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ECONOMIC POLICY UNCERTAINTY; IMPACT ON FINANCING RISK AND TOTAL FINANCING OF ISLAMIC BANKS

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Abstract: Slowing performance of the global Islamic financial economy amid economic uncertainty has led to a global increase in food commodity inflation due to disruptions in the food commodity supply chain and fertilizer scarcity, which in turn triggers food protectionism. This research focuses on the relationship between Economic Policy Uncertainty (EPU) and financing risk and total financing of Islamic banks in Indonesia. Time series data is used in this study, comprising 96 monthly data from January 2015 to December 2022, with analysis using Pearson correlation statistics. The first finding indicates a negative correlation between Economic Policy Uncertainty (EPU) and financing risk of Islamic banks, with a correlation coefficient of 72.9%. The second finding reveals a positive correlation between Economic Policy Uncertainty (EPU) and financing of Islamic banks, with a correlation value of 69.2%. Lastly, financing risk is negatively associated with financing of Islamic banks, with a correlation value of 94.7%.

Keywords: *Economic Policy Uncertainty (EPU), Financing Risk and Financing*

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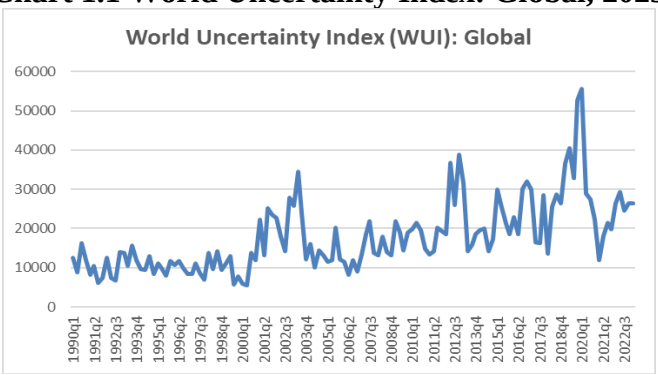
1. Introduction

Since the global financial crisis in 2008 and the COVID-19 pandemic, there has been a surge in global uncertainty. Global economic uncertainty has become a major concern for economists, policymakers, and financial institutions. They believe that uncertainty is a primary cause of crises and leads to economic downturns. The condition of economic uncertainty has been well-documented (Ahir et al., 2023), this can be seen in Graph 2, which shows the fluctuating but significant increase in the World Uncertainty Index during the period of 2018-2020.

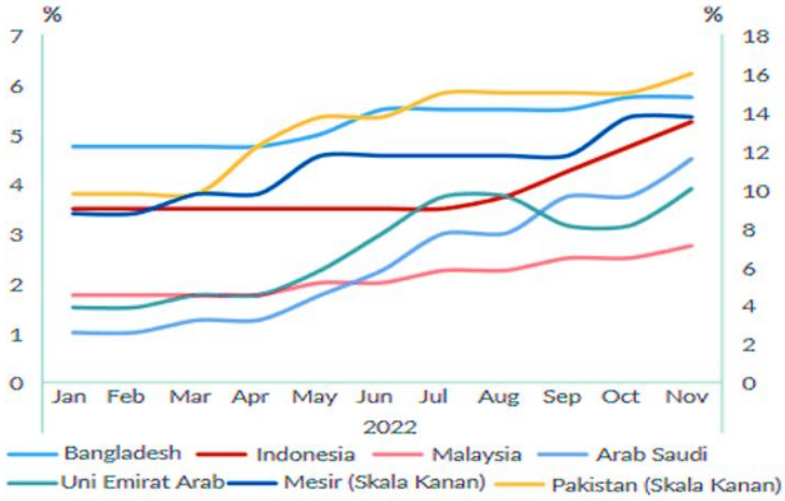
Chart 1.1 World Uncertainty Index: Global, 2023



Source: https://worlduncertaintyindex.com

The slowing performance of the global Islamic financial economy amidst economic uncertainty has led to an increase in global food commodity inflation due to disruptions in the food commodity supply chain and scarcity of fertilizer supplies, which in turn triggers food protectionism. Responding to the heightened global uncertainty caused by inflationary pressures, the majority of central banks, including several countries within the Organisation of Islamic Cooperation, have tightened their monetary policies. In advanced countries such as the United States and the European Union, monetary tightening through interest rate hikes has been implemented as a response to rising inflation, particularly in essential commodities such as food and energy. Similar measures have also been taken by member countries of the Organisation of Islamic Cooperation (Bank Indonesia, 2022).

