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# Development, Social Change, and Islamic Finance in Contemporary Indonesia

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

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## 1. INTRODUCTION

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

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

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

Two transformations have occurred in the Muslim world in the past decade—each occurring alongside the rise of Islamic orthopraxy—that suggest different perspectives on consumers'

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

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

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

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

Rather than starting with the customers of Islamic banks and determining what characteristics they share, this paper starts with all potential consumers and investigating the factors that separate those who use Islamic financial products from those who do not. The result is the first comprehensive study of the individual-level determinants of the use of Islamic financial products in a majority-Muslim country, using data from an original, nationally-representative survey in Indonesia—which has both a large conventional banking industry and a large and growing Islamic financial industry. There is robust evidence supporting the class and internationalist approaches to the sources of demand for Islamic financial products: the frequency with which Indonesian Muslims report using Islamic financial products increases both as a function of family income and of respondents' views of the importance of establishing strong political ties with Saudi Arabia. In sharp contrast with the existing empirical literature—including the only existing study of consumer attitudes toward Islamic banks in Indonesia (Abduh & Omar, 2007)—there is no evidence that Islamic piety is even a partial

determinant of the use of Islamic financial products in Indonesia. These findings cannot be explained by differential access to Islamic financial products among different segments of the Indonesian Muslim population, nor can they be explained simply by the ability of wealthier Indonesians to diversify their holdings across different kinds of financial products.

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

## 2. ISLAMIC FINANCE: AN OVERVIEW

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

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

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

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

trade-based transactions and profit-sharing agreements. Trade-based transactions work as a form of deferred sale. Working with the above transaction, instead of providing a loan to the entrepreneur, the bank simply buys the machine itself, and then sells it to the entrepreneur. The bank bills the entrepreneur for the cost of the machine plus a service charge. This contract form is known as *murabaha*. The entrepreneur and the bank may also negotiate a separate contract in which the entrepreneur may defer portions of the payment into the future; this is known as *bai bithaman ajil*. Related contract forms exist which allow the entrepreneur to lease the machine (*ijara*), often with the option to purchase it at the end of the term of the lease (*takjiri*). What makes these contract forms permissible is that the bank takes legal possession of the machine before selling it to the entrepreneur, which many Islamic scholars interpret as meaning that the bank has exposed itself to risk. In practice, however, the period of legal possession may be extremely short, measuring only in seconds. In such cases it is clear that the bank's "service charge" functions nearly identically to interest in conventional financial systems.

Profit-sharing agreements, by contrast, resemble venture capital. Under such contracts, the bank provides a loan to the entrepreneur, but retains a right to an agreed-upon percentage of all of the future profits that flow from the entrepreneur's investment. Where the bank provides all of the financing for the machine, the contract is known as *mudharabah*; where the bank provides only some of the financing, the contract is known as *musharakah*. Scholars interpret this as compatible with Islamic principles because the bank is exposed to the same risk as is the entrepreneur, for the investment may not yield future profits. The profit-sharing clauses in such contracts therefore bear much less resemblance to interest in conventional financial systems than do the trade-based transactions described in the previous paragraph. However, in the same way that venture capital is ill-suited to the day-to-day financing needs of businesses and consumers, profit-sharing contracts such as *mudharabah* and *musharakah* are seldom used for basic business and consumer lending activity (Zubair, 2002).<sup>3</sup>

From these two types of contracts Islamic financiers have synthesized a wide range of financial products, from group insurance (*takaful*, see Abdul Rahim, Lewis, and Kabir Hassan (2007)) to savings and deposit accounts (*wadiah* and other forms, see Haron (1998)) to equity investments of various sorts (see Warde (2000, pp. 138–142)). The economist Mahmoud El-Gamal (2006, p. 176) concludes that "beyond doubt . . . any conventional financial product can be synthesized from premodern contracts." In a world where financial engineering makes the synthesis of Islamic financial products from permissible Islamic contracts straightforward and instantaneous (and thereby costless), the difference between Islamic and conventional contracts is not one of substance (see also El-Gamal, 2008).

The preceding discussion indicates that in a developed financial market, Islamic financial institutions and conventional financial institutions offer products that from the standpoint of the consumer are *functionally identical* in terms of their ability to fulfill consumers' goals of obtaining financing, deposit-taking, and other functions. Their difference lies exclusively in whether or not the products offer the additional feature of being synthesized using contract forms that are deemed consistent with Islamic principles.

### 3. DATA AND METHODS

To study the factors that shape individual use of Islamic financial products, I employ original survey data collected in

Indonesia during May–June 2008. The survey was large, including 2548 Indonesians (2241 Muslims, or 88% of the total sample), and drew respondents from every province in the country through multistage random sampling (see AUTHOR). The survey focused on issues pertaining to individual views of contemporary economic and political conditions in Indonesia. Uniquely among such surveys, it included a battery of survey items pertaining to respondents' views of Islamic finance products along with a rich set of covariates covering personal religious practices, demographic characteristics, and political attitudes.

