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# FROM CRISIS TO STABILITY: HOW MACROECONOMICS SHAPES ISLAMIC BANKING AND MSME FUTURES?

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**ABSTRACT –** *This study examines the impact of the COVID-19 pandemic on the nexus between macroeconomic conditions, Islamic banking performance, and MSME financing in Indonesia. Utilizing Partial Least Squares Structural Equation Modeling (PLS-SEM) and secondary data spanning January 2020 to June 2023, the research analyzes the direct effects of macroeconomic factors on both the financial performance of Islamic banks and the provision of financing to MSMEs. The findings indicate a statistically significant positive relationship between macroeconomic stability and both Islamic banking financial performance and MSME financing. Conversely, the study reveals no statistically significant relationship between the financial performance of Islamic banks and the scale of MSME financing during the period. These results highlight the critical role of macroeconomic stability as a primary determinant of financial performance for both Islamic banks and MSMEs, particularly during periods of economic crisis.*
***Keywords****: Macroeconomics, Islamic Banking, MSME Financing, PLS-SEM, COVID-19*

***ABSTRAK – Dari Krisis ke Stabilitas: Bagaimana Makroekonomi Membentuk Masa Depan Perbankan Syariah dan UMKM?*** *Penelitian ini mengkaji dampak pandemi COVID-19 terhadap keterkaitan antara kondisi makroekonomi, kinerja perbankan syariah, dan pembiayaan UMKM di Indonesia. Menggunakan metode Partial Least Squares Structural Equation Modeling (PLS-SEM) dan data sekunder yang mencakup periode Januari 2020 hingga Juni 2023, penelitian ini menganalisis pengaruh langsung faktor-faktor makroekonomi terhadap kinerja keuangan bank syariah dan penyediaan pembiayaan kepada UMKM. Hasil penelitian mengindikasikan adanya hubungan positif yang signifikan secara statistik antara stabilitas makroekonomi dengan kinerja keuangan perbankan syariah dan pembiayaan UMKM. Sebaliknya, studi ini tidak menemukan hubungan yang signifikan secara statistik antara kinerja keuangan perbankan syariah dengan skala pembiayaan UMKM periode tersebut. Temuan ini menunjukkan pentingnya stabilitas makroekonomi sebagai penentu utama kinerja keuangan, baik bagi bank syariah maupun UMKM, terutama dalam masa-masa krisis.*
***Kata Kunci:*** *Makroekonomi, Perbankan Syariah, Pembiayaan UMKM, PLS-SEM, COVID-19*

## INTRODUCTION

The COVID-19 pandemic has had a profound and multifaceted impact on the global economy, with Indonesia being no exception. As noted by Sabri et al. (2021), the pandemic triggered a decline across numerous sectors and regions within the country. This economic disruption can be attributed, in part, to the significant influence of the pandemic on Indonesia's macroeconomic conditions (Fakhri & Nuriyah, 2022).

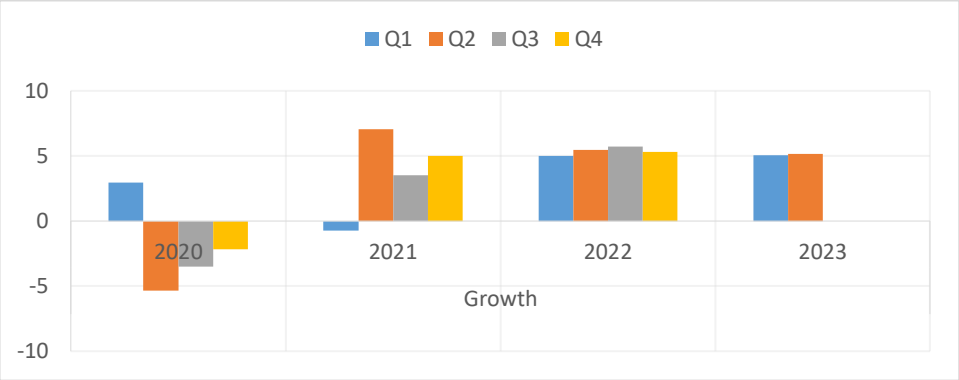


Figure 1. Indonesia Economic Growth
(Source: BPS, 2023)

Figure 1 displays the effects were particularly evident in the sharp contraction of Indonesia's economic growth, plummeting to -5.32% in the second quarter of 2020. While a rebound occurred in 2021, reaching 7% growth in the second quarter, the period from 2022 to 2023 has been marked by stabilization at a moderate average growth rate of 5% (BPS, 2023).

This period of economic volatility has had a significant impact on the financial performance of Indonesia's banking sector, including Islamic banking institutions. Eslami et al. (2013) emphasize the vulnerability of the banking sector to economic downturns, a finding echoed by Fakhri & Darmawan (2021) who specifically highlight the susceptibility of Islamic banks to financial performance decline during crises. However, Candera et al. (2021) offer a more optimistic perspective, suggesting that Islamic banking demonstrated resilience during the COVID-19 crisis. This contrast underscores the need for a nuanced understanding of the factors influencing Islamic banking performance within the context of the pandemic.

