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Commentary

Strong economy with a dual banking industry and financial stability

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DESCRIPTION

In particular, prior research only offered scant information on the connection between digital payments and financial stability in a developing nation with a dual banking system, such as Indonesia, where conventional and Islamic banking coexist. This study aims to determine how digitization has affected Indonesia's financial stability, particularly banking stability. Using monthly data from December 2013 through July 2021, it analyses the relationship using the Vector Error Correction Model (VECM) and Vector Autoregressive (VAR) models. The Payment Penetration Ratio (PPR) serves as a proxy for digital payment transactions, while the Z-Score value for the Indonesian banking sector serves as a proxy for financial soundness. It also makes use of the Autoregressive Distributed Lag (ARDL) model to assess robustness. Since PPR and Z-Score co-integrated, the study claims that there is an equilibrium and long-term relationship between digital payment transactions and financial stability in Indonesia. Additional research shows a positive short-run relationship between the variables as well as a one-direction causal relationship between digital payments and financial stability. Despite being the largest Muslim nation in the world, Indonesia's assessment result revealed no connection between the stability of Islamic banking and digital payments. Even if there may not be much Islamic banking in the nation, it is anticipated that the influence will be greater if it does take off and win over the public and the government in the post-COVID era. Overall, the findings of our research are in favour of regulatory policies that enable stable banking and financial systems in developing nations with two different banking systems. Financial digitalization is one of the most important aspects of the contemporary financial landscape, especially in light of the Covid-19 pandemic's explosion. Contactless transactions have increased by 69% since January 2020, and according to Forrester Research, they will continue to expand at a 16.1% CAGR through 2021. Additionally, approximately 50% more consumers worldwide plan to use digital payments going forward than they did before the outbreak. In 2021, 82% of US citizens will use digital payments, up from 78% in 2020 and 72% five years earlier, predicts McKinsey. However, industrialised nations are not the only ones adopting financial digitalization more widely. In India, for instance, 33% more people now utilise digital payments than they did before the outbreak. In the meantime, digital payment usage in Indonesia increased significantly between 2018 and 2019, up to 300%, and it continued to grow in 2021, when 150 million transactions were recorded, a 24% rise from the total in 2020.

Digital transactions and digitisation are necessities in the future, but little is understood about their economic and financial ramifications. Looking at the literature, a few studies look at how financial technology, or digitalization, affects banking services and the economy as a whole. Studies generally concluded that the use of digital payments might enhance banking services, stimulate the economy, and raise GDP. Even fewer studies evaluate its impact on banking and financial stability in both developed and developing economies. The majority of research claimed that little was known about the connection between digital financial transactions and financial stability. Building on this line of inquiry, we employ a quantitative research approach to investigate the relationship between digitalization and financial system stability in Indonesia, a growing economy with a dual banking system that allows for the coexistence of Islamic (Lipton, 2009) and conventional banking. The Vector Autoregressive (VAR) and Vector Error Correction Model (VECM) are used, and the Autoregressive Distributed Lag (ARDL) model is used to further test the robustness of the model. The payment penetration ratio serves as a proxy for the digital payment transaction (PPR). The value of Z-Score for the Indonesian banking sector is used as a proxy for financial stability because the banking system dominates Indonesia's financial system. Additionally, the model has a number of control variables. Inflation, the measure of consumer confidence, money market rates, the expansion of the money supply, Covid-19 dummy variables, the issuing of electronic money regulations, and the size of Islamic banks are among them. We make use of monthly data from January 2013 through July 2021 that was obtained from the Central Bank of Indonesia, the Indonesian Financial Services Authority (OJK), and data stream and made available to the public.

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