Indonesia is a good context for studying individual preferences for Islamic finance because it is a large, diverse, relatively financially open majority-Muslim democracy (Juoro, 2008). Indonesia has a large and diverse conventional financial system which in recent years has grown to include a number of domestic and foreign banks which offer what in Indonesia are known as "sharia-compliant" financial products through special "sharia windows" or "sharia offices." Some people's credit banks (known as *Bank Perkreditan Rakyat*, and connoting small-scale banks that offer savings accounts and make loans to local businesses (Sunarto, 2007, pp. 6–7)) offer sharia-compliant products as well. There are also a number of banks that offer only exclusively sharia-compliant products. Following Indonesian conventions, I denote banks that offer exclusively Islamic financial products as sharia banks (*bank umum syariah*), units within conventional banks that offer sharia-compliant products as sharia units (*unit syariah*), and sharia-only branches of conventional banks as sharia offices (*kantor unit syariah*). To avoid terminological confusion, and again following local convention, I denote all financial products that are compliant with Islamic financial principles—regardless of whether they are offered by sharia banks or conventional banks with sharia units—as sharia banking products. My focus in this paper is not on consumers' use of sharia banks versus sharia units within conventional banks, but rather on sharia banking products themselves.<sup>4</sup>

Indonesia is also a good context to explore the consumer demand for sharia banking products due to the marked social changes that have accompanied modernization and globalization in recent decades (Robison, 1981; Tanter & Young, 1990). Analysts of contemporary Indonesian politics and society have noted the vigorous renewal of a Muslim identity dating from the 1980s (Effendy, 2006; Fealy & White, 2008; Sukma & Joewono, 2007). The confluence of modernization and globalization, on one hand, and Islamic renewal, on the other, suggests that these processes are intertwined in what Fealy (2008) has been termed "commodified religion and aspirational piety." It has become nearly impossible to speak about contemporary Indonesian Islam without noting how it has been shaped by the twin forces of modernization and globalization, and how Islam in turn shapes local discourse about Indonesian society, polity, and economy (see e.g. Rudnyckyj, 2009). The Indonesian case therefore presents an opportunity to tease out the role of piety versus other socioeconomic transformations in shaping the demand for Islamic finance.

Some data from Bank Indonesia (2010) give a general picture of the structure of the Indonesian financial industry (see Table 1).

While most Indonesian financial institutions remain in the conventional sector, the past 5 years have witnessed an explosive growth in the number of sharia banks and sharia units. Figures indicate that as a percentage of total banks, and as a percentage of total funds in circulation and private bank assets, sharia banks and sharia units occupy a relatively small portion of the Indonesian banking market. Yet the growth

Table 1. *Sharia banks and sharia units, 2005–10*

	2005	2006	2007	2008	2009	2010
Sharia banks						
Total banks	3	3	3	5	6	10
Total offices	301	346	398	576	711	1113
Sharia units						
Total banks	19	20	26	27	25	23
Total offices	133	163	170	214	287	251
General banks <sup>a</sup>						
Total banks	131	130	130	124	121	122
Total offices	8236	9110	9680	10,868	12,837	13,246
Ratio of sharia funds to conventional funds <sup>b</sup>	1.42	1.44	1.28	1.65	2.05	2.55
Ratio of sharia assets to conventional assets <sup>c</sup>	1.42	1.58	1.67	2.16	2.63	2.93

Source: Bank Indonesia (2010). All figures are for December, except for 2010 (July).

<sup>a</sup> Includes those banks with and without sharia units.

<sup>b,c</sup> The numerator includes funds and assets from sharia units at conventional banks.

Table 2. *Use of banks, sharia compliant banking products, and beliefs about interest*

	USE SHARIA PRODUCTS				Total
	Never	Sometimes	Often	Always	
<i>FORBID RIBA</i>					
Strongly disagree	6	2	0	2	10
Somewhat agree	293	31	9	4	337
No opinion	106	11	7	1	125
Somewhat agree	285	38	28	13	364
Strongly agree	11	1	3	0	15
Total	701	83	47	20	851

Includes only Muslim respondents who report using banking products.

of sharia banking in Indonesia is clear from these figures, and Bank Indonesia has emphasized the importance of creating a robust but well-regulated market for Islamic financial products in order to fulfill what it considers its institutional mission to meet the demands of Indonesian consumers (while also safeguarding the stability of the Indonesian financial system) (Bank Indonesia, 2008).

#### (a) Measurement

The dependent variable of interest here is the choice of sharia versus conventional banking products. I measure this through a survey item that asked respondents the extent to which they used sharia banking products.<sup>5</sup> The response had four categories: never, sometimes, often, and always. From this I create a four-category ordinal variable, *USE SHARIA PRODUCTS*. I also collapsed the last three categories to create a binary variable, *USE SHARIA PRODUCTS (BINARY)*, that is coded 0 for respondents who never use sharia banks, 1 otherwise. An alternative way to measure banking sector preferences is to examine Indonesian Muslims' beliefs about sharia versus conventional banks. One survey item asked respondents whether the Indonesian government must ban conventional interest (*riba*) because it is inconsistent with Islam. This variable (*FORBID RIBA*) has five values—strongly agree, somewhat agree, no opinion, somewhat disagree, and strongly disagree.

The joint distribution of responses to *USE SHARIA PRODUCTS* and *FORBID RIBA* among respondents who are both (1) Muslim and (2) reported bank users appears in Table 2.

First note the marginals along the bottom: within this sample, the vast majority of respondents *never* use sharia products. The marginals along the right indicate a roughly symmetrical

bimodal distribution of responses, with most respondents either somewhat in favor or somewhat opposed to banning interest. The joint distribution indicates that there is some evidence that individuals who are more likely to favor banning interest are also those who are more likely to use sharia banking products more frequently, but while the relationship is statistically significant, it is weak (Kendall's  $\tau_b = .0922$ ,  $p < .01$ ).

