharia banks, in terms of responsibility, hold to prudential banking practices and responsibilities in the social field, including religious values, such as sharia banks having the Private Zakat Institution (Lembaga Amil Zakat, LAZ), as was explained in a previous discussion.

### **Institutional Purification**

Two new policies of purification of Islamic banking institutions are a spin-off program and the existence of a *fatwâ* institution.

#### **1. The Spin-off program.**

A spin-off is a new organization, object, or entity that resulted from the separation or splitting of a larger one. *Black's Law Dictionary*, as quoted by Khotibul Umam, explained:

*Spin-off* is a corporate divestiture in which a division of a corporation becomes an independent company and stock of the new company is distributed to the corporation's shareholders.<sup>89</sup>

As stated in Article 1, paragraph 12 of Law No. 40 of 2007 on Limited Liability Companies:

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<sup>88</sup> Zarkasyi (2008: 113–4).

<sup>89</sup> Gomer (2004: 1437); Umam (2010: 610).

*Spin-off* is a law implemented by a company to separate [a portion of] its business, which results in all of the company's assets and liabilities being transferred as a matter of law to two or more companies, or some of the company's assets and liabilities are transferred as a matter of law to one or more companies.

The above two definitions indicate that a spin-off is the process of creating a subsidiary and making it into an independent company in terms of shares, management, assets and liabilities, business units, and legal responsibilities.

A spin-off in sharia banking regulations is a business unit separated from one bank and made into two or more business entities, following the applicable provisions of the relevant law.<sup>90</sup> The spin-off policy was an important change from the period of Law No. 10 of 1998 to Law No. 21 of 2008 concerning Sharia Banking, or, in the author's terms, to the purification policy of the sharia banking institution.

The meaning of institutional purification is that Islamic banking institutions from the period of Law No. 10 of 1998 on Banking could be operated as an SBU, or only as an Islamic banking windows in a conventional bank, could become full-fledged sharia banks.

The spin-off policy that affected sharia banks will institutionally return to was stated in Law No. 7 1992 or GR No. 72, 1992. As stated in Article 68, paragraphs 1 and 2 of Law No. 21 of 2008 on Sharia Banking:

- (1) In case a Conventional Commercial Bank has Sharia Business Units of which the asset value has reached at least 50% (fifty percent) of the parent bank's total asset value, or 15 (fifteen) years after the enactment of this act, the Conventional Commercial Bank shall be required to separate the Sharia Business Units into a Sharia Commercial Bank.
- (2) Further provisions concerning Separation and sanctions for Conventional Commercial Banks that do not do separate as referred to in paragraph (1) shall be regulated by Bank Indonesia regulations.

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<sup>90</sup> See Article 1 No. 32 of Law No. 21 of 2008 on Sharia Banking.



Corporate actions in the form of mergers, consolidations, acquisitions, and separation in the banking sector may only be conducted with permission from Bank Indonesia.<sup>91</sup>

The spin-off policy, as part of purification, is very strategic. Politically, the government responded by launching BRI Syariah as the first sharia commercial bank created with the spin-off mechanism. This reflects the form of the government's consistency and commitment, as in the period of Law No. 7 of 1992 regarding the establishment of the first sharia bank in Indonesia. The spin-off policy represents progress toward controlling the sharia banking market as stated in Article 68 of Act 21 of 2008 and Article 40 of PBI No. 11/10/PBI/2009:

An Sharia Business Units (SBU) must spin off to become an Sharia Commercial Banks.

The spin-off program may be applied if the value of the SBU's assets have reached 50 percent of the parent conventional bank's total assets, or if 15 years have passed since the enactment of Law No. 21 of 2008 on Sharia Banking. To achieve that purpose, the growth of a sharia business unit's assets should be boosted to accelerate spin-offs from parent conventional banks.

This refers to the main conventional bank's average assets, which are very large. Thus the SBU's assets should also be driven in terms of the amount so their value will reach 50 percent.

## 2. *Fatwâ* Institution

*Fatwâ* is a Muslim religious practice that helps to mold the thoughts and actions of a society or persons on any special issue that affects social, economic, and personal interests.

The institution of *fatwâ* plays a vital role in a contemporary Islamic society with differing people and legal views.<sup>92</sup> Indonesia has an institution tasked to deal with many sharia banking and economic issues, namely the National Sharia Council-Indonesian Ulema Council.

<sup>91</sup> Article 17 of Law No. 40 of 2007 on Limited Liability Companies.

<sup>92</sup> Mehmood, *et al.* (2015).



It was established on a recommendation from the Sharia Mutual Fund Workshop in July 1997, which stated:

The National Sharia Council (DSN) should be established as an autonomous institution under the Indonesian Ulema Council (MUI).

Its formation aimed at implementing Islamic values in economic activities and in financial sectors such as banking, insurance, pawn shops, capital markets, mutual funds, and others.<sup>93</sup> Its legality was decided by Decree of the National Sharia Council No. 1 of 2000 on the Basic Guidelines for the National Sharia Board/Indonesian Ulema Council during the period of 1995 to 2000, and Decree of the Leadership Board of the Indonesian Ulama Council No. Kep-754/MUI/II/99 on the establishment of the National Sharia Council.<sup>94</sup>

At that time, the DSN-MUI only issued *fatwâ* as references in the development of contracts on the products of sharia financial institutions. After the enactment of Law 21 of 2008, the DSN-MUI became an institution legalized by the law and had full authority to issue *fatwâ* in the field of sharia economics.

All *fatwâ* issued by the DSN-MUI formally serve as references for sharia economic institutions, and this strengthens the DSN-MUI existence as the *fatwâ* issuer recognized by law. As stated in Article 1, paragraph 12 of Law No. 21 of 2008:

The sharia principle is the principle of Islamic law in banking activities based on a *fatwâ* issued by an institution that has the authority to stipulate *fatwâ* in the field of sharia.

The above article explicitly states the principle of Islamic law based on *fatwâ* issued by an institutional authority is the DSN-MUI development that is not contained in the previous regulations of Law No. 10 of 1998 on Banking, Law No. 23 of 1999, or Law No. 3 of 2004 on Bank Indonesia.

The DSN-MUI's members consist of scholars, practitioners, and experts in the field of economics and sharia *muâmalat* (agreements).

<sup>93</sup> Antonio (2001: 285).

<sup>94</sup> Nafis (2011: 82); Gayo, *et al.* (2011: 43–4).

In sharia, *muâmalat* involving interactions and exchanges among people provide considerably more room to develop and change the act to facilitate human interactions. For example, they promote justice in interactions and exchanges among people involved in such things as sales and sureties, stock exchanges, international trading, finance, and so on. All that is distinct from sharia *ibâdat*, which are ritual acts of worship, such as praying, fasting, or the *hajj*, which are not changed and remain constant.

### 3.5 The Influence of Sharia Banking Policy

#### Political Aspects

The political effects on a national scope are contained in three banking regulations. First, the early establishment of sharia banks in 1992. The political impact was the encouragement of the political superstructure to issue rules that support Islamic banks' existence. Government issued three regulations, Nos. 70, 71, and 72 of 1992 concerning Islamic banks with profit-sharing principles.

Second, the political impact entered into the legislature. Law No. 10 of 1998 on banking was enacted with much content about sharia banking principles. This law gave both executives and legislatures the responsibility of creating a sharia market more open to the public. In this period, double windows emerged in national banking. This reflects the emergence of interests in sharia banking policies shared by governments, markets, and Muslims.