Chart 1.2 Development of Organisation of Islamic Cooperation State Policy Interest Rates in 2022



Source: CEIC, Kajian Ekonomi & Keuangan Syariah, 2022.

Many literature has investigated the impact of economic uncertainty, with a significant focus on economic growth (Balcilar et al., 2016; Barrero et al., 2017; Pece et al., 2015). In terms of real economic aspects, the findings indicate that uncertainty is a major force leading to the depth and duration of economic downturns (Azzimonti, 2018; Bachmann et al., 2013; Baker et al., 2016). Al-Thaqeb & Algharabali, (2019) document that macroeconomic changes have a negative impact on firm income, particularly during adverse events (Bonsall et al., 2013). Therefore, it can be concluded that economic uncertainty leads to a decline in economic activity and influences balanced real economic growth.

Economic uncertainty also influences business financial decisions (Bonaime et al., 2018; Çolak et al., 2017), oil prices (Balcilar et al., 2016), and the Bitcoin market (Wang et al., 2020). Only a few studies have explored the relationship between economic uncertainty and the performance and risk of Islamic banks in Indonesia. These banks must navigate economic uncertainty in order to successfully achieve supply-side structural reforms for gradual development under the new normal era. Economic policy uncertainty (EPU) tends to cause volatility in financial markets and increase business risks for firms, potentially driving companies to make financial investments based on speculative savings motives and precautionary measures. Therefore, economic policy uncertainty affects the allocation of corporate financial assets.

Economic policy uncertainty (EPU) presents unique challenges for companies, as economic uncertainty creates stronger risk-taking incentives (Chatjuthamard et al., 2020). This is because economic policy uncertainty (EPU) has been shown to affect investors, leading to reduced firm activity and making it difficult for investors to assess company developments, ultimately resulting in decreased direct investment in firms (Liu et al., 2018). On the other hand, economic policy uncertainty (EPU) also influences interest rate movements, as an increase in interest rates typically reduces the value of future income. In such conditions, investors may choose to keep their money in banks rather than using it for investments. This is because excessively high interest rates also increase a company's cost of capital and make investment opportunities less attractive (Ozili, 2021b). Furthermore, uncertainty has a negative impact on stock returns (Dzielinski, 2012).

Regarding the relationship between uncertainty and credit risk, Caglayan & Xu, (2018) using a panel dataset from 18 countries worldwide during the period 1985-2013, found that economic policy uncertainty (EPU) reduces credit availability and increases credit risk and loan loss provisions. Consistent with these findings, economic policy uncertainty (EPU) has a negative impact on credit risk (Ozili, 2022; Wu et al., 2020). In contrast, Ng et al., (2020) found a positive impact of policy uncertainty on loan loss provisions, where higher economic policy uncertainty (EPU) leads to banks making larger loan loss provisions. Furthermore, Karadima & Louri, (2021), using a panel dataset from 507 banks in four regional countries (France, Germany, Italy, and Spain) during the period 2005-2017, found that economic policy uncertainty (EPU) has a positive impact on non-performing loans. Chi & Li, (2017) found that economic policy uncertainty (EPU) increases credit risk and leads to a decline in loan size.

Non-performing loans reflect the bank's ability to collect the credit it has disbursed. High levels of non-performing loans can affect a bank's lending policy, making them more cautious. Banks that continue to lend when non-performing loans are high are considered risk-takers. Many studies have found that higher non-performing loans reduce the level of lending, indicating a negative relationship between non-performing loans and credit (Ismawanto et al., 2020; Kesuma, 2018; Khairiyah et al., 2022; Rosalina et al., 2019). This means that if the level of non-performing loans in a bank is high, its credit disbursement will be low because the bank's capital or profits are reduced and allocated as provisions for credit risk. In contrast, some studies have found a positive relationship between non-performing loans and credit, indicating that higher non-performing loans have a significant impact on the credit provided (Kurniati & Putri, 2020; Oktaviani & Pangestuti, 2012). Recent studies have focused on bank lending channels, where economic policy uncertainty (EPU) slows down US credit growth and ultimately harms the economy (Bordo et al., 2016; Buch et al., 2015; He & Niu, 2018). Specifically, the negative effect of economic policy uncertainty (EPU) on loan growth is more pronounced for large banks and risky banks (Hu & Gong, 2019).