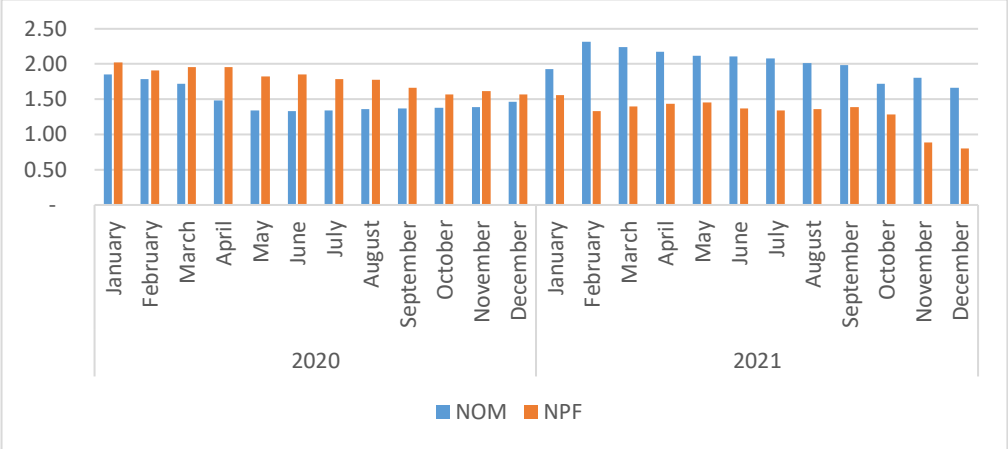


Figure 2. Financial Performance of Islamic Banking 2020 – 2021
(Source: OJK, 2023)

Existing literature has explored various macroeconomic variables that can significantly affect the financial performance of Islamic banks, such as interest rates, inflation, exchange rates, and economic growth (Idawati, 2023; Maritsa & Widarjono, 2021). For instance, higher interest rates can negatively impact bank profitability by increasing borrowing costs and affecting lending activities (Idawati, 2023), while inflation and exchange rates can also have adverse effects on Islamic bank performance (Maritsa & Widarjono, 2021). Additionally, financial system stability, which is influenced by macroeconomic conditions, can impact the financial performance of Islamic banks (Kasri & Azzahra, 2020). Other factors, such as operating efficiency, financial risk), capital adequacy, asset size, asset management, liquidity, and deposits, have also been identified as potential determinants of Islamic bank profitability (Yahya et al., 2017; Gafrej & Boujelbéne, 2021; Nadia & Ibrahim, 2019). Therefore, it is important for Islamic banks to monitor and anticipate macroeconomic variables to mitigate potential negative impacts on their financial performance (Firmansyah, 2022). Overall, understanding the relationship between macroeconomic factors and financial performance is crucial for Islamic banks to develop strategies and ensure competitiveness (Salindeho, 2023; Nisak & Ibrahim, 2014).

However, while these studies provide valuable insights into the relationship between macroeconomic factors and Islamic banking performance, there remains a significant gap in understanding the intricate relationship between these variables and their subsequent impact on Micro, Small, and Medium Enterprises (MSMEs) financing during periods of extreme economic uncertainty, such as the COVID-19 pandemic. MSMEs play a crucial role in

the Indonesian economy, contributing to job creation, poverty reduction, and inequality mitigation (Mulyani & Mulyadi, 2019; Setiawan et al., 2021). Access to finance is critical for the sustainable growth and profitability of MSMEs, as it facilitates the creation of new businesses and encourages innovation and development of existing ones (Gunartin et al., 2021). During the first year of the COVID-19 pandemic, MSMEs experienced critical conditions, with decreased sales, production, and income (Hernikawati, 2022). MSMEs development is essential for strengthening the national economy and reducing unemployment (Puteri & Asyari, 2023). Therefore, supporting and developing MSMEs, including providing access to banking and financial services, is critical for national economic growth and stability (Kristiana et al., 2021; Gunartin et al., 2021; Mulyani & Mulyadi, 2019; Setiawan et al., 2021; Puteri & Asyari, 2023).

This study aims to address this research gap by investigating the direct and indirect linkages between macroeconomic factors, Islamic banking performance, and MSME financing within the specific context of the COVID-19 pandemic in Indonesia. By employing a comparative analysis using Partial Least Squares Structural Equation Modeling (PLS-SEM) with the SmartPLS model, this research seeks to provide a comprehensive understanding of these complex relationships. The novelty of this study lies in its focus on the interplay between macroeconomic conditions, Islamic banking performance, and MSME financing during a period of unprecedented economic crisis. The findings of this research are expected to provide valuable insights for policymakers and stakeholders in developing effective strategies to bolster both Islamic banking stability and MSME resilience in the face of future economic shocks. By offering an early warning system and actionable recommendations, this study aims to contribute to the development of a more resilient and inclusive financial ecosystem in Indonesia.

## LITERATURE REVIEW

### Macroeconomic Factors and Financial Performance in Islamic Banking

Macroeconomics is a branch of economics that focuses on the behavior and performance of an economy as a whole, examining aggregate variables such as GDP, inflation, unemployment, and interest rates, and how they interact and influence each other (Butt & Taib, 2021; Megaravalli & Sampagnaro, 2018; Ibrahim, 2018). Macroeconomic variables are quantitative indicators that

represent various aspects of the economy, including price levels, financial stability, and economic growth (Foroni & Ravazzolo, 2019). Examples of macroeconomic variables include exchange rates, inflation rates, interest rates, stock market indices, and GDP growth rates, which are crucial for understanding and assessing the overall state and performance of an economy (Sehgal et al., 2021).