The independent variables of interest are piety, class, and what I gloss here as “international orientation.” To measure piety among Muslims, I rely on a series of 11 survey items that queried respondents about various aspects of their religious beliefs and religious behavior. A list of these items, and the distribution of their responses as percentage of total (Muslim) respondents, appears in Table 3.

The 11 indicators are all highly intercorrelated (Cronbach's  $\alpha = 0.778$ ), and no single indicator is obviously the proper measure of piety. Accordingly, I use principal component analysis to reduce these indicators to an index that reflects the diversity of the survey responses while capturing the commonalities among them. All indicators load strongly onto the first principle component, with an eigen value of slightly above 3.5 and which explains 32% of the variance in the 11 indicators. The second and third principal components have eigen values of slightly larger than 1, indicating that they may capture important alternate dimensions of piety as revealed in the data. But a scree plot (see Figure 1) indicates that this first component explains the majority of the variation among the indicators; a scatterplot of this first component against the mean of the 11 indicators confirms the tight intercorrelations among them. I therefore define a single new variable, *PIETY INDEX*, as the first principal component of these indicators.

To measure class, I rely on respondents' self-reported family income (*INCOME*), measured as a 14-point interval scale. The

Table 3. *Indicators of piety*

	Not at all	Not very	Fairly	Very	<i>N</i>
Religion is important to R	0.0	0.3	20.7	79.0	2233
R is pious	0.1	5.9	58.4	35.7	2216
	Never	Seldom	Often	Always	<i>N</i>
R thinks about religion	2.7	6.6	43.0	47.7	2223
R prays at obligatory daily times	0.6	11.7	21.3	66.4	2246
R fasts during Ramadan	0.4	3.7	14.2	81.6	2247
R studies or reads the Qur'an	7.2	36.8	29.9	26.2	2238
R attends Friday prayers	3.9	39.4	33.8	22.9	2237
R performs additional (nonobligatory) rituals ( <i>shalat sunnah</i> )	6.7	44.0	31.7	17.6	2221
R attends communal religious meetings	7.9	34.0	32.4	25.8	2238
R participates in ritual prayers for the deceased ( <i>tahlilan</i> )	13.4	28.1	31.3	27.2	2236
R pays <i>zakat</i> after Ramadan	0.9	3.2	12.2	83.7	2239

Cells indicate the percentage of total respondents responding in each category.

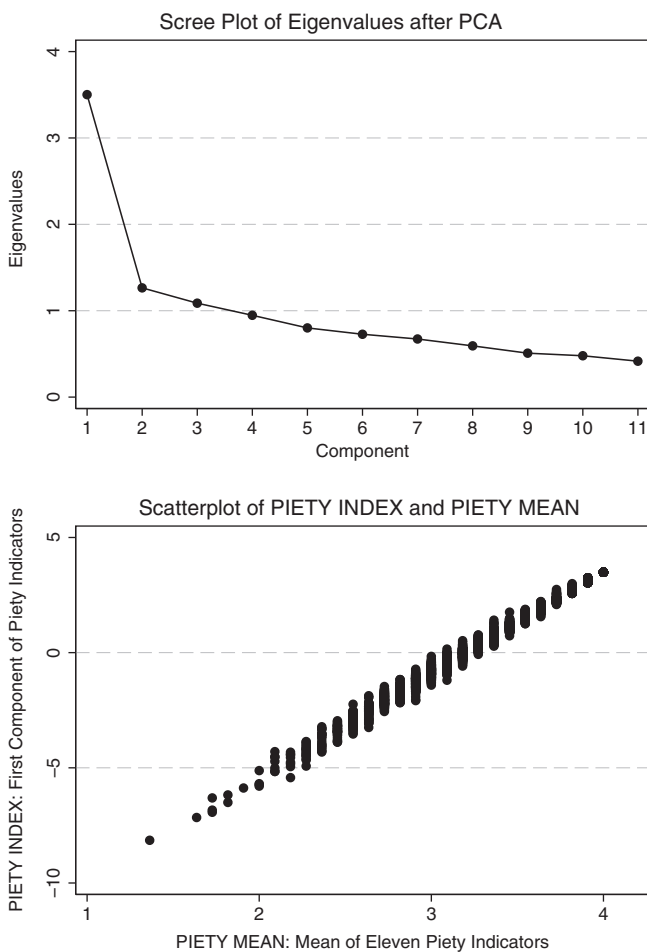


Figure 1. *The unidimensionality of PIETY INDEX.*

intervals are set at Rp 200,000 bins for the first ten categories. Thereafter it increases by Rp 2,000,000 unit intervals for the next three categories, with the final category comprising household incomes of Rp 5,000,000 and above. Over 90% of respondents fall below the 2,000,000 threshold. There is no evidence that any results below are affected by the nonlinear nature of *INCOME*.

To measure international orientations, I use two measures. The first is the degree to which individuals believe it important

that the country of Indonesia has strong ties with Muslim countries (*MUSLIM TIES*).<sup>6</sup> The possible responses here are “very important,” “somewhat important,” “not very important,” and “not important.” The second is the degree to which individual respondents report having positive feelings toward (*suka*, or “like”) the people of Saudi Arabia (*PRO SAUDI*). The possible responses are “very much like,” “somewhat like,” “do not like very much,” and “do not like at all.”