The effect of increased risk from economic policy uncertainty (EPU) on business performance has been well-documented (Wu et al., 2020). Higher economic policy uncertainty (EPU) increases the likelihood of company defaults and transmits higher risks to commercial banks. Additionally, increased economic uncertainty hampers the ability to accurately forecast investment project returns, thus reducing bank income (Peng et al., 2018). Conversely, economic uncertainty can incentivize banks to seek higher returns by investing in high-risk projects with high returns (Dell'Ariccia et al., 2014), a behavior that can potentially increase risk-taking and business performance of banks. In contrast to existing

literature, other studies have added variables that directly examine the relationship between bank risk, governance, and performance (Aljughaiman & Salama, 2019; Nahar et al., 2016).

Uncertainty cannot be directly measured, and therefore, several proxy measures have been proposed in the literature in an attempt to indirectly quantify it. Some measures of uncertainty are based on stock market volatility (Baker & Bloom, 2013; Bloom, 2009; Caldara et al., 2016), while others utilize forecast errors based on data collected from surveys (Bachmann et al., 2013; Jurado et al., 2015; Rossi & Sekhposyan, 2015). Furthermore, in the literature, some measures are based on the frequency of references to specific keywords, such as "uncertainty," in newspaper articles (Zalla, 2017).

This study focuses on the relationship between economic policy uncertainty (EPU) and financing risk and total financing of Islamic banks in Indonesia, using the economic policy uncertainty index (EPU index) developed by Baker et al., (2016). This widely used index is based on articles from major newspapers in the United States and other countries, including France, Germany, Italy, and Spain. Given that the Islamic banking system is believed to provide solutions for building a more stable and secure banking system, as it has better stability compared to conventional banking systems (Cihak & Hesse, 2008; Hasan & Dridi, 2010; Parashar & Venkatesh, 2010), the hypotheses proposed in this research are as follows:

H1: Economic policy uncertainty (EPU) has a positive relationship with financing risk in Islamic banks.
H2: Economic policy uncertainty (EPU) has a negative relationship with total financing in Islamic banks.
H3: Financing risk has a negative relationship with total financing in Islamic banks.

2. Research Method

This study uses time series data consisting of 96 observations from January 2015 to December 2022 in Islamic banks in Indonesia. The data was obtained from the statistical reports of Islamic banking (Otoritas Jasa Keuangan, 2023) and the well-documented Economic Policy Uncertainty (EPU) data (Baker et al., 2023). Pearson correlation statistics are used to test the correlation between Economic Policy Uncertainty (EPU), financing risk, and total financing. Pearson correlation statistics measure the statistical relationship or association between two continuous variables (Ozili, 2021a) and the strength of association between two variables (Gujarati & Porter, 2009).

There are three variables in the analysis: The first variable is the EPU variable, which is the EPU index based on Baker et al., (2016). The EPU index developed by Baker et al., (2016) consists of four components: (1) Disagreement on government purchases component, (2) News-related component, (3) Tax code expiration component, and (4) Disagreement on consumer price index (CPI) forecast component (Ozili, 2021a). The second variable is the financing risk variable, measured using the non-performing loan to Gross Loan Ratio. This is a measure of credit risk and asset quality (or loans) in the banking sector (Ozili, 2019). Since this study focuses on Islamic banking, the calculation used for the financing risk variable utilizes the non-performing financing ratio. Lastly, the third variable is the total financing provided by Islamic banks to customers.

3. Results and Discussion

3.1. Results

Table 3.1 Results of Pearson Correlation Analysis

Correlations

		EPU	Risk	Financing
EPU	Pearson Correlation	1	-.729**	.692**
	Sig. (1-tailed)		.000	.000
	N	96	96	96
Risk	Pearson Correlation	-.729**	1	-.947**
	Sig. (1-tailed)	.000		.000
	N	96	96	96
Financing	Pearson Correlation	.692**	-.947**	1
	Sig. (1-tailed)	.000	.000	
	N	96	96	96

**. Correlation is significant at the 0.01 level (1-tailed).

Source: Data Processing, 2023

Based on the conducted analysis, the results in Table 3.1 show that the correlation between EPU and financing risk yields a Pearson correlation value of -0.729. This result indicates a negative relationship between economic policy uncertainty (EPU) and financing risk in Islamic banks of 72.9%. Therefore, the hypothesis proposed in this study can be rejected since the obtained value is negative, indicating a strong relationship as it falls within the range of >0.5-0.75 (Sugiyono, 2019).