Third, the insignificant economic impact on the development of Islamic banks, which was unable to rise to 5 percent of market share, required new regulatory encouragement that was politically more powerful.

Law No. 21 of 2008 on Sharia Banking marked the success of the collaboration between economic and religious elements that were supported by the political superstructure of the legislatures and in agreement over the Sharia Banking Act. In the same period, Law No. 19 of 2008 on State Sharia Securities was also enacted.<sup>95</sup>

<sup>95</sup> Law No. 19 of 2008 on State Sharia Securities containing 32 articles in 10 chapters, ratified and promulgated May 7, 2008, by President Susilo Bambang Yudhoyono.

Some previous legislation in the field of sharia economics or approved Islamism were enacted, such as Law No. 38 of 1999 on *Zakât* Management,<sup>96</sup> Law No. 17 of 1999 on *Hajj* Implementation,<sup>97</sup> and Law No. 41 of 2004 on *Waqf*.<sup>98</sup> Some products of legislation also supported the implementation of an Islamic economic system, such as Law No. 40 of 2007 on Limited Liability Companies, Law No. 3 of 2006 on Religious Courts, Law No. 3 of 2004, the Amendment to Law No. 23 of 1999 on Bank Indonesia, Law No. 21 of 2008 on the Financial Services Authority, and others.

All the above legislation shows the legislature understood the need to encourage the legality of the Islamic economic system in Indonesia. The changes in the paradigm of the legislative politics with Islamic economic nuances were also influenced by the political conditions of reform. As written by Azizy, the Reform Era has had a major impact on fundamental changes in social studies, especially in the fields of religion and politics.<sup>99</sup>

Compare this with Turkey. Research conducted by Seda and Selva Demiralp, published as “The Rational Islamic Law or Evidence from Islamic Banking,” showed that in 1997 the military-backed Turkish government coalition accused Islamic banks of funding radical Islamic movements.<sup>100</sup> Socially, Turkey is Islamic, but politically it has not been in favor of Islamic banks.

This thesis was confirmed by Filiz Baskan’s research in Turkey, which concluded that the political condition is parallel with the growth and development of Islamic financial institutions.<sup>101</sup>

<sup>96</sup> Law No. 38 of 1999 on the Management of Alms consists of 25 articles in 10 chapters, promulgated September 23, 1999, signed by President B.J. Habibie.

<sup>Then</sup> Law No. 38 of 1999, amended by Law 23 of 2011 on Management of Zakat, consisting of 47 articles in 11 chapters, ratified Nov. 25, 2011, by President Susilo Bambang Yudhoyono.

<sup>97</sup> Law No. 17 of 1999 on the Implementation of the Hajj containing 28 articles in 15 chapters, ratified and promulgated on May 3, 1999, by President B.J. Habibie.

<sup>98</sup> Law No. 41 of 2004 on Endowments contains 71 articles in 11 chapters, ratified October 27, 2004, by President Susilo Bambang Yudhoyono.

<sup>99</sup> Azizy (2002: 178).

<sup>100</sup> Demiralp and Demiralp (2004: 4).

<sup>101</sup> Filiz Baskan, “The Political Economy of Islamic Finance in Turkey: The Role of Fethullah Gulen and Asya Finance” in Henry dan Wilson (eds.) (2004).



*Effects on an International Scope*

Indonesia is a member of the OIC, an organization directly involved in the establishment of the IDB. At the ASEAN level, Malaysia has developed Islamic banks, and in some country's Islamic banks or other Islamic financial institutions have developed.

Establishing Islamic banks in the 1990s affected President Soeharto's international political bargaining power. In the 1990s, Soeharto was active in international roles and became chairman of the Non-Aligned Movement (NAM) in 1993.<sup>102</sup> Indonesia had been involved on an international scale, such as with APEC (Asia Pacific Economic Cooperation)<sup>103</sup> and AFTA (ASEAN Free Trade Agreement).<sup>104</sup> In the 1990s, Indonesia sustained tremendous progress in economic growth, in which big companies from rich countries invested in Indonesia.<sup>105</sup>

It is completely illogical for Indonesia not to respond to the development of Islamic banking and financial institutions. Moreover, Islamic banks and financial institutions have grown in politically non-Muslim countries.

The development of Islamic banks and finance in several European countries, Australia, and the United States may be observed in the research conducted by Belouafi and Belabes, researchers from the Islamic Economics Research Center, King Abdul Aziz University, Jeddah.<sup>106</sup> There is widespread development of Islamic banks in various countries.

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<sup>102</sup> The Non-Aligned Movement (NAM) was an international organization with more than 100 countries that had no alliance with any major power bloc.

<sup>103</sup> Asia Pacific Economic Cooperation (APEC) is a forum for economic, trade, and investment cooperation in the Asia Pacific region, established in 1989.

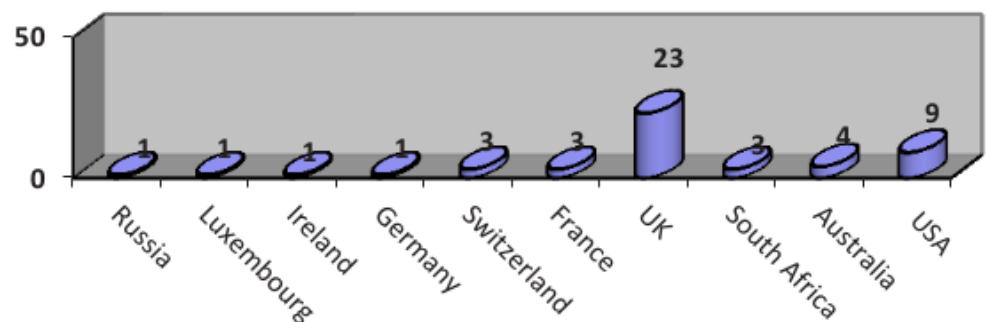
<sup>104</sup> AFTA (ASEAN Free Trade Agreement) declared at the fourth meeting of the Heads of ASEAN (ASEAN Summit) in Singapore in 1992.

<sup>105</sup> Sumawinata (2004: 9–10).

<sup>106</sup> Belouafi and Belabes (2010: 40).



Picture 3.1  
The Number of Islamic Banks in Several Countries



In terms of quantity, the above data is not yet significant, except for those growing in the UK. Their existence is not enough to prove the Islamization of financial institutions, but in terms of political recognition, their existence is very effective in the policies of non-Muslim countries.

**Banking Market**

The analysis of the banking market does not always use the macroeconomic scope, like in the research conducted by Katherine Johnson, “The Role of Islamic Banking in Economic Growth,” as explained in the literature review. Johnson found that the spread of Islamic banks does not have any significant influence on economic growth.<sup>107</sup>

There are many indicators in banking markets, such as an expansion of bank branch networks, the increased centralization of deposit and loan rates set by some banking organizations, the emergence of nationwide networks of automated teller machines, customer dynamics, and others.<sup>108</sup>

In this section, the Islamic banking market’s impact is simply confined to network expansion, namely the number of Islamic banks, the number of Islamic bank office networks, and Islamic banks’ market share.

<sup>107</sup> Johnson (2013).

<sup>108</sup> Moore, K.B., Amel, D.F. & Kennickell, A.B. (2008: 1).

A previous discussion explained that only one SCB was established between 1992 and 1998, and five sharia commercial banks, and 27 sharia business units were established between 1998 and 2008.<sup>109</sup> Sharia banking continued to grow up to 2011, as presented in Chart 3.1.