The financial performance of Islamic banks is significantly influenced by various macroeconomic factors (Fakhri et al., 2019). A study conducted in Indonesia found that external factors, such as the exchange rate and inflation, affected the profitability of Islamic banking (Widarjono, 2018). Fakhri and Nuriyah (2022) examined the effects of the Covid-19 pandemic on macroeconomic indicators and the performance of Islamic banks in Indonesia, while a study in Malaysia highlighted the impact of macroeconomic variables, including interest rates, inflation, and economic growth, on the financial performance of Islamic banks (Idawati, 2023). These findings suggest that macroeconomic conditions play a crucial role in shaping the financial performance of Islamic banks. Based on the aforementioned literature, the first hypothesis can be drawn as follows:

$H_1$: Macroeconomics has a positive effect on the financial performance of Islamic banks.

**Macroeconomic Factors and MSMEs Financing**

Micro, Small, and Medium-Sized Enterprises (MSMEs) play a vital role in the financial stability and growth of a country's economy, contributing to job creation, poverty reduction, and inequality mitigation in both developed and developing nations (Mulyani & Mulyadi, 2019). However, the macroeconomic environment significantly influences the provision of MSME financing. Studies have shown that variables such as gross domestic product (GDP), interest rates, inflation, and exchange rates impact the distribution of MSME finance (Iqbal et al., 2021; Zaimsyah & Fitri, 2022). Improvements in macroeconomic conditions, such as an increase in GDP and a decrease in interest rates, can stimulate the growth of MSME finance (Iqbal et al., 2021).

Several studies have examined the influence of macroeconomic factors on MSME financing in Islamic banking in Indonesia. Widarjono (2018) found that macroeconomic conditions, such as the exchange rate and inflation, can affect the profitability of Islamic banking, emphasizing the importance of managing



bad financing and stabilizing macroeconomic performance. Zaimsyah & Fitri (2022) examined the macroeconomic factors influencing MSME financing in Indonesian Islamic banks and found that inflation and exchange rate partially affect the distribution of MSME financing. Additionally, Nursyamsiah (2018) analyzed the relationship between Islamic banking financing and macroeconomic variables, including real output, price level, interest rate, and trade, and found significant associations. These studies highlight the importance of considering macroeconomic factors in understanding the financing dynamics of MSMEs in Islamic banking in Indonesia. Thus, the second hypothesis can be drawn as follows:

$H_2$: Macroeconomics has a positive effect on MSME financing at Islamic Banks.

**Financial Performance in Islamic Banking and MSMEs Financing**

Islamic banks are more involved in providing financing to MSMEs compared to conventional banks (Disli et al., 2023; Aysan et al., 2016). The financial performance of Islamic banking has a significant influence on MSME financing in Indonesia. Factors such as return on assets (ROA), capital adequacy ratio (CAR), financing to deposit ratio (FDR), and non-performing financing (NPF) have a positive response to shocks and positively affect the volume of Islamic financing, while total operational cost (BOPO) and third party funds (DPK) have a negative impact on financing (Nastiti & Kasri, 2019). Permataningayu and Mahdaria (2019) found that NPF and FDR do not directly affect the volume of financing in Islamic commercial banks, but DPK has a positive effect on financing. Yudiansyah et al. (2022) highlight the importance of Islamic banking in increasing MSME financing, as MSMEs face challenges in accessing bank loans.

Murabaha financing, a dominant type of financing in Islamic banking, contributes significantly to MSME financing in Indonesia (Husaeni, 2017). Factors such as Third Party Fund (DPK), Capital Adequacy Ratio (CAR), financing to deposit ratio (FDR), Non-Performing Financing (NPF), and Return on Assets (ROA) affect the financing of murābaḥa in Islamic Commercial Banking (Husaeni, 2017). However, there is still a disconnection between Islamic financing and the halal industry, particularly for MSMEs, which hinders the penetration of Islamic financing in Indonesia (Qoyum & Fauziyyah, 2019; Nadia et al., 2019). The growth of Islamic fintech has the potential to

accelerate MSMEs' growth and enhance their access to financing (Iqbal et al., 2021). Based on the facts, the third hypothesis can be drawn as follows:

$H_3$: Financial performance in Islamic banking has a positive effect on MSME financing.

**Previous Studies and Research Gaps**

Several studies have examined the impact of macroeconomics and the financial performance of Islamic banking on MSME financing. Qoyum and Fauziyyah (2019) explored the halal aspect and Islamic financing among MSMEs in Yogyakarta, finding that the attitude of MSMEs towards Islamic financing is influenced by cost-benefit considerations, reputation, and the importance of "*Berkah*" (blessings) in Islamic financing. Darsono and Darwanto (2019) focused on strengthening MSMEs through institutional cooperation between MSMEs and Sharia Microfinance Institutions (SMFIs), emphasizing the ethical and fair nature of Islamic financing methods employed by SMFIs. Sabri et al. (2021) investigated the effect of profit sharing and financing ceiling on non-performing financing in Islamic banks, suggesting that the distribution and amount of financing must be aligned with the business and repayment capabilities of MSMEs. Zaimsyah and Fitri (2022) examined the influence of macroeconomic factors on the distribution of MSME financing in Indonesian Islamic banks, finding that macroeconomic conditions play a role in shaping the distribution of MSME financing.