Furthermore, the correlation between EPU and total financing results in a Pearson correlation value of 0.692. This suggests that economic policy uncertainty (EPU) has a positive relationship of 69.2% with total financing in Islamic banks. This relationship can be categorized as strong since the value falls within the range of >0.5-0.75 (Sugiyono, 2019). The conclusion drawn from the proposed hypothesis in this study can be rejected based on the positive value obtained.

Lastly, the correlation between financing risk and total financing in Islamic banks yields a Pearson correlation value of -0.947. This indicates that financing risk has a strong negative relationship of 94.7% with total financing in Islamic banks, falling within the range of >0.75-0.99 (Sugiyono, 2019). Thus, it can be concluded that the hypothesis proposed in this study is accepted since the obtained value is negative.

3.2. Discussion

Table 3.1 presents the complete correlation results consisting of 96 monthly data from the years 2015 to 2022, which were used as the sample. As observed, economic policy uncertainty (EPU) is negatively correlated with financing risk in Islamic banks, with a correlation coefficient value of 72.9%, which is statistically significant. The negative sign on the correlation coefficient indicates that when economic policy uncertainty increases, financing risk in Islamic banks decreases. This condition can occur due to its influence on confidence and trust, where economic policy uncertainty can disrupt the confidence and trust of market participants, including lenders. High uncertainty can create uncertainty in economic prospects, policy direction, and overall market conditions. This can reduce lenders' confidence in borrowers' ability to repay loans, leading Islamic banks to exercise caution in providing financing and tighten financing requirements.

Moreover, considering its impact on the business cycle, economic policy uncertainty can affect the overall business cycle. Policy changes or uncertainty about policy changes can create fluctuations in economic conditions, including economic growth, interest rates, inflation, and consumer demand. An unstable business cycle can increase credit risk as the risk of default becomes higher during economic slowdowns or uncertainties.

The findings of this study also support previous research conducted by Ozili, (2022) and Wu et al., (2020), which state that EPU has a negative relationship with credit risk. However, these findings do not support the findings of (Karadima & Louri, 2021; Ng et al., 2020), who found a positive relationship between economic policy uncertainty (EPU) and the magnitude of non-performing loans in banks. These findings indicate that the turbulence caused by economic policy uncertainty, where higher values of EPU result in lower financing risk in Islamic banks, suggests that Islamic banks are able to minimize financing risk when economic policy uncertainty is high. Therefore, it is possible that the Islamic banking system provides a solution for building a more stable and secure banking system, as it is free from riba (interest), maysir (gambling), and gharar (uncertainty), which are absent in conventional banking systems. These findings further strengthen previous research (Cihak & Hesse, 2008; Hasan & Dridi, 2010; Parashar & Venkatesh, 2010) that demonstrate the superior stability of the Islamic banking system compared to the conventional banking system.

The second observation is that economic policy uncertainty (EPU) correlates positively with the total financing of Islamic banks, with a correlation value of 69.2%, which is statistically significant. The positive value indicates that as the level of economic policy uncertainty increases, the amount of financing provided by Islamic banks to customers also increases. This suggests that Islamic banks are able to maintain their condition during periods of rising economic policy uncertainty. This is because Islamic banks can provide high levels of financing to their customers. This condition may occur when efforts are made to stimulate economic growth. In situations of economic uncertainty, the government or monetary authorities may take policy measures designed to stimulate economic growth. For example, they may lower interest rates or provide credit incentives to boost economic activity. These actions can encourage financial institutions to extend credit due to lower borrowing costs or incentives to lend to potential borrowers.