All models include a standard set of demographic controls: age (*AGE*), sex (*FEMALE*), urban or rural (*URBAN*). I also control for unobserved region-specific heterogeneity using reGENCY-level fixed effects (see below).

#### (b) *Sources of Inference*

There are two key assumptions which underlie my empirical analysis. The first is about the availability of sharia banking products: absent data on the presence of sharia bank branches throughout the Indonesian archipelago, it is difficult to interpret nonuse of sharia banking products as reflecting the lack of opportunity to use these products or the lack of interest in using them. I confront this issue two ways. First, I include in all models fixed effects by *kabupaten* or reGENCY—roughly equivalent to a county in the United States—to capture any location specific determinants of banking product choice. When I estimate models with a binary dependent variable, this has the effect of discarding all respondents who do not live in a reGENCY where at least one respondent did report using sharia banking products. Second, for models without a binary dependent variable, I restrict the analysis to only those respondents who live within a reGENCY in which at least one person has used sharia-compliant products.

The second assumption is that *as a class*, “price” does not distinguish sharia banking products from conventional products. This is important for any argument that links an individual’s class—measured via family income—with his or her choice of financial products. If it is the case that sharia banking products are just more expensive (or that they share profits on deposits at effective rates that are lower than the corresponding interest rates) than conventional banking products, then all that we learn from a correlation between income and banking choice is that sensitivity to price is a declining function of income. To rule this out, I draw on two pieces of evidence. The first is the observation that sharia banks and conventional banks in Indonesia compete vigorously on price. The second is the fact that there is no connection between income and the declared sensitivity to price among the respondents in our sample. I treat these in turn.

Table 4. "Ratios" and "equivalent rates" for Bank Muamalat, July 2010

Jenis Simpanan	Nisbah (Nasabah)	Porsi (Nasabah)	Ekuivalen Rate (%)
RUPIAH (Rp)			
Deposito 1 bulan	50.00	5.01	5.95
Deposito 3 bulan	51.00	5.11	6.06
Deposito 6 bulan	53.00	5.31	6.30
Deposito 12 bulan	54.00	5.41	6.42

Source: Bank Muamalat (2010).

It is clear that sharia banks in Indonesia compete directly with conventional banks in terms of price. For example, business periodicals regularly report that Indonesia's sharia banks adjust their profit disbursement schedules as a reaction to changes in interest rates among Indonesia's conventional banks (which are determined in turn by Bank Indonesia's statutory lending rate) (see e.g. "BI Rate Terpangkas, Nisbah Bank Syariah Mengkerut [BI Rate Trimmed, Sharia Banks' Ratios Contract]," *Kontan*, August 10, 2009). Moreover, Indonesia's Islamic banks actually report "interest rate equivalents." An example is reproduced in Table 4, drawn from the website of one of Bank Muamalat, one of Indonesia's oldest sharia banks.

Here, the "ratio" (*nisbah*) that governs the "portion" (*porsi*) of the deposit disbursed to the customer (*nasabah*) is translated directly into an *ekuivalen rate*. Bank Muamalat and other sharia banks clearly do this in order to help customers to compare their products to conventional banking products. Note, moreover, that that advertised ratio varies according to the length of the deposit, much as do interest rates on conventional deposits.

The survey itself also provides critical data that allow me to test if it is really true that there is a positive relationship between a respondent's income and the degree to which he or she is sensitive to price when making decisions about bank products—at least in terms of what he or she *claims* about what motivates his or her choice of banking products. The survey asked respondents a series of questions about what determines their choice of banking products, one of which was cost, return, or profit. If income is negatively correlated with the importance placed on cost, return, or profit, then this would suggest that any cost or price concerns that might differentiate sharia banking products from conventional banking products could threaten the inferences that I draw here.

The analysis in Table 5, however, suggests that this is not a major concern. The table presents the results of three OLS models of the relationship between *INCOME* and the importance that respondents' placed on cost, return, or profit in making banking choices.<sup>7</sup> The models focus on progressively

smaller groups of consumers: Model 5.1 includes all consumers, Model 5.2 includes only those who report using banks, and Model 5.3 includes those who report using banks *and* who live in a regency where at least one respondent reported using sharia banking products. As described above, the models incorporate regency-level fixed effects, and reported standard errors are robust to arbitrary intra-regency correlation.

In all three models, coefficient estimates are negative, but they are far from significant at conventional levels. The results indicate that household level income has no systematic effect on respondents' reported sensitivity to cost when choosing banks. It is important to emphasize that these are estimates of *reported* rather than *actual* sensitivity to cost, but they are nevertheless reassuring that the findings below about the correlation between income and banking choice do not simply reflect the fact wealthier individuals are more likely to use more expensive products.

#### 4. ANALYSIS

The main results appear in Table 6. Individually, when controlling for only regency-level effects, piety is uncorrelated with the frequency of use of sharia banking products at conventional levels of significance (Model 6.1,  $t = 1.50$ ), while both higher incomes and increased interest in ties with Muslim countries are associated with increased frequency of use of sharia banking products (Models 6.2 and 6.3). These results are unchanged when the three variables jointly enter the model (Model 6.4), and also hold when controlling for various demographic controls (Model 6.5).

The result that my measure of piety among Muslims is uncorrelated with the use of sharia banking products is striking. In Model 6.6 I enter into the sample all respondents who reported never using any type of bank, as well as those who live in regencies where no one reported using sharia banks, and reestimate the model. In this much broader sample, we find evidence that piety is associated with *USE SHARIA PRODUCTS*, as expected. But even these results do not hold up against alternative explanations and demographic controls (Model 6.7) in that broader sample. The results in Model 6.7 instead confirm that the best predictors of the frequency of use of sharia banking products—regardless of how I define the sample—are class and international orientation.