Chart3.1  
Number of Sharia Banks in 2008–2011

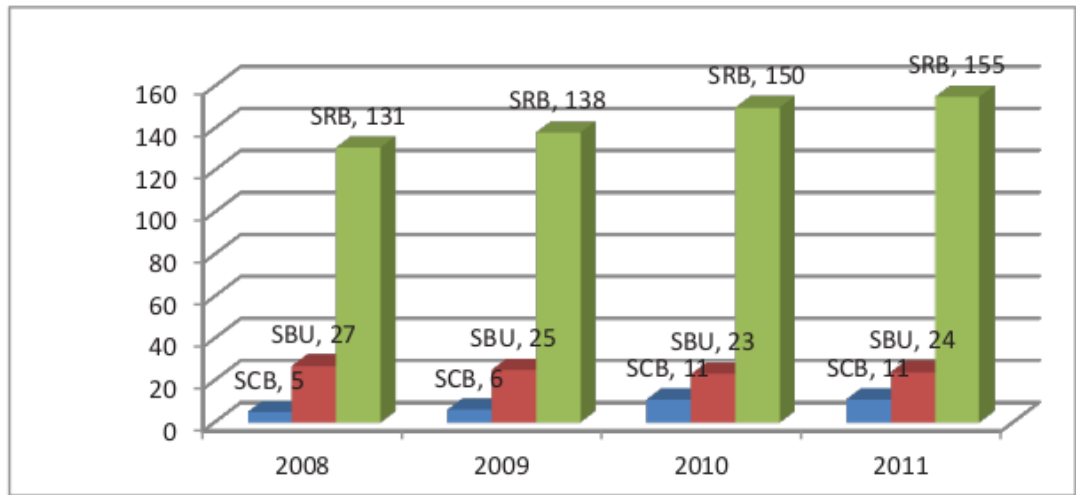


Table 3.1 shows that the number of sharia banks in Indonesia continues to increase, compared to the previous period of 1992 to 1998 when there was only one SCB. A significant increase of almost 100 percent in the number of SCBs occurs from 2009 to 2010. However, in terms of the number of institutions, the growth of sharia banks was dominated by sharia business units (24),<sup>110</sup> which was almost 60 percent, instead of sharia commercial banks (11).<sup>111</sup>

<sup>109</sup> See Table 4.2 in this chapter.

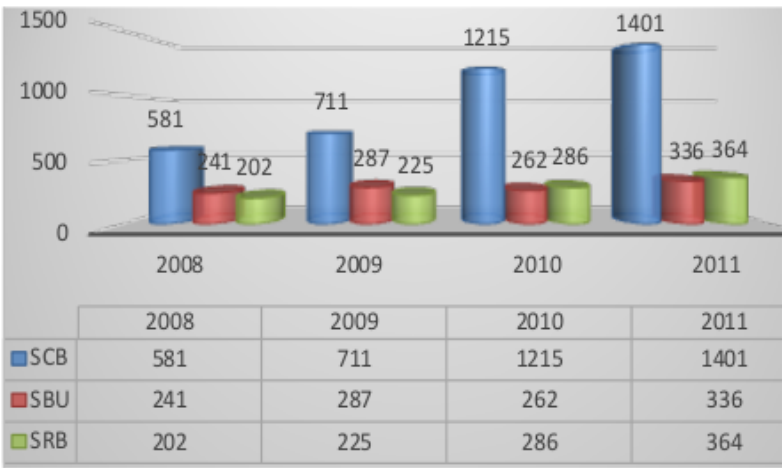
<sup>110</sup> The 24 Sharia Business Units are Bank Danamon, Bank Permata, Bank Internasional Indonesia (BII), CIMB Niaga, HSBC, Bank DKI, BPD DIY, Bank Jateng (Central Java), BPD Jawa Timur (East Java), BPD Banda Aceh, BPD Sumatera Utara (North Sumatra), BPD Sumatera Barat (West Sumatra), BPD Riau, BPD Sumatera Selatan (South Sumatra), BPD Kalimantan Selatan (South Borneo), BPD Kalimantan Barat (West Borneo), BPD Kalimantan Timur (East Borneo), BPD Sulawesi Selatan (South Makasar), BPD Nusa Tenggara Barat (West Nusa Tenggara), BTN, Bank Tabungan Pensiunan Nasional (BTPN), OCBC NISP, Bank Sinarmas, and BPD Jambi. Direktori Bank Indonesia (online), “Daftar Bank di Indonesia” (<http://bank-id.blogspot.com/2011/08/daftar-bank-sentral-bumndan-swasta-di.html>).

<sup>111</sup> The 11 Sharia Commercial Banks are Bank Syariah Mandiri, Bank Muamalat Indonesia, BNI Sharia, BRI Sharia, Bank Mega Indonesia Sharia, Bank Jabar and Banten Sharia, Bank Panin Syariah, Bank Bukopin Syariah, Bank Victoria Syariah, BCA Syariah, and MayBank Indonesia Syariah.

In terms of the number of office networks, SCBs developed far more than SBUs from 2008 to 2011. Sharia commercial bank office networks increased by 205 in 2008, 130 in 2009, 504 in 2010, and 186 in 2011.

Meanwhile, SBU office networks grew insignificantly, by an average of 55 per year: 40 in 2009, minus 25 in 2010, and 74 in 2011. In 2010, SBU office networks decreased because several sharia business units were spun off. In 2010 and 2011, the number of sharia business unit office networks was exceeded by the number of sharia rural bank office networks.

Chart3.2  
Number of Islamic Bank Offices in 2008–2011



During this period, regulation purification through a spin-off policy was quickly responded to by sharia business units, especially the two pillars of a government bank, namely BRI Sharia, which was spun off on December 19, 2008, becoming effective on January 1, 2009, and BNI Sharia, which was spun off on June 19, 2010. The spin-off was implemented by the state-owned Islamic bank as a sign of the government’s seriousness in encouraging national Islamic banking to develop from the institutional, capital, and economic aspects.

In the economic aspects, the development of Islamic banks tends to come in the growth of SBUs instead of SCBs. Conventional banks indecisively support the growth of Islamic banking, which may be observed from SBU assets as compared to SCB assets in 2008.

Table 3.5  
Assets of Sharia Banks in 2004–2008 (IDR billions)

Indicators	Year					Average
	2004	2005	2006	2007	2008	
Sharia Commercial Banks	12,527	17,111	21,151	27,286	34,036	
Amount of increase in assets		4,584	4,040	6,135	6,750	5,377.25
Growth		73.2%	80.9%	77.5%	80.2%	77.9
Sharia Business Units	2,684	3,769	5,571	9,252	15,519	
Amount of increase in assets		1,085	1,802	3,681	6,267	3,208.75
Growth		71.2%	67.7%	60.2%	59.6%	64.7

Source: *Indonesian Banking Statistics*, Vol. 8, No. 1, December 2009, 95.

Table 3.5 shows that the increase of SBU assets was quite significant in 2008, up to IDR 6.3 trillion, which is close to the increase of sharia commercial bank assets of IDR 6.7 trillion. From the perspective of SBU average growth, it always exceeds 50 percent or 64.7 percent. However, the significant growth and additions of SBU assets in 2008 insufficiently encouraged the acceleration of conversion from SBUs to SCBs for increasing the Islamic banking target of a 5 percent national market share.

The target even deviates far from Bank Indonesia’s “Blueprint of Islamic Banking Development”, in which one of the asset targets of Islamic banks is as follows:

Table 3.6  
Target of Islamic Banks’ Market Share

Year	2006	2007	2008	2009	2010	2011	2015
Market Share Target	1.6%	2.8%	5%	7%	9%	10%	15%

Source: Bank Indonesia (2007: 14).