Furthermore, this also occurs when there is an increased demand for financing. In situations of economic uncertainty, some economic agents may face financial difficulties or seek additional funding to cope with the uncertainty. This can lead to an increase in the demand for financing from borrowers who seek additional liquidity or working capital, and Islamic banks are able to respond by increasing their provision of financing to meet the rising demand. The findings of this study also support previous research indicating that economic policy uncertainty (EPU) hinders credit growth in the United States and ultimately harms the economy (Bordo et al., 2016; Buch et al., 2015; He & Niu, 2018; Hu & Gong, 2019). Specifically, the negative effect of economic policy uncertainty on loan growth is greater for large banks and risky banks (Hu & Gong, 2019). Based on these previous findings, which primarily focus on conventional banks, it can be concluded that Islamic banks are stronger and more stable than conventional banks.

The third observation reveals that there is a negative relationship between financing risk and total financing provided by Islamic banks, with a correlation coefficient of 94.7% and statistical significance. This negative value indicates that higher financing risk reduces the provision of financing to customers of Islamic banks. It implies that when financing risk is high, it signifies a decline in the bank's health and a decrease in the level of financing

disbursement. Therefore, Islamic banks must ensure that their total financing provision stays away from financing risks. However, if an Islamic bank fails to manage its financing properly, it may need to reduce the financing provided to customers. Additionally, Islamic banks adhere to Sharia principles, including principles of justice and business sustainability. High financing risk can jeopardize the business sustainability of Islamic banks as it can lead to significant losses and potentially disrupt compliance with Sharia principles. Therefore, Islamic banks tend to be more cautious in evaluating and minimizing high financing risks to ensure good business continuity.

These findings are consistent with previous studies conducted by (Ismawanto et al., 2020; Kesuma, 2018; Khairiyah et al., 2022; Rosalina et al., 2019), which indicate a negative relationship between non-performing loans and credit provision. This negative relationship implies that an increase in non-performing loans is followed by a decrease in credit disbursement, and vice versa. Increasing financing provided to customers is likely to have low financing risks, but if the opposite occurs, it is still considered a normal situation due to the increase in non-performing loans resulting from increased credit. However, if the non-performing loans exceed the maximum threshold set by Bank Indonesia, it can limit or even reduce the financing disbursement by Islamic banks.

4. Conclusion

This study examines the correlation between economic policy uncertainty (EPU) and financing risk as well as total financing disbursement. The findings indicate that economic policy uncertainty (EPU) has a negative correlation with financing risk in Islamic banks, with a correlation coefficient of 72.9%, which is statistically significant. Therefore, the first hypothesis can be rejected. The second observation shows that economic policy uncertainty (EPU) has a positive correlation with total financing disbursement in Islamic banks, with a correlation coefficient of 69.2%. Hence, the second hypothesis can be rejected. The final observation reveals that financing risk has a negative relationship with total financing disbursement in Islamic banks, with a correlation coefficient of 94.7% and statistical significance.

The implications of these findings suggest that the performance characteristics of Islamic banks can influence the correlation between economic policy uncertainty (EPU) and financing risk as well as total financing disbursement. Secondly, bank regulators should intensify their supervision and regulation efforts to ensure that banks do not take excessive risks during periods of high economic policy uncertainty (EPU). Existing supervisory mechanisms can help mitigate the impact of increased economic policy uncertainty (EPU) on financing risk and total financing disbursement. Thirdly, risk managers in Islamic banks should pay more attention to the shocks of policy uncertainty. They need to make more frequent adjustments to financing risk management indicators in response to expected and unexpected changes in economic policy. This will ensure that risk managers balance profitability with manageable risks when lending to borrowers in the real economy.

One limitation of this study is the use of simple correlation tests. Another limitation is related to the weaknesses of the economic policy uncertainty (EPU) index, as it is only available for advanced countries and not for developing countries. Additionally, the economic policy uncertainty (EPU) index does not account for other components that can affect economic policy uncertainty (EPU), such as government elections, trade wars, and oil price crises. Finally, the economic policy uncertainty (EPU) index is mostly based on text

search newspaper archives, which can pose some comparative issues when analyzing economic policy uncertainty (EPU) across different countries.

These findings also suggest potential topics for future research, where more studies are needed on the correlation between economic policy uncertainty (EPU) and other performance indicators in banks. Further research should also investigate the balance between economic policy uncertainty (EPU) and performance indicators in non-bank financial institutions. Future research can provide more insights into the influence of economic policy uncertainty (EPU) on financial inclusion.

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