Could these null findings for piety reflect a wholesale rejection of sharia banking products because Indonesia's most pious Muslims believe that sharia products are insufficiently Islamic? Almost certainly not, for two reasons. First, if these pious Muslims object to Indonesia's sharia banking products on religious grounds, then they certainly will also refuse to

Table 5. Household income level and the importance of cost

	Model 5.1	Model 5.2	Model 5.3
<i>INCOME</i>	-0.003 (0.007)	-0.009 (0.010)	-0.016 (0.012)
<i>Constant</i>	2.999*** (0.033)	3.065*** (0.060)	3.098*** (0.075)
Sample	All respondents	Bank users	Bank users, sharia banks in regency
<i>N</i>	2133	998	618
Adj. $R^2$	0.246	0.233	0.188

OLS regression with regency-level fixed effects (suppressed for presentation). Robust standard errors, clustered by regency, in parentheses.

Dependent variable is the importance of cost or return in determining bank choice.

\*\*\*  $p < 0.001$ .

Table 6. *Use of sharia banking products*

	Model 6.1	Model 6.2	Model 6.3	Model 6.4	Model 6.5	Model 6.6	Model 6.7
<i>PIETY INDEX</i>	0.042 (0.028)			0.030 (0.026)	0.034 (0.026)	0.016* (0.007)	0.009 (0.007)
<i>INCOME</i>		0.035*** (0.010)		0.032** (0.012)	0.034** (0.012)		0.031*** (0.006)
<i>MUSLIM TIES</i>			0.241*** (0.061)	0.214* (0.081)	0.223* (0.086)		0.067** (0.021)
<i>Constant</i>	0.419*** (0.009)	0.184** (0.065)	-0.441* (0.211)	-0.535 (0.294)	-0.570 (0.330)	0.128*** (0.000)	-0.273** (0.090)
Demographic controls?	No	No	No	No	Yes	No	Yes
<i>N</i>	543	622	608	525	516	2057	1866
Adj. <i>R</i> <sup>2</sup>	0.028	0.069	0.062	0.094	0.093	0.046	0.089

OLS regression with regency-level fixed effects (suppressed for presentation). Robust standard errors, clustered by regency, in parentheses. Dependent variable is frequency of use of sharia banking products. Sample includes only respondents who report having used banks in regencies where at least one respondent reported using sharia banking products in Models 6.1–6.5. Sample includes all Muslims in Models 6.6 and 6.7.

\* $p < 0.05$ .  
\*\* $p < 0.01$ .  
\*\*\* $p < 0.001$ .

Table 7. *Use of banks by decile of PIETYINDEX*

<i>PIETYINDEX</i> decile	count	Percent using banking products
1	212	26
2	214	34
3	222	43
4	203	44
5	214	41
6	212	44
7	213	43
8	212	46
9	220	46
10	208	46

Sample includes all Muslims.

use conventional banking products. Yet my results rely exclusively on respondents who report using banks—respondents who do not use any banking products at all are excluded from analysis (see e.g. the note in Table 6). Accordingly, any pious Muslims who object to sharia banking products are not the analysis sample. Put otherwise, my inferences rely only on those pious Muslims who believe that sharia banking products are sufficiently Islamic to be permissible, on the assumption that if they did not, they would not use conventional banking products either. Second, the data do not reveal any difference in the willingness of the most pious Muslims' willingness to use banks. In Table 7 I divide *PIETYINDEX* into deciles, and for each decile calculate the fraction of respondents who report using banks.

The results show that the most pious Indonesian Muslims are just as likely to report using banking products as their less pious counterparts. This evidence is inconsistent with the idea that the most pious Muslims are selectively opting out of the financial markets and believe that sharia-compliant banking products are insufficiently Islamic.

In Table 8 I reexamine the relationship between international orientations and the use of sharia banking products using the alternative definition of international orientations, *PRO SAUDI*. The results for alternative measure are not consistent with those from *MUSLIM TIES*: it is uncorrelated with the frequency of use of sharia banks either alone or in conjunction with other variables (Models 8.1–8.3). Including it alongside *MUSLIM TIES* weakens the relationship between

that variable and the frequency of use of sharia banks, but does not render it insignificant at conventional levels (8.4).

The results thus far constitute powerful evidence in favor of class and international orientation as being the central factors explaining of the use of sharia banking products among Indonesian Muslims, and against the view that piety comprises a meaningful explanation for the use of sharia banking products. One key estimation issue, however, is the fact that the distribution of responses to the dependent variable *USE SHARIA PRODUCTS* is skewed toward zero, or nonuse. I confront this issue two ways. First, I change dependent variable to its binary definition (*USE SHARIA PRODUCTS (BINARY)*) and estimate conditional logistic regressions (Chamberlain, 1984) that account for regency-specific unobserved heterogeneity. Note that by making the comparison between those who use sharia banking products sometimes and never, this operationalization also alleviates the potential confounding issue that some individuals wish to use sharia banking products all of the time, but due to the unavailability of certain kinds of products (say, insurance) in their locality, they can only use sharia banking products sometimes.