Table 3.6 shows the market share growth target in 2011 was 10 percent and in 2015 was 15 percent. In fact, until 2016, as reported by the OJK, the growth of the Islamic banking market share was still at 4.86 percent as of July 2016.<sup>112</sup>

<sup>112</sup> Fuad (2016).



Subjectively, this condition was influenced by conventional bank businessmen who did not seriously encourage the growth of sharia banks. The number of banks and office networks of SBU is quantitatively higher than those of SCB, but the assets and capital of SBU are much smaller than those of SCB (see Chart 3.1 on the number of institutions compared to Table 3.5 on assets).

Therefore, the spin-off policy is a very strategic political policy to force conventional bank businessmen to “willingly” separate their SBU from the conventional parents, and the development of sharia banking will be deemed successful in economic terms.

### **Social Affairs**

#### **1. Dynamics of Customers**

Usually, bank customers only seek profits through deposit of funds or look for low credit charges, without any religious motivations. These are pragmatic or rational customers.

Sharia banks in Indonesia serve emotional customers. They are bank users who partners with a bank not just for profit but because they are motivated by religious factors.

For example, a person chooses to become a customer of a sharia bank because the bank uses sharia principles. This type of customer tends to be loyal when considering sharia banks as a substitute for conventional banking interest. That is *ribâ*. As stated by Will Kenton in *Investopedia* (online, updated Jan 8, 2018), *ribâ* is a concept in Islam that refers broadly to the concept of growth, increasing or exceeding illegal, exploitative gains made in business or trade, under Islamic law. Then, *ribâ* was made a concept in Islamic banking that refers to charged interest. It has also been referred to as usury, or the charging of unreasonably high interest rates. There is also another form of *ribâ*, according to most Islamic jurists, which refers to the simultaneous exchange of goods of unequal quantities or qualities.

Debates on bank interest as *ribâ* or transactions have been and are still long among Muslims in Indonesia. Kara, in his dissertation,

wrote a lot about the debates concerning banking interest and usurious transactions.

Prawiranegara,<sup>113</sup> Hatta,<sup>114</sup> and Singodimedjo<sup>115</sup> are some figures who did not agree banking interest was usury. Prawiranegara argued that bank interest is only rent, a reasonable interest rate, and does not violate the law, so it is not usury. Economic activity will be called usury if the profit taken is abnormal or exceeds the unnatural limits of the financial market and contains aspects of compulsion and powerlessness.<sup>116</sup>

Hatta said bank interest may be indicated to be *ribâ* if it contains an excessive consumerist element. When it is meant to achieve productivity and improve economic welfare, then it is only a rent mechanism.<sup>117</sup>

Singodimedjo did not argue that profit-taking in banking through interest is usury, since it is under government regulations, but he initiated Islamic economic institutions such as Bayt-ul-Mâl Wa-t-Tamwîl (BMT), and *zakât* and *waqâf* institutions as alternative financial institutions.<sup>118</sup>

The endless debate about banking interest and usury is a crucial aspect in the development of Islamic banks, since the spirit of anti-*ribâ* practices is a basic principle of Islamic bank formation.

To neutralize the banking interest debates, the Indonesian Ulema Council, as an institution that played a major role in the establishment of the first Islamic bank in Indonesia, issued the Decree of the Indonesian Council of Ulama's Fatwa No. 1 of 2004 on Interest (*fa'ida*).<sup>119</sup>

<sup>113</sup> Sjafruddin Prawiranegara (1911–1989) was an economics and financial expert. He was once the chairman of the Central Indonesian National Committee of Workers, in 1946. Dahlan, *et al.* 1997: 1415–6).

<sup>114</sup> Muhammad Hatta (1902–1980) was a populist economist and served as vice president during the Soekarno administration.

<sup>115</sup> Kasman Singodimedjo (1904–1982) was an Honoris Causa Doctor at the Faculty of Engineering, University of Muhammadiyah Jakarta in 1977. He was an important activist of the MASYUMI Party, as well as the Chairman of the Central Indonesian National Committee, which was the forerunner of the DPR.

<sup>116</sup> Prawiranegara (1988: 290).

<sup>117</sup> Hatta (1958).

<sup>118</sup> Singodimedjo (n.y.: 170–1); Kara (2005: 81–3).

<sup>119</sup> This *fatwâ* was issued by the IOC Fatwa Commission on 05 Dzul-hijah 1424H/January 24, 2004, signed by the Chairman of the Fatwa Commission KH. Ma'ruf Amin and Secretary Drs. Hasanudin, M.Ag.

In consideration of the *fatwa*, it explained:

1. Indonesian Muslims still question the legal status of interest (*fa'ida*) imposed in the transaction of lending (*qard*) or accounts payable (*dayn*), implemented by financial institutions or individuals;
2. The Ulama decision (*ijtima'*) of the Indonesian Fatwa Commission dated 22 Shawwal 1424 H/December 16, 2003, states the legal status of interest;
3. Therefore, the Indonesian Ulema Council deems it necessary to stipulate a *fatwâ* concerning interest to be a guideline.

The *fatwâ* exposed a debate regarding its effectiveness for reinforcing or addressing the government policy, economic market orders from sharia banking, or an urgent public need.

Ghafur conducted a study on the influence of the MUI's *fatwâ* on the prohibition of interest on the development of Islamic banking in Indonesia. The results show that it did not significantly influence the growth of Islamic banking.<sup>120</sup>

However, considering the normative aspects or literature used as the basis for the *fatwâ*, it is not an economic order from an Islamic bank, but is an aspect written in several books of *fiqh mu'tabar* (best Islamic jurisprudence book), and refers to various organizations' decisions, such as those of NU and *Muhammadiyah*, as well as international Islamic organizations' decisions.

In an interview with M. Syafi'i Antonio related to the MUI *fatwa*, he said it was purely a scientific matter, without attempting to encourage public awareness about banking interest.<sup>121</sup>

The *fatwâ* aimed to show that a national religious institution like the MUI was affirmative over the issue, namely Islamic banking, developing among Muslim people. With the *fatwâ*, the MUI has adopted the political and social responsibility to support the mission of keeping Islamic banks free of usury.

<sup>120</sup> Ghafur (2008: 335).

<sup>121</sup> Antonio, *interview*.



## 2. Developing Islamic Political Infrastructure

The change of the symbol or label from “Islam” to “sharia” in banking and economics had an impact on social development among politicians who used attributes with Islamic or sharia symbols. Although the phenomenon of Islamic or sharia symbol utilization was also influenced by the political conditions of reform in 1988, which gave the freedom to gather and argue as long as one did not violate Pancasila and the law.

Two different aspects concerning Islam or sharia are inherent in the political infrastructure. First, sharia may be defined as a purely political move, and second, as part of an Islamic economic system.

A movement in a purely political sense is an activity of a social group that tends to act like a pressure group;<sup>122</sup> thus the existence, movement, and goals to be achieved are commonly local and unsustainable. Examples of some Islamic political infrastructure in several regions have different names, and they commonly aim at creating political policies in the form of regional sharia regulations.