Our current study departs from prior research by specifically examining the impact of macroeconomic factors on Islamic banking performance. Unlike previous studies that compared Islamic and conventional banks, this work delves deeper into the internal dynamics of Islamic banking. This targeted approach is expected to yield a more nuanced understanding of the relationship between the broader economic environment and the performance of Islamic financial institutions. Furthermore, this research incorporates a novel set of variables, including the Bank Indonesia Rate (BI Rate), foreign exchange reserves, inflation, and money supply, all of which have been demonstrably influenced by the COVID-19 pandemic. This inclusion allows for a more accurate assessment of the impact of current economic conditions on Islamic banking.

In contrast to previous studies that focused solely on *Murabaha* financing, this research examines two financing structures particularly relevant to MSMEs,

working capital financing and equity-based financing (*Musharakah*). This focus aligns with the specific needs of MSMEs seeking to develop their businesses. The key innovation of this research lies in its comprehensive approach. By simultaneously analyzing the impact of macroeconomic factors, Islamic banking performance, and MSME financing structures, this study seeks to establish a clear and factual understanding of the complex interrelationships between these vital elements, particularly during periods of economic crisis.

## METHODOLOGY

### Research Design

This study employs an empirical research approach to investigate the influence of macroeconomic factors and Islamic banking financial performance on MSME financing within Islamic banks. The primary analytical method utilized in this research design is partial least squares structural equation modeling (PLS-SEM). The application of PLS-SEM is particularly well-suited for this study due to several reasons. Firstly, PLS-SEM allows researchers to estimate complex models with numerous latent and observed variables, making it ideal for research involving intricate relationships (Chin et al., 2020). Secondly, PLS-SEM can generate solutions even with limited sample sizes, avoiding identification or convergence issues, which is beneficial for research with restricted data availability (Chin et al., 2020). Thirdly, PLS-SEM offers particular advantages in predictive modeling, complementing traditional causal-explanatory modeling approaches (Hair et al., 2017).

### Data Collection

This analysis utilizes secondary data. Macroeconomic data, including information on foreign exchange reserves, inflation, the BI rate, and the total money supply, is collected from the Bank Indonesia website and designated as variable X1. Islamic banking financial performance data (Capital Adequacy Ratio (CAR), Return on Assets (ROA), Non-Performing Financing (NPF), Financing to Deposit Ratio (FDR), Balance of Payment Override (BOPO), Net Operating Margin (NOM), and Earning Assets Quality (EAQ), categorized as variable X2, and MSME financing data (investment and working capital), designated as variable Y, are obtained from the OJK website. The study employs time series data spanning from January 2020 to June 2023, encompassing a period characterized by a multidimensional crisis, namely the COVID-19 pandemic.

## Modeling Development and Data Analysis

This study leverages PLS-SEM as an instrument for empirical investigation. The analytical steps utilizing the PLS-SEM model are outlined as follows (Al-Emran et al., 2019):

*Path Model and Variable Specification*

The initial stage involves establishing the PLS-SEM structural model. This entails defining the path analysis, encompassing direct and indirect influences. The path model, depicted in Figure 2, was employed in the study.

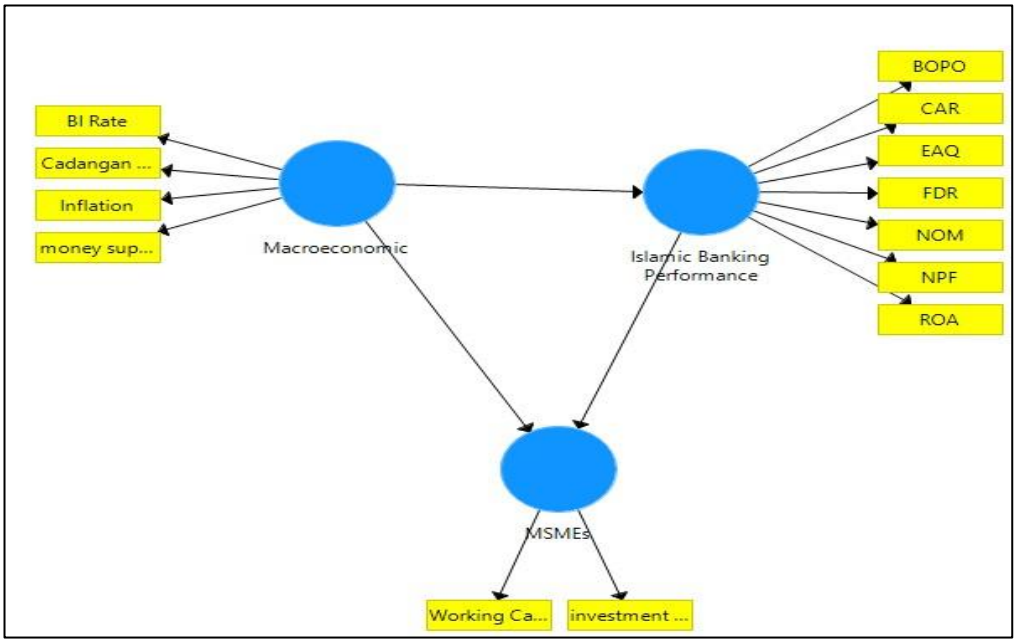


Figure 3. Path Model
(Source: PLS-SEM, 2023)