Second, I return to the four-valued dependent variable and estimate an ordered probit regression to account for the non-linearity in the dependent variable. Given the importance of accounting for unobserved regency-specific heterogeneity, this introduces complications, for fixed effects ordered probit models are inconsistent. I therefore proceed with two different specifications. Model 9.6 ignores the potential for unobserved heterogeneity by dropping regency-level fixed effects, while Model 9.7 reinserts them and ignores the potential inconsistency of the parameter estimates. The results appear in Table 9.

The results indicate that all of the substantive conclusions from earlier models are unchanged, although their interpretations do. In Models 9.1–9.5, coefficient estimates correspond to the change in the log odds of using sharia banks at all. As before, higher values for *INCOME* and *MUSLIM TIES* are always associated with increases in the log odds of using sharia banks, while piety never is. The results in Models 9.6 and 9.7 yield similar conclusions. To facilitate interpretation of these results, I plot the predicted cumulative probability<sup>8</sup> of the first three responses across the range of values for *INCOME* and *MUSLIM TIES* in Figure 2, holding other variables at their means. These results are from Model 9.6.

The area below the bottom curve (labeled “Never”) is the probability of never using sharia banking products for various

Table 8. *Use of sharia banking products, alternate definition of international orientation*

	Model 8.1	Model 8.2	Model 8.3	Model 8.4
<i>PRO SAUDI</i>	0.085 (0.060)	0.093 (0.060)	0.103 (0.062)	0.105 (0.062)
<i>PIETY INDEX</i>		0.028 (0.025)	0.035 (0.025)	0.033 (0.025)
<i>INCOME</i>		0.032** (0.012)	0.031* (0.013)	0.032* (0.012)
<i>MUSLIM TIES</i>				0.190* (0.088)
<i>Constant</i>	0.155 (0.174)	-0.055 (0.190)	-0.070 (0.267)	-0.756* (0.349)
Demographic controls?	No	No	Yes	Yes
<i>N</i>	584	506	497	490
Adj. <i>R</i> <sup>2</sup>	0.042	0.077	0.078	0.105

OLS regression with regency-level fixed effects (suppressed for presentation). Robust standard errors, clustered by regency, in parentheses. Dependent variable is frequency of use of sharia banking products. Sample includes only respondents who report having used banks in regencies where at least one respondent reported using sharia banking products.

\*  $p < 0.05$ .

\*\*  $p < 0.01$ .

Table 9. *Use of sharia banking products, alternate specifications*

	Model 9.1	Model 9.2	Model 9.3	Model 9.4	Model 9.5	Model 9.6	Model 9.7
<i>PIETY INDEX</i>	0.072 (0.071)			0.044 (0.070)	0.080 (0.072)	0.039 (0.037)	0.063 (0.046)
<i>INCOME</i>		0.093** (0.030)		0.079* (0.035)	0.086* (0.037)	0.056*** (0.015)	0.066** (0.023)
<i>MUSLIM TIES</i>			0.709*** (0.200)	0.489* (0.237)	0.502* (0.246)	0.349** (0.112)	0.428** (0.164)
Demographic controls?	No	No	No	No	Yes	Yes	Yes
Regency fixed effects	Yes	Yes	Yes	Yes	Yes	No	Yes
Dependent variable	Binary	Binary	Binary	Binary	Binary	Ordered	Ordered
<i>N</i>	528	601	580	499	490	516	516
Pseudo <i>R</i> <sup>2</sup>	0.003	0.024	0.027	0.034	0.042	0.032	0.132

Models 9.1–9.5 are conditional logistic regressions. Models 9.6 and 9.7 are ordered probit models. Robust standard errors, clustered by regency, are in parentheses. Sample includes only respondents who report having used banks in regencies where at least one respondent reported using sharia banking products.

\*  $p < 0.05$ .

\*\*  $p < 0.01$ .

\*\*\*  $p < 0.001$ .

values of the independent variable of interest (with other variables held at their means). The two areas between the three curves (“Sometimes” and “Often”) correspond to the probabilities of these two responses, and the area above the third curve (“Always”) is the probability of always using sharia banking products. Together, the two figures show that the probability of never using sharia banking products declines as a function of both increasing values of *INCOME* and *MUSLIM TIES*, while the probability of being in each of the remaining three groups increases.

Do class and international orientation also shape individual beliefs about whether interest must be banned due to its theological impermissibility? It need not be the case that one’s own use of sharia banking products corresponds to a belief that interest should be banned for others. The data in Table 2 indicate that among those twenty respondents who always use sharia banking products, only thirteen (65%) agree (either strongly or to some degree) that interest should be banned. Interestingly, it is also the case that of the 701 respondents who never use sharia banking products, fully 42% of them agree that interest

should be banned. To explore whether piety, class, and international orientation have the same relationships to beliefs about banning interest as they do to the use of sharia banking products, in Panel A of Table 10 I estimate three models that replicate the previous models, but with *FORBID RIBA* as the dependent variable.

The results in Panel A indicate that a respondent’s international orientation is related to his or her individual beliefs about banning interest, but that class—as measured by family income—no longer has a significant relationship beliefs about banning interest. In Model 10A.3 we also discover that more pious Muslims are more likely to favor banning interest. However, while this may be interpreted as limited evidence that piety may shape beliefs about banning interest even if it does not shape actual use of sharia banking products, these results are from a fixed effects ordered probit model, and therefore should be interpreted with care.