The reforms have made much Islamic political infrastructure develop in a purely political sense that seeks to access the executive branch and legislature to create various policies. Those Islamic political infrastructures are:

1. KPPSI (Preparatory Committee for the Enforcement of Islamic law) in Bulukumba, West Sumatra,
2. KPPSIB (Banten Preparatory Committee for Sharia Enforcement) in Banten, Java,
3. GPSI (Islamic Sharia Enforcement Movement) in Yogyakarta,
4. LP3SI (Assessment, Enforcement, and Application of Islamic law) in Garut, LPPI (Institutions for Islamic Studies and Development) in Tasikmalaya, and BPSI (Agency for the Assessment and Development of Islamic law) in Sukabumi, West Java,
5. FTJ (Thariqatul Jihad Front) in Kebumen, Central Java,

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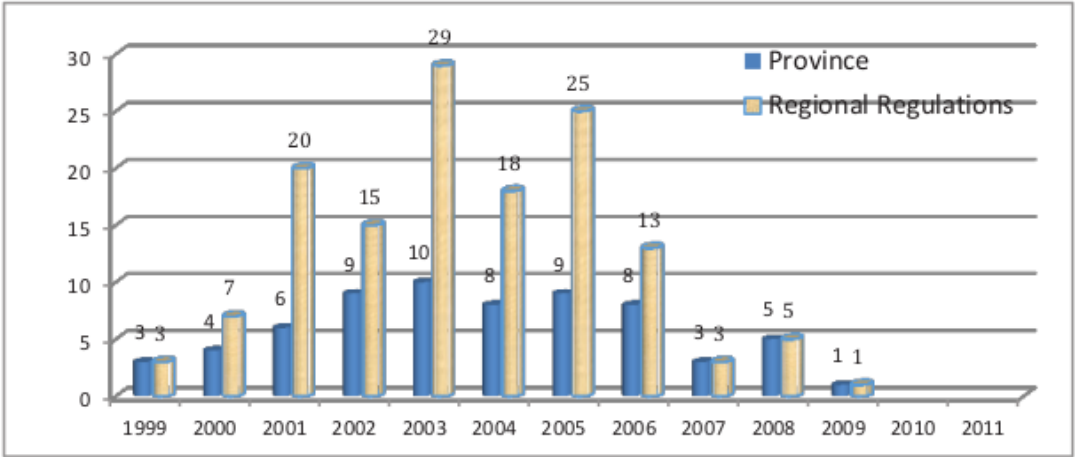
<sup>122</sup> Pressure groups intentionally form for a specific purpose and they specifically try to influence or pressure government officials to approve their demands. See Surbakti (1993: 140).



6. LPPSI (Preparatory Institution for Islamic law Enforcement) in Madura, East Java.<sup>123</sup>

The sharia-compliant political products grew rapidly, although they have started to decline since 2009. The number of regional sharia regulations per province may be viewed in the following chart:

Chart3.3  
Numbers of Provinces and Regional Sharia Regulations 1999–2011



Source: Jati (2013: 315).<sup>124</sup>

Chart 3.3 shows that in 2003, 29 regional sharia regulations were issued in ten provinces, while in 2009 only one sharia regulation was issued in one province.

In practice, many regional sharia regulations aiming at improving people’s moral and ethical behavior based on religion faced problems between sharia regulations as *lex specialis* and the highest legal products (*lex generalis*).<sup>125</sup>

3. Political Infrastructure of Islamic Economy

The important moment for political infrastructure in the Islamic economy field was the time of the establishment of the first Islamic

<sup>123</sup> Anugrah (2011: 51).  
<sup>124</sup> Dewi Candraningrum, “Perda Sharia and The Indonesian Women’s Critical Perspective,” SOAL, Vol. 1, No. 1, 2011, 1–2 in Jati (2013: 315).  
<sup>125</sup> Jati (2013: 310–11).

bank in Indonesia. In a political-economic perspective, it is clear that the relations between elements of the Islamic political infrastructure (MUI, ICMI, etc.) continue to struggle, which may influence the political infrastructure (the rulers) in the policy packages of GR Nos. 71, 72, and 73 of 1992, which provided opportunities for the establishment of a bank with profit-sharing principles.

Kahf explained that the existence of Islamic banks is a phenomenon of a new power awakening over the wealth of natural resources and the rise of Islamic thinkers, especially in the 1970s, when the DIB and the IDB emerged. The presence of Bank Muamalat supported by Islamic political power was a phenomenon indicative of the Islamic revival in Indonesia.<sup>126</sup>

In pure political theory, referring to Thaba's opinion, the condition at that time (1992) was a political accommodation of the government toward Islamic political infrastructure. It was harmonization of Islam and the government, especially after the Muslim acceptance of Pancasila as the single set of principles between 1985 and 1997.<sup>127</sup>

However, the Islamic political mainstream still refers to the substantive and prioritizing matters related to the meaning and contents, instead of the forms and symbols.<sup>128</sup> The reason is that Islam's practical political space has still hardly been realized, even though accommodation has taken place. Thus the existing political parties remain three, referring to Law No. 1 of 1985 on the Amendment to Law No. 15 of 1969 on General Elections.

Article 1, point 8 stated:

General Election is attended by three socio-political power organizations of Golongan Karya, Indonesian Democratic Party (PPP), and the United Development Party (PDI), which have the same position, rights, and obligations.

On the other hand, the Islamic political infrastructure's struggle in realizing the first Islamic bank in Indonesia was very intense, and

<sup>126</sup> Monzer Kahf, "Islamic Banks: The Rise of a New Power Alliance of Wealth and Shari'a Scholarship," in Henry and Wilson (eds.) (2004: 17–36).

<sup>127</sup> Thaba (1996: 250–70)

<sup>128</sup> Ahmad (2004: 120).

many government power elements, such as Soeharto's children, were supportive of the establishment of Islamic banks in Indonesia.

With these two contradictory matters, the economic aspects have been realized in the "formalization of an Islamic institution", Bank Muamalat, but in the political aspects it is still in the "substantialism of Islamic political parties", or there is no space for Islamic political parties.

Therefore, the establishment of BMI or several sharia rural banks before BMI was an anomaly, since the system used is explicitly a system with Islamic principles, which means that Islamic banks are a form of formalist Islam in Islamic financial institutions manifested in products that use contract agreements such as *mudâraba*, *mushâraka*, *murâbaha*, and others. In contrast, the New Order still did not provide more space for Islamic symbolism or elements in political parties.

Arbi Sanit stated that the establishment of Islamic social and political organizations was related to their social goals and demands.<sup>129</sup> Thus, to realize sharia banks and various policies that are in conformance to Islamic banks' objectives, various social organizations needed to encourage the realization of the ideal Islamic bank. In this case, the social organizations have emerged since 1992 in the Islamic economic fields, such as Asbisindo (the Association of Indonesian Islamic Banks),<sup>130</sup> the Sharia Economic Community (MES),<sup>131</sup> IAEI (Association of Islamic Economic Experts),<sup>132</sup> and others.

Many figures participated in the declaration of the IAIE, including Burhanuddin Abdullah (Bank Indonesia Governor), K.H. Ma'ruf Amin (Chairman of the MUI National Sharia Board/DSN), Achmad Subianto (Chairman of BAZNAS), Mustafa Edwin Nasution (University of Indonesia, Jakarta), Prof. Dr. Halide (Hasanudin University Makassar), and A. Riawan Amin (Director of Bank Muamalat Indonesia).

<sup>129</sup> Sanit (2010: 22–3).

<sup>130</sup> The Indonesian Syariah Bank Association (Asbisindo) established on 17 Ramadhan 1412 H/ March 31, 1992 in Bandung (<http://www.asbisindotraining.org>).

<sup>131</sup> The Sharia Economic Community (MES) established 1 Muharram 1422 H/March 26, 2001 M (<http://www.ekonomisyariah.org>).