*Convergent Validity*

Convergent validity, as defined by Cable & DeRue (2002), refers to the extent to which measurement results for one construct demonstrate a positive correlation with those of other constructs, which are also expected to exhibit a positive relationship. In simpler terms, convergent validity measures the strength of the correlation between the construct and its corresponding latent variable (Cheah et al., 2018; Mailinda et al, 2018). The effectiveness of individual item reliability assessments can be evaluated by calculating the standardized loading factor value. A loading factor value exceeding 0.7

indicates that the indicator is reliable for measuring the construct, which is desirable. Models with standardized loading factors greater than 0.5 are considered, while those below 0.5 are excluded.

*Discriminant Validity*

To assess the discriminant validity of the reflective model, the AVE value is compared to the square of the correlation between the constructs (or the AVE square root is compared to the correlation between the constructs). According to Cheah et al. (2011), if the AVE square root is greater than the correlation between the constructs and other constructs, or if the AVE value surpasses the square of the correlation between the constructs, this signifies another indication of discriminant validity. As per Hair et al. (2017), an AVE exceeding 0.5 demonstrates data validity. If the data is found to be invalid under AVE criteria, it will be removed or eliminated.

*Construct Reliability*

As suggested by Taber (2018), the coefficients of the latent variables can be used to determine composite reliability. This analysis would provide both the composite reliability and Cronbach's alpha. Both values should ideally be greater than 0.70 for better reliability. If the Cronbach's alpha value falls below 0.7, the variable will be excluded.

*Structural Model Evaluation (Inner Model)*

The evaluation of the structural model (inner model) considers the path coefficient, R-squared ($R^2$), and model fit test. This model fit test determines how well a model aligns with the data. The three test indices employed in the model fit test are the average path coefficient (APC), average R-squared (ARS), and average variance inflation factor (AVIF). The p-value for both APC and ARS should be less than 0.05 (significant). Additionally, for AVIF to function effectively as a multicollinearity indicator, it must be lower than 5 (Muda et al., 2017).

## RESULTS AND DISCUSSION

This section presents the research findings in the following order: (1) outer model results, (2) composite reliability and discriminant validity, and (3) goodness-of-fit assessment.

## Outer Model Results

The outer model evaluation primarily focuses on the loadings of the measurement items. Hair et al. (2018) suggest that loadings exceeding 0.7 are considered acceptable, while those below 0.7 are excluded from further analysis. The results of the outer model are presented in Figure 4 (to be inserted).

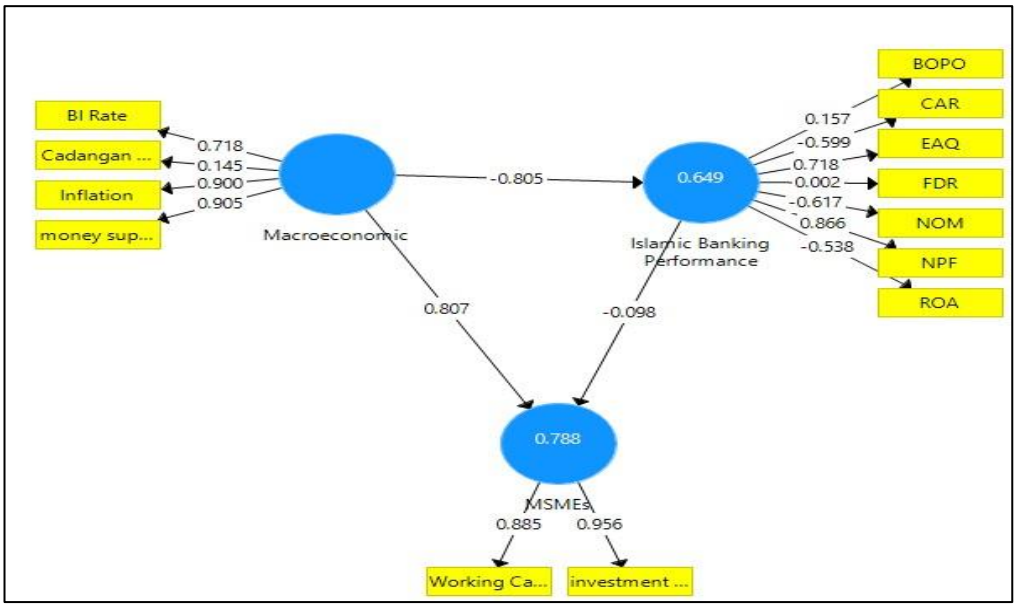


Figure 4 .Results of Outer Model
(Source: data processing)

Based on these findings, any indicator exhibiting a loading value below 0.7 is deemed unsuitable due to potentially negative influences on the model. Consequently, only variables with loadings of 0.7 or higher are retained for further analysis (Hair Jr. et al., 2021). The path diagram depicting the final model is presented in Figure 5.

