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Islamic Financial Literacy for Indonesian MSMEs during COVID-19 Pandemic: Issues and Importance

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ABSTRACT

Financial literacy has been universally regarded as one of the crucial pillars for the achievement of the financial inclusion programmes. Having financial literacy enables people to make more efficient and effective decisions related to the monetary aspect of their lives. The concept of financial literacy also extends to the domain of business financial management. This paper aims to explore and identify the critical issues, challenges, and opportunities for Micro, Small, and Medium Enterprises (MSMEs) in Indonesia to improve their Islamic financial literacy levels and consequently influence their decision to participate in Islamic financial services. The paper also discusses the critical role of financial literacy for MSMEs in facing the uncertainties brought about