<sup>132</sup> The Indonesian Islamic Economic Expert Association (IAEI) was declared on March 3, 2004, at the University of Indonesia, Jakarta (<http://www.iaei-pusat.org>).



MES's movements mostly involved academics, thus it did not eliminate the functions of MUI and ICMI as interest groups in the Islamic political economy. Moreover, the most important law against conventional banks was in the context of interest-based credit; it is thought to lack justice. This was Arne Brigsten's critique of the natural impacts of conventional banks.<sup>133</sup> However, to realize it, there was a dualism in the public response.

Regulations and politics play an important role in the Islamization of banking institutions. Pakistan's success in establishing Islamic banks was the result of President Zia ul-Haq's policy, through the Council of Islamic Ideology in 1979, leading to the establishment of large Islamic banks such as the National Bank, Muslim Commercial Bank, Habib Bank, and United Bank.<sup>134</sup>

However, the existence of an interest group encouraged various policies and the development of Islamic banks in Indonesia cannot be analogized as technocrats who have the power to give advice or pressure a policymaker. In the history of the New Order, a group of economic technocrats emerged as a very popular group, namely the "Berkeley Mafia".<sup>135</sup> Their existence in the environment of Indonesia's New Order government was very influential on policies made by the government.<sup>136</sup>

The end of the New Order, which led to the Reform Era, even eroded the important influence of the group of interest, the ICMI. Its existence was no longer significant for pushing its influence on national sharia banking policies and development.

<sup>133</sup> Chapra (2005: 328).

<sup>134</sup> Chapra (2001: 286–7).

<sup>135</sup> The Berkeley Mafia are alumni of the University of California, Berkeley, who received scholarships from the Ford Foundation. They are Widjojo Nitisastro, Ali Wardhana, Emil Salim, Subroto, Mohammad Sadli, and Soemarlin. These six people were the Economic Advisory Team appointed based on Presidential Decree No. 195 dated June 15, 1968. The Economic Advisory Team was needed to strengthen the Economic Stability Board chaired by President Soeharto. There were also influential technocrats in the government, Sumitro Dojohadikusumo, Radius Prawiro and Frans Seda. Mallarangeng (2002: 36–7). Rossotti (2018).

<sup>136</sup> Ricklefs (2007: 572–3).



#### 4. Criticism of the Sharia Compliance

Sharia compliance is the implementation of compliance in risk management, and in the corporate governance of Islamic banking. Constructive criticism is performed by domestic and foreign thinkers. Of the domestic thinkers, M. Dawam Rahardjo argued in his article "Criticism of Sharia Banking", which was published in *Kompas* on February 14, 2014. He did not hesitate to criticize the development of Islamic banks, which shifted from the epistemology of Islamic banks themselves.

It was proven in Indonesia that, besides non-optimal sharia compliance, some cases of criminal violation involving Islamic banking started to occur, such as the case of the fictitious IDR 102 billion in credit claimed by sharia commercial bank leaders in Bogor in October 2003.<sup>137</sup>

Some foreign thinkers who criticized Islamic banking include Munawar Iqbal *et al.* Their research, supported by the International Development Bank, on the best ten Islamic banks in several countries in 1994 to 1996,<sup>138</sup> showed that one-tier *murâbaha* multivariate investment is far more dominant than two-tier *mudâraba*.<sup>139</sup> The average financing accumulated in *murâbaha* is 70.19 percent, while in *mudâraba* it is only 7.29 percent. The Bahrain Islamic Bank is even financing with an average of only 1.93 percent, with *murâbaha* up to 92.63 percent.<sup>140</sup>

Salman Ahmed Shaikh, Director of the Islamic Economics Project in Pakistan, also criticized the profit-making mechanism in *mudâraba* in Islamic banks, which is based on only profit sharing without loss sharing.<sup>141</sup>

Noman was very appreciative of the International Association of Islamic Banks (IAIB, 1997), which reported a return of 70 percent

<sup>137</sup> This case stuck out nationally and stories about it were published in various print and online media on a national scale.

<sup>138</sup> The 10 banks: Albarakah Islamic Investment Bank, Bahrain Islamic Bank, Faysal Islamic Bank of Bahrain, Islamic Bank Bangladesh, Dubai Islamic Bank, Faysal Islamic Bank of Egypt, Jordan Islamic Bank, Kuwait Finance House, Bank Islam Malaysia Berhad, Qatas Islamic Bank.

<sup>139</sup> Iqbal, *et al.* (2002: 28).

<sup>140</sup> Iqbal, *et al.* (2002: 28).

<sup>141</sup> Shaikh (2011: 3).

of total assets. However, he criticized the achievement since it was obtained through a fixed return based on profit-and-loss sharing.<sup>142</sup>

Some of these criticisms socially show that Islamic banks have become one of the community's institutions of public concern and part of global economic activity. Therefore, their existence has been the concern of many parties in the sense of positive views, or even from the perspective of a purely economic approach such as in Katherine Johnson's research, "The Role of Islamic Banking in Economic Growth", which observed the impact of Islamic banks on a country's economic growth.

## 5. Human Resources Problem

Ebrahim and Kai Jo wrote that Islamic banks must adhere to two aspects: general jurisdiction and Islamic law (under a sharia council). Therefore, bankers or practitioners involved in Islamic banks must ideally be those who understand banking law and the Sharia Council.<sup>143</sup>

Referring to two aspects, namely general law and Islamic law as described by Ebrahim, sharia banking instruments in Indonesia are well established, especially after the enactment of Law No. 21 of 2008 on Sharia banking. Moreover, politically, the enactment of Law No. 21 of 2008 is supported by nine of the ten parliamentary groups in the House of Representatives.

Likewise, the developing methods of Islamic law products in Islamic banks have authorized the DSN-MUI to be the sole *fatwâ*-making authority, as stated in Article 1, paragraph 12 of Law No. 21 of 2008 on Sharia Banking. This means that Islamic law products developed in Islamic banks are almost strong and have no contradiction.

However, the legal infrastructure of established Islamic banks is not accompanied by the establishment of human resources, which are incidentally still dominated by conventional bank's output practitioners. This fact absently leads to a lack of synergism between banking policies referring to the law of business economy and the Sharia Council, which prioritizes the norms and principles of Islamic law.

<sup>142</sup> Noman (2002: 7)

<sup>143</sup> Ebrahim and Joo (2001: 321).

### 3.6 Political and Religious Integration in Sharia Banking Policy

Sharia banking is a manifestation of religious ways in economic activity that differ from other religious practices such as prayer, fasting, and the *hajj*. Islamic banking requires openness, inclusiveness, rationality, technological aspects, and political power to realize Islamic economic legality within national economic law and the public trust.

Historically, the idea of establishing sharia banks was often initiated by Nahdlatul Ulama (NU) and Muhammadiyah, the two largest Islamic social organizations in Indonesia, through *fatwâ* declaring bank interest to be *harâm* (forbidden). However, the idea was deadlocked because the political powers had not agreed to it. As stated by Muhammad Ali in *Islam and Economic Development in New Order Indonesia (1967–1998)*, Muhammadiyah and NU had long carried out economic activities before the New Order in 1965, but until the 1980s, the political role of Muslims was marginalized.

In the late 1980s, the public criticized the New Order government over its economic development policy for favoring the Chinese minority. Some Muslim businesspersons who studied economics and business in Western countries were not involved in the government.<sup>144</sup>

The above context shows the journey of the Islamic economy. Islamic banking in Indonesia was not realized until the 1980s because it did not have political support from the New Order. Even though, at that time, many Muslim businesspersons emerged, the rulers preferred *Chinese entrepreneurs*.