In Panel B of Table 10 I check to see if *FORBID RIBA* itself explains individuals’ use of sharia banking products when controlling for alternative explanations. Model 10B.1, which



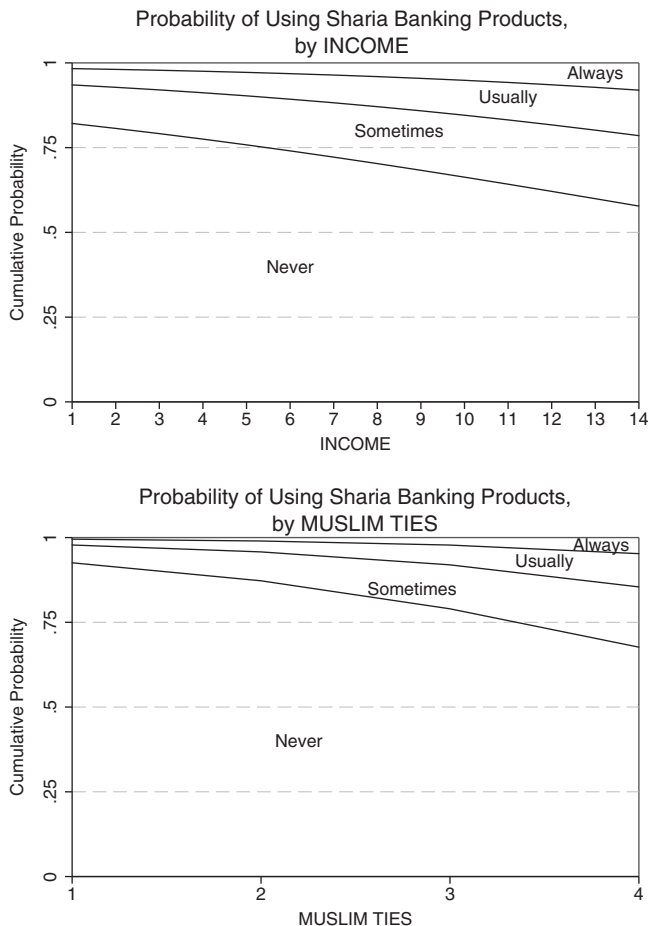


Figure 2. Probability of using sharia banking products.

includes only regency-level fixed effects, indicates that it does. But when the measures of piety, class, international orientation, and other demographic controls are included (Models 10B.2–10B.5), this relationship is no longer statistically significant.

## 5. DISCUSSION AND CONCLUSION

The rise of Islamic finance is part of a larger phenomenon of a global Muslim renewal that has occurred over recent decades. Mainstream development scholars are today beginning to take seriously the important changes in national financial systems that have been brought about through the rise of Islamic finance. Theoretical studies of Islamic finance have demonstrated the ways in which contract forms deemed theologically permissible to Muslim scholars can be applied to modern financial practices. Likewise, studies of Islamic financial systems have charted the historical origins of modern Islamic finance, described how Islamic finance works in practice, and identified the ways in which various national systems differ from one another. Almost entirely omitted from this literature is the focused study of what determines individual demand for Islamic financial products. This paper begins to fill this gap in the literature.

Considering the use of Islamic financial products as a claim about identity rather than merely a consequence of one's piety or religiosity encourages analysts to look beyond religion to other factors that may influence individuals' strategies for identity maintenance. Focusing on Indonesia—where conventional

and Islamic financial systems coexist, where expressed piety is on the rise, and where Muslims face the social changes inherent in modernization and globalization—we discover that piety is far less important as a factor in shaping individuals' use of Islamic financial products than commonly believed. Instead, modernization and globalization play decisive roles in shaping individual use of Islamic financial products. The picture that these empirical results paint is static, focusing on a snapshot of contemporary Indonesia rather than on the processes through which class formation and global identity formation promote the use of Islamic financial products. But the cross-sectional variation that identified here among Indonesian with regard to their individual use of Islamic financial products is informative, and is consistent with the view that modernization and globalization rather than religious change itself are the factors driving the rise of Islamic finance.

These findings give new context to research on development, social change, and identity in the Muslim world by exploring an important but understudied component of Muslims' daily lives. Far from being irrelevant or inconsequential due the fact that it so closely parallels conventional finance, Islamic finance is a uniquely powerful symbol of identity politics in the Muslim world *precisely because* it is so nearly indistinguishable from conventional finance. The choice of Islamic financial products—at least in plural banking systems such as those found in Indonesia—is therefore a window into the ways in which social and economic changes are filtered through religion to yield concrete changes in the lives for millions of Muslims.

These findings are also a window into a set of questions that the literature on Islamic finance has only begun to ask, and are an interesting parallel to existing research on the origins of Islamic economics and Islamic finance, which Kuran (2004) has argued lie in a set of social, political, and economic changes that began in the 1930s in the Indian subcontinent and received critical support as a consequence of the oil boom of 1970s. Much as the origins of Islamic financial institutions—the supply of Islamic finance—begin with modernization and globalization, these findings suggest that the use of Islamic financial institutions—the demand for Islamic finance—can be tied to analogous processes at work today.