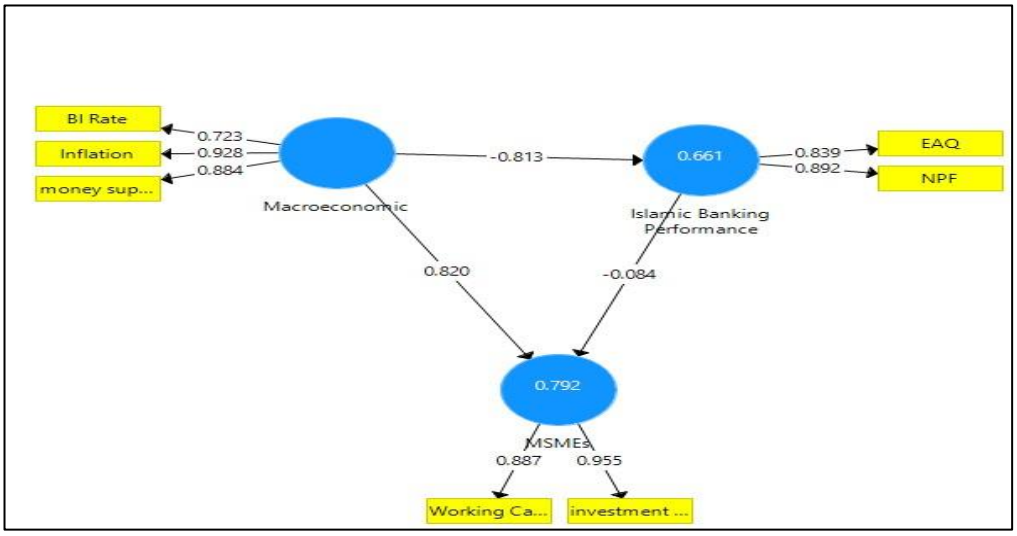


Figure 5. Path Diagram of Results

## Composite Reliability and Discriminant Validity

Composite reliability and average variance extracted (AVE) are employed to assess data validity and suitability for subsequent analysis. The current study demonstrates that all variables possess composite reliability scores exceeding 0.7.

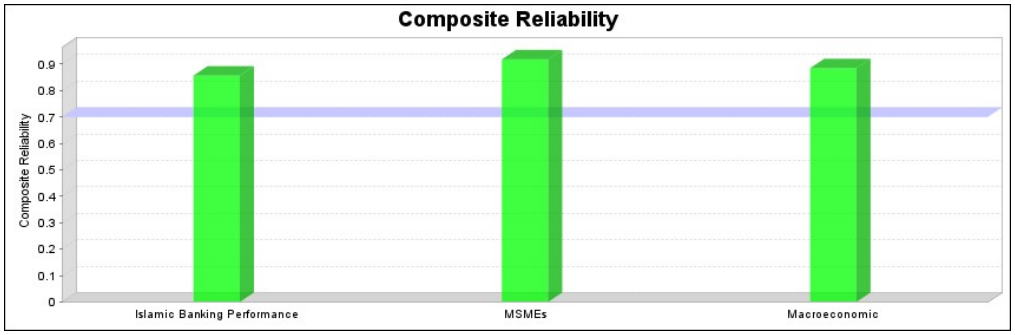


Figure 6. Composite Reliability

Additionally, each variable generates AVE values greater than 0.5, indicating the reliability and appropriateness of the data for further examination. The composite reliability and AVE values are presented in Figures 6 and 7, respectively.

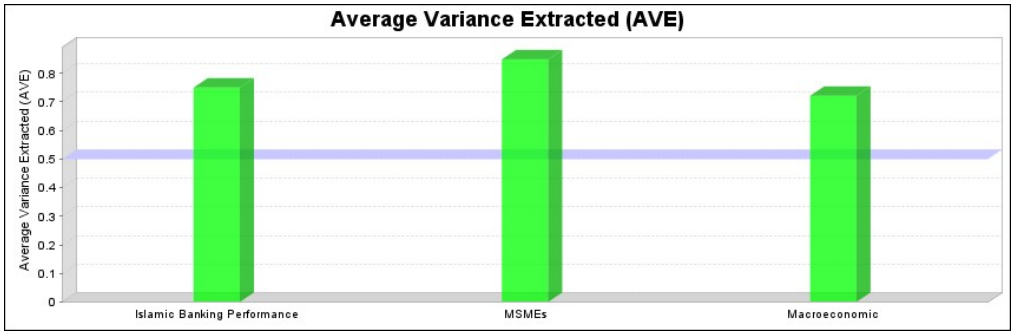


Figure 7. Average Variance Extracted

## Goodness-of-Fit Model

An analysis of variance (ANOVA) was conducted to determine the influence of independent variables on the dependent variable, along with the coefficient of determination ($R^2$ = R-squared) value.

The results indicate that the macroeconomic factors included in the model explain 65% of the variance in Islamic banking performance ($R^2$ = 0.65). Similarly, the model explains 78% of the variance in the MSME financing indicator ($R^2$ = 0.78). These findings suggest that the selected macroeconomic factors are strong predictors of both Islamic banking performance and MSME financing. Figure 8 visually represents the $R^2$ values.