In the 1990s, the New Order was changing its political views against intellectual Muslims and some of the Islamic political infrastructure was accommodated in government.

The founding of the first Islamic bank in Indonesia in 1992 was evidence of Soeharto's political openness aimed at Islamic communities, such as the ICMI and MUI, so that they could drive government policy to intervene in economic markets in the field of sharia banking without opposition.

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<sup>144</sup> Ali (2004: 12).



The national political openness aimed at Islamic symbolization was parallel to the opportunity for establishing Islamic banks. The stronger position of Islamic politics created greater opportunity to establish Islamic banks, and a weaker position lowered the chances. This thesis was confirmed by Filiz Baskan's research in Turkey, that political conditions are parallel to the growth and development of Islamic financial institutions.<sup>145</sup>

Sharia banks in Indonesia are an important part of realizing the integration of politics and religion on the economic field. Sharia banking is an institution that has worldly economic activities, but it is also meant to carry out religious activities (*din*) through sharia contracts that are contained in the banking products, and their existence is supported by political power (*dawla*).

The political force resulting from political power (*dawla*), the force of the MUT's and ICMI's Islamic political infrastructure, and the force of Islamic businesspersons made it easy to establish the first Islamic bank. Then, the integration of religious activities (*din*) and politics (*dawla*) was realized with the reform of banking regulations; thus three government regulations, Nos. 70, 71, and 72 of 1972, were enacted.

This situation was far different from the process of establishing the BIMB. The success of the BIMB's establishment in 1983 as a full-fledge Islamic commercial bank socially and economically originated from the Tabung Haji program, which has been popular in Malaysia since 1963. It was operated by the Muslim Pilgrims Savings Corporation, which contributed 12.5 percent of the BIMB's total initial capital of RYM 80 million.<sup>146</sup>

Referring to the history of Tabung Haji, the establishment of the BIMB was dominated by an economical process (*dunyâ*) and it made Malaysia the world's country of reference for the model and development of Islamic banks.

Bank Muamalat's development had no embryo of sharia-based financial institutions as an encouraging factor, like Tabung Haji. Some

<sup>145</sup> Filiz Baskan, "The Political Economy of Islamic Finance in Turkey: The Role of Fethullah Gulen and Asya Finance," in Henry dan Wilson (eds.) (2004).

<sup>146</sup> Ariff (1988: 47). BIMB (Bank Islam Malaysia Berhad), the first Islamic bank in Malaysia, began operations in July 1983.



sharia rural banks were established in the early 1990s, but they were not rooted in society and were not related to the establishment of BMI, especially from the capital perspective.

The political aspects that were driven by the MUI and ICMI as *din* factors showed the Islamic political infrastructure had a dominant role in the establishment of BMI. Sukamdani Sahid Gitosardjono (a hotel owner and an advisor to the Da'wat Fund Foundation) stated that one day MUI Secretary-General Prodjokoesoemo and M. Amin Aziz, founder of the ICMI, discussed with him that they intended to establish an interest-free bank. Amin Aziz was appointed as the project officer for the establishment of a bank that did not deviate from Islamic law. They made a letter of request for permission from President Soeharto, sent through the Minister of State Secretary Moerdiono. Then, President Soeharto followed up on it by responding positively.

Soeharto intervenes subordinates; like ministers, state foundations, and even state-owned companies that have nothing to do with Islam, namely PT. PAL and PT. Pindad to involved in BMI's core capital. In the theory of the Islamic political economy, the state intervention in the economic field was called by Sadr *at-tadâkhulu-d-dawla*<sup>147</sup>, in which the state may intervene the social and economic affairs as part of its political responsibility.

Soeharto's favorable response was to a series of lobby efforts by the MUI's Preparatory Team for Islamic bank establishment. Karnaen said the lobbying teams were formed, politically, to persuade Soeharto to agree with the establishment of Islamic banks. First, Soeharto was lobbied by ministers, and second, by Soeharto's sons and daughters, and even by J.B. Soemarlin, who was a non-Muslim minister.

Moerdiono, Minister of State Secretary, arranged the schedules for the MUI lobby teams to meet President Soeharto. He emphasized that the idea of establishing an Islamic bank or a bank with a profit-sharing principle was not related to NII (Negara Islam Indonesia/Islamic State of Indonesia), or meant to revive the Presidential Decree of July 1959 concerning the running of Islamic sharia for its adherents.<sup>148</sup>

<sup>147</sup> Sadr (1981: 721).

<sup>148</sup> Perwaatmadja, *interview*.

Muhamad Syafi'i Antonio explained that the MUI team formulated the bank names, like the Indonesian Islamic Bank, Bank Muamalat Syariah Indonesia, Bank Muamalat Indonesia, and Bank Muamalat Islam Indonesia, that would be proposed to President Soeharto.<sup>149</sup>

The MUI team met President Soeharto in 1991,<sup>150</sup> as stated by Karnaen, who accompanied Hasan Basri as Chairman of MUI at the time:

The MUI team proposes two names, namely Bank Muamalat Islam Indonesia and Bank Muamalat Indonesia. Then, Soeharto chooses Bank Muamalat Indonesia (BMI), without further comment.<sup>151</sup>

Triyuwono, Professor of Brawijaya University, East Java, argued that Hasan Basri said:

Soeharto's political policy eliminates the word Islam from the bank's name, which is due to the word *Muamalat* has shown in Islam. Therefore, the President does not use the word Islam in the bank's name, to maintain the nation's unity, prevent *moyo* (Javanese, which means a source of social disease), and fearing that it will cause a commotion in the society.<sup>152</sup>

However, Karnaen stated that Soeharto did not give any further opinions like the above statement.<sup>153</sup> In this session, the author found the central figures in the process of establishing the first Islamic bank in Indonesia in 1992, namely B.J. Habibie and Karnaen Perwaatmaja. They were the rulers or part of the political superstructure, but also of the Islamic political infrastructure as the founding father of the ICMI.

The integration of the ICMI, MUI, and various people like businesspersons and bureaucrats had the power to influence the rulers in making policies that would strengthen the existence of Islamic banks.

In political terms, the process of establishing the first banks in Indonesia was dominated by political aspects, in comparison to the Islam-based economic transaction processes like those that brought

<sup>149</sup> Antonio, *interview*.

<sup>150</sup> The author has not had time to clarify the date, month, and year, and Mr. Karnaen died on Monday, July 10, 2017.

<sup>151</sup> Perwaatmadja, *interview*.

<sup>152</sup> Triyuwono (2000: 116); Basir (2009: 26).

<sup>153</sup> Perwaatmadja, *interview*.

about the establishment of Bank Islam Malaysia Berhad, which had been initiated by the social aspects of Tabung Haji since 1963 and was developed professionally by the Pilgrims Management and Fund Board in 1969.

The banking reform was supported by the religious council and political integration was a good phenomenon of the New Order, something exceptionally difficult to do in other aspects. Islamic sharia was stated in economic transactions and formalized in government regulations Nos. 70, 71, and 72 of 1992, which reflects Islam's omnipresence, that the Islamic religion is everywhere and gives appropriate moral guidance for human actions.<sup>154</sup> Referring to Fazlur Rahman's terms, it is a coherent totality offering solutions to life's problems.<sup>155</sup>

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<sup>154</sup> Binder (1988: 4).

<sup>155</sup> Rahman (1996: 241); Effendy (1998: 7).