One cautionary note is in order for scholars of Islamic finance in other national contexts. Indonesians' approach to Islamic finance may not be representative of all Muslims due to differences in Islamic jurisprudence across Sunni Muslim communities. Indonesian Muslims overwhelmingly follow the Shafi'i "school" (*madhhab*) of Islamic jurisprudence, which is predominant in Southeast Asia, East Africa, and parts of Egypt and the southern Arabian Peninsula (see Abdal-Haqq, 2002, pp. 67–74 for information on the various schools of Sunni jurisprudence). The jurisprudential traditions differ in the extent to which they accept various contract forms. Venardos (2006, p. 89), for example, argues that the Hanafi school—predominant in Turkey and Pakistan, among other countries—is far less permissive on financial transactions than the Shafi'i school. What may be considered a theologically impermissible financial arrangement by a pious Pakistani Muslim may be considered wholly Islamic by a pious Indonesian Muslim. If so, this necessitates care in generalizing about piety and banking choice to countries where other schools of Islamic jurisprudence place restrictions on the types of financial products that may be labeled Islamic.

This cautionary note notwithstanding, the implications of this research for the literature on bank choice are both methodological and theoretical. Methodologically, these findings demonstrate the dangers of selection bias—starting with all consumers and then determining what characteristics they

Table 10. *Forbidding interest and sharia banking products*

	Model 10A.1	Model 10A.2	Model 10A.3		
Panel A: Dependent variable = <i>FORBID RIBA</i>					
<i>PIETY INDEX</i>	0.061 (0.035)	0.043 (0.034)	0.093* (0.046)		
<i>INCOME</i>	0.013 (0.014)	0.020 (0.015)	0.025 (0.018)		
<i>MUSLIM TIES</i>	0.262** (0.099)	0.274* (0.107)	0.342** (0.129)		
Regency fixed effects?	Yes	No	Yes		
<i>N</i>	508	508	508		
Adj. <i>R</i> <sup>2</sup>	0.125				
Pseudo <i>R</i> <sup>2</sup>		0.015	0.138		
	Model 10B.1	Model 10B.2	Model 10B.3	Model 10B.4	Model 10B.5
Panel B: Dependent variable = <i>USE SHARIA PRODUCTS</i>					
<i>FORBID RIBA</i>	0.091* (0.044)	0.063 (0.047)	0.135 (0.127)	0.105 (0.060)	0.104 (0.088)
<i>PIETY INDEX</i>		0.033 (0.026)	0.085 (0.077)	0.039 (0.041)	0.062 (0.049)
<i>INCOME</i>		0.036** (0.013)	0.095* (0.040)	0.058*** (0.017)	0.072** (0.025)
<i>MUSLIM TIES</i>		0.228* (0.087)	0.535* (0.242)	0.370** (0.114)	0.448** (0.168)
Regency fixed effects?	Yes	Yes	Yes	No	Yes
<i>N</i>	541	500	471	500	500
Adj. <i>R</i> <sup>2</sup>	0.046	0.118			
Pseudo <i>R</i> <sup>2</sup>			0.057	0.041	0.148

Models 10A.1, 10B.1, and 10B.2 are OLS regressions. Models 10A.2, 10A.3, 10B.4, and 10B.5 are ordered probit regressions. Model 10B.3 is conditional logistic regression. Robust standard errors, clustered by regency, are in parentheses. Sample includes only respondents who report having used banks in regencies where at least one respondent reported using sharia banking products. All models except for 10B.1 include demographic controls.

\* $p < 0.05$ .

\*\* $p < 0.01$ .

\*\*\* $p < 0.001$ .

share makes it impossible to differentiate between users and nonusers. This makes it difficult to discover the factors that are common to just Islamic bank users in particular rather than those factors that are common to all Muslims, the latter being much less interesting to bankers and marketing scholars

than the former. Theoretically, these findings also suggest that there are unappreciated socioeconomic and even political factors that shape individual bank choice. Fuller appreciation of these “nonbank” drivers of bank choice yields important insights into consumer demand for Islamic financial products.

## NOTES

1. There is nothing unique to Islam in this regard. Similar tensions have been noted elsewhere in emerging Asia; see, for example, Goodman and Robison (1996).

2. The Arabic term *riba* does not mean interest. It means “increase.” See El-Gamal (2006, pp. 46–59) for a close analysis of the economic content of Islam’s prohibition of *riba*.

3. *Mudarabah* profit-sharing contracts are commonly used by Islamic banks offering deposit accounts (Zubair, 2002). Here, the depositor is the lender and the bank is the borrower, and the bank agrees to share its profits with its depositors rather than paying interest (although the profits are disbursed regularly and are advertised as a percentage of the deposit, much like interest). Strictly speaking the bank is not required to pay profits, and in some cases the bank does not guarantee the deposit. Alternative principles through which banks can offer deposit accounts include *qardh ul-hasan* (benevolent loan) and *wadiah* (trust), among others; see Haron (1998).

4. In our survey we asked respondents about their use of *jasa-jasa bank syariah*, which translates more accurately as “sharia bank services,” but denotes the same thing.

5. In our survey question we clarified that by sharia banking products we also meant what they might refer to as “Islamic” banking products (*jasa-jasa perbankan Islam*).

6. The survey question gives three specific examples: Saudi Arabia, Egypt, and Qatar.

7. We operationalize this concept with a simple and broad term: *paling menguntungkan*, which translates as “most profitable.”

8. These predicted probabilities are derived from simulated parameter estimates ( $\hat{b}$ ), obtained from 5000 draws from the multivariate normal distribution whose means are the parameter estimates  $\hat{b}$  and whose variance is the estimated variance-covariance matrix:  $\hat{b} \sim N(\hat{b}, \text{Var}(\hat{b}))$ . See King, Tomz, and Wittenberg (2000).

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