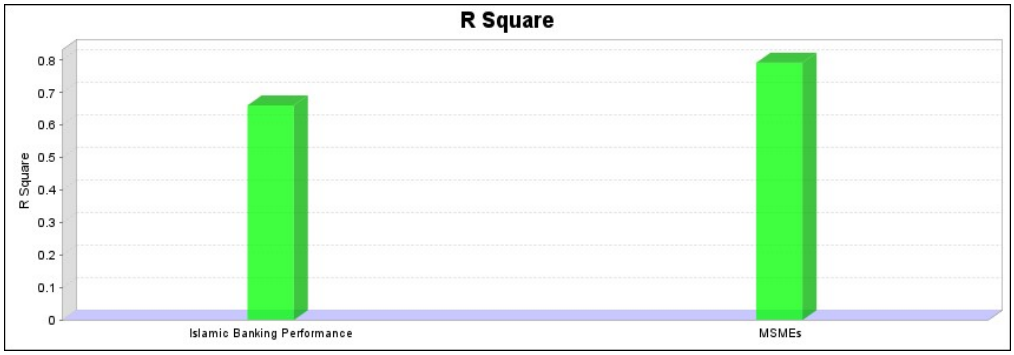


Figure 8. R Square

The model's overall fit is then evaluated using the calculated Q-square value. The Q-square value was determined through the following formula:

$$R\text{-squared} = 1 - ((1-R1) * (1-R2)) \quad (1)$$

Following the calculation, the Q-square value for this study's model is 0.923. This result suggests a satisfactory level of fit for the model, indicating that the data can be further analyzed with confidence.

where R1 and R2 represent the R-squared values for Islamic bank performance and MSME financing, respectively. The calculation yields a Q-square value of 0.923, indicating a satisfactory fit for the model in this study. This implies that the data can be reliably used for further observations.

**Results of Hypothesis Testing**

This study investigated the correlations between macroeconomic indicators in Indonesia and the performance indicators of Islamic banking and MSME financing within Islamic banks. The results are summarized in Table 1.

Table 1. Results

| Relationship | Std. Deviation | T-Statistic | P-Value |
|---|---|---|---|
| Islamic Banking Performance → MSME Financing | 0.130 | 0.647 | 0.5180 |
| Macroeconomic → Islamic Banking Performance | 0.055 | 14.730 | 0.0000 |
| Macroeconomic → MSME Financing | 0.110 | 7.4370 | 0.0000 |

(Source: Data Processing)

Table 1 demonstrates a significant correlation between macroeconomic factors and the financial performance of Islamic banks. The P-value of 0.000, which is less than the conventional significance level of 0.05, indicates a statistically significant relationship. This finding supports Hypothesis 1 ($H_1$), suggesting that macroeconomic factors significantly impact the performance of Indonesian Islamic banks.

Similarly, the P-value for the relationship between macroeconomic factors and MSME financing is also 0.000, indicating a statistically significant association. Therefore, Hypothesis 2 ($H_2$) is also supported, implying that the macro-economy significantly affects MSME financing in Islamic banks.

However, the P-value for the relationship between Islamic banking performance and MSME financing is 0.518, exceeding the significance level. This suggests no statistically significant correlation between the two variables. Consequently, Hypothesis 3 ($H_3$) is not supported, indicating that Islamic banking performance does not have a significant impact on MSME financing

in this context. Figure 9 provides a visual representation of the relationships between the studied constructs based on the PLS-SEM analysis.

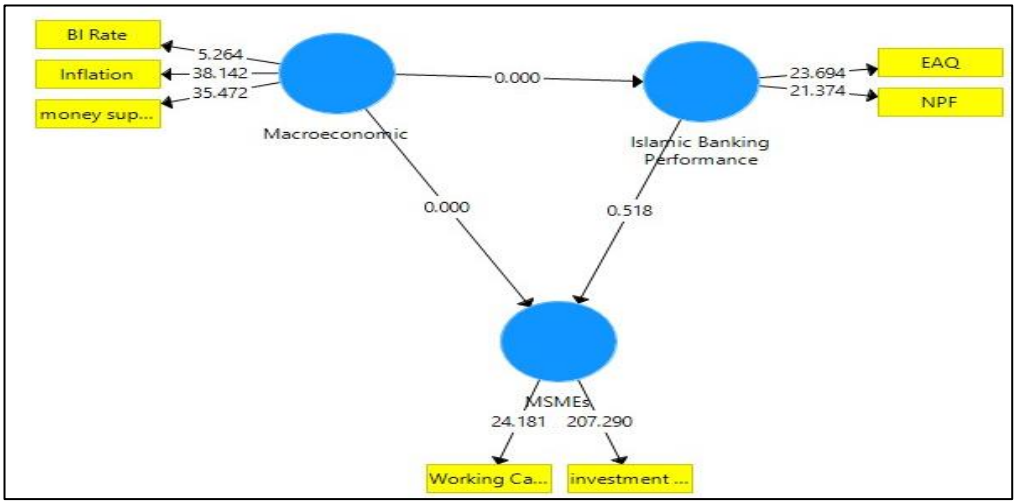


Figure 9. Result
(Source: data processing)