# Conclusion

## 1. Islamic Political Infrastructure Movement

Political interrelations were politically antagonistic and less harmonious between the New Order government and Islamic political infrastructure before 1983, but it became a reciprocal relationship after that year.

In the early 1990s, the New Order changed its policies in relation to the Muslim movements, known as political accommodation. Even Soeharto, the New Order's President, appointed some ministers from the ICMI and the legislature also consisted of a lot of Muslims.

President Soeharto's initiatives helped to accommodate Muslim interests, but he did not fully implement Islamic political freedom. The governments' policy still upheld the "No to Islamic Politics" status quo of the New Order.

The presence of the first Islamic bank in Indonesia was a success of the Islamic political infrastructure to be an interest group. The ICMI and MUI, through B.J. Habibie, approached the political superstructure as a power holder to make policies that supported the establishment of Islamic banks.

Therefore, the important point in the political economy is that the bottom-up power was initiated by an interest group. The power of the political superstructure was not merely for the accommodation of interest groups, but the ruler was forced by the political infrastructure to create explicit policy products, such as Law No. 7 of 1992 on Banking and the packages of GR Nos. 70, 71, and 72 of 1992 marking the legality of establishing banks and rural banks with the profit-sharing principle.

Until 1988, the New Order had taken up an antithetical policy or antagonistic relationship to the Islamic struggle in Indonesia. The policy of the sharia bank was a "political anomaly" since the government still maintained "Islam in restriction" in the political field, but in the Islamic

economy field, implementing “Islamic formalization” by legalizing regulations and bank institutions with profit-sharing principles.

The New Order’s anomaly of understanding the formalism of Islam between the economic system and the political system was a success for the Islamic political infrastructure such as the ICMI, MUI, and Soeharto’s children in the 1990s to influence policy change. In the 1980s, LSAF (Institute for the Study of Religion and Philosophy) and the PPA (Center for Agribusiness Development) were the actors that greatly influenced the change in Muslim economic thinking in Indonesia.

Therefore, the success of the Islamic political infrastructure in realizing sharia banks and regulations showed that the Islamic movement in the economic field was a “synthesis” of the Islamic revival in Indonesia through the political process.

## 2. Policies on Sharia Banking

In the early 1990s, the Islamic political infrastructure tended to compromise, which was caused by political accommodation by the government. This made establishing Islamic banks easier, and also reforming banking regulations.

Reform of regulations allowed for the opening of Islamic banks, which was previously difficult to change. At that time, many regulations facilitated the establishment of Islamic banks, such as the package of the three Government Regulations, Nos. 70, 71, and 72 of 1992.

The regulatory reforms were continued by institutional reforms through realizing banks with sharia principles or profit-sharing principles. However, this reform has not been followed up by social reform or a change of the society’s views about sharia banks.

In terms of social reform, its success is still restricted on the *fatwā* of the ICMI, MUI, LSAF, and other organizations with respect to interest-free banks. However, it does not yet respond to people comprehensively. Islam-based community organizations such as NU and *Muhammadiyah* also did not respond concretely to the establishment of sharia commercial banks and sharia rural banks until 1998.

When political power left the New Order at the start of the Reform Era in 1998, it was the growing liberalism and freedom to express an opinion in political, economic, and social settings for the people.

Law No. 10 of 1998 on Banking, which changed the brand of Islamic full-fledged banks to sharia principles in banks, was a product of liberalization of the legislature. The word “sharia” explicitly appeared in several articles in Law No. 10 of 1998 as an extraordinary policy product since Islamization in legislation was a difficult policy in the New Order.

The actors involved in the policy process were not only interest groups and executives, such as the president and his ministers, but also the Islamic political infrastructure, namely Islamic political parties.

Policy liberalization also meant reducing the government’s role in banking regulations, which was manifested in the delegation of banking power from the Minister of Finance to Bank Indonesia following Law No. 23 of 1999 on Bank Indonesia.

Within ten years, Islamic banking policy returned to the track with the enacting of Law No. 21 of 2008 on Sharia Banking. It was the greatest moment of Islamic political economy.

Politically, the components of the Islamic political infrastructure or interest groups were not dominated by a single organization such as the ICMI in the early 1990s. Also, some Islamic political infrastructure grew in the mass organizations that concentrated on the sharia economy, such as MES (Sharia Economic Society), Asbisindo (the Indonesian Islamic Bank Association), the Association of Sharia Economic Experts (IAEI), the Sharia Economic Lecturers Association (ADESy), and others.

Economically, Law No. 21 of 2008 exposed Islamic banking purification. It was a long-term policy with a maximum duration of 15 years from 2008 to 2023.

Institutional purification took place with the spin-off of sharia business units if they had reached 50 percent of its parent bank’s capital or if 15 years had passed since the enactment of Law No. 21 of 2008, then the sharia business units had to convert to being full-fledged



sharia banks. There are to be no more sharia banks that serve only as conventional bank sub-institutions in the future.

### 3. The Effects of Sharia Banking Policy

The growth of sharia economics and banking in Indonesia influenced some elements. In the political context, the formal judiciary is more open to accommodating Islamic terms, as the public law contains sharia principles, such as *wadī'a*, *mudârabah*, *mushârah*, *murâbahah*, and *ijârah*. It was a new thing in the legal field, such as for religious courts, limited liability companies, Bank Indonesia, the Financial Services Authority, and others.

In the economic aspects, the presence of sharia banks allows more open competition among banks. In 2011, the 11 sharia commercial banks and 24 Islamic business units led to positive impacts, although in terms of capital assets, they were still far behind the sharia commercial banks. Also, from 2008 to 2011 the number of sharia commercial bank offices increased by an average of 205: by 130 in 2009, 504 in 2010, and 186 in 2011.

Meanwhile, sharia business units have not significantly increased their network offices, adding only an annual average of 55 units: 40 in 2009, minus 25 in 2010, and 74 in 2011. In 2010, the network offices decreased because several sharia business units were spun off. In 2010 and 2011, the number of network offices of sharia business units were exceeded by the number of sharia rural bank network offices.

The sharia business units' assets were indeed quite significant in 2008: up to IDR 6.3 trillion, equivalent to that of the Islamic commercial banks' combined IDR 6.7 trillion. The average SBU growth always exceeded 55 percent. However, this was not enough to accelerate the conversion of sharia business units to sharia commercial banks to achieve the target of a national market share of about 5 percent. As reported by the OJK, the growth of the Islamic bank's market share was still 4.86 percent in July 2016.

The above conditions, influenced by conventional banking business, had not seriously encouraged the growth of sharia banks. The number



of sharia business unit offices is higher than that of sharia commercial banks, but in terms of assets and capital, sharia business units have much fewer assets. Thus, the spin-off is a strategic political policy meant to force conventional banks to willingly separate their sharia business units and convert them into sharia banks.

Although the MUI supported the social aspects by issuing Fatwa No. 1 of 2004 on the prohibition of the system of interest charges, the issue of bank interest as *ribâ* or non-*ribâ* continued to be debated in public.

People are still partitioned into being rational and pragmatic customers of sharia banks. However, some people emotionally use sharia banking services without profit-taking, especially for *umrah* (minor *hajj*) registration services.

The positive impacts in the social domain are that the sharia economy-based political infrastructure, such as the Sharia Economic Community (MES), Asbisindo (the Association of Indonesian Islamic Banks), IAEI (the Association of Sharia Economic Experts), and others, are rapidly developing.

In the future, the integration of the political and religious fields is needed to drive Islamic economic development in Indonesia, as the country with the largest Muslim population. Indonesia must be a major player in world Islamic economic and business growth.





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