**Discussion and Implications**

This study aligns with existing research highlighting the crucial role of macroeconomic factors in Islamic banking performance. For instance, Fakhri et al. (2019) found that external macroeconomic factors significantly impact Islamic banking performance. Studies by Widarjono (2018) and Fakhri & Nuriyah (2022) in Indonesia further emphasize the influence of inflation and exchange rates on Islamic banking profitability, with the latter focusing on the COVID-19 pandemic's impact. Similarly, Idawati (2023) from Malaysia demonstrated the influence of interest rates, inflation, and economic growth on Islamic banking performance. These findings solidify the current research's contribution by corroborating prior studies. A key implication is the need for stakeholders to closely monitor macroeconomic changes to inform policy decisions impacting Islamic banking performance. For instance, implementing customer financing deferral policies can help mitigate the rise of non-performing financing (NPFs) during economic downturns.

Furthermore, the study reveals the substantial impact of macroeconomic factors on MSME financing in Islamic banks. This finding resonates with Zaimsyah & Fitri's (2022) analysis, which identified exchange rates and inflation as significant, albeit modest, influences on MSME financing distribution in Indonesian Islamic banks during 2022. This result presents a valuable reference

point, particularly for government entities, to prioritize MSME support during economic crises. This could involve providing subsidies to affected businesses.

However, the lack of a significant impact of Islamic banking performance on MSME financing observed in this study diverges from prior works by Husaeni (2017) and Qoyum & Fauziyyah (2019). These studies suggested a significant influence of Islamic banking performance on MSME financing. This discrepancy can be attributed to the cautious approach adopted by Islamic banks during the COVID-19 pandemic, where financing distribution continued but with greater scrutiny. This cautious approach aligns with the expectation that Islamic banks would develop innovative products tailored to support struggling MSMEs, such as Cash Waqf Linked Deposits (CWLD) as proposed by Utomo & Ismal (2024).

This study contributes to the existing literature by providing empirical evidence on the relationship between macroeconomic factors, Islamic banking performance, and MSME financing within the context of the COVID-19 pandemic in Indonesia. The findings have important implications for various stakeholders, including policymakers, regulators, Islamic banking institutions, and MSMEs themselves.

From a policy and regulatory perspective, it is crucial for policymakers and regulators to maintain a close watch on macroeconomic indicators and their influence on the Islamic banking sector. In response to these observations, proactive steps such as monetary policy adjustments or targeted fiscal interventions may be required to alleviate potential risks and maintain the stability of the Islamic banking sector during times of economic instability. Considering the substantial impact of macroeconomic factors on MSME financing, it is recommended that policymakers implement targeted policies to bolster the resilience of MSMEs during economic downturns. Such policies could encompass access to subsidized financing, tax incentives, or loan guarantees.

For Islamic banking institutions, the study underscores the importance of robust risk management practices and portfolio diversification to cushion the effects of macroeconomic shocks. This could entail venturing into new markets, creating innovative financing products, or reaching out to underserved segments. The findings also highlight the necessity for Islamic banks to devise financing products tailored to the specific needs of MSMEs, especially in times

of crisis. This could involve offering flexible repayment terms, reducing collateral requirements, or providing technical assistance to enhance the viability of MSMEs.

As for MSMEs, the study emphasizes the importance of prioritizing financial literacy and planning to effectively navigate economic uncertainties. This includes understanding the impact of macroeconomic factors on their businesses and developing contingency plans to mitigate potential risks. Given the potential limitations of traditional financing channels during crises, MSMEs are encouraged to explore alternative financing options, such as crowdfunding, venture capital, or angel investors.

## CONCLUSION

This study examined the intricate relationship between macroeconomic factors, Islamic banking performance, and MSME financing in Indonesia during the tumultuous period of the COVID-19 pandemic. The findings underscore the profound influence of macroeconomic conditions on both the financial performance of Islamic banks and the provision of MSME financing. A stable macroeconomic environment is therefore crucial for a resilient Islamic banking sector capable of effectively supporting MSME growth. Interestingly, the study revealed that while macroeconomic conditions significantly impacted both Islamic banking performance and MSME financing, there was no statistically significant direct relationship between the performance of Islamic banks and their financing activities towards MSMEs. This suggests other factors, potentially including government interventions or shifts in risk appetite, may have played a more dominant role during the pandemic.

These findings carry significant implications for various stakeholders. Policymakers should prioritize macroeconomic stability and implement targeted interventions to support both Islamic banks and MSMEs during crises. Islamic banking institutions should focus on strengthening their risk management practices and developing innovative financing solutions tailored to the evolving needs of MSMEs.

This study was limited by its focus on the Indonesian context and its exclusion of specific government policy responses to the pandemic. Future research could expand on these findings by conducting cross-country comparative studies and incorporating government policy variables into the analysis. Longitudinal studies would offer valuable insights into the long-term dynamics of these



relationships. Furthermore, qualitative research exploring the perspectives of Islamic banking practitioners and MSME owners would provide a more nuanced understanding of the challenges and opportunities in MSME financing within the Islamic banking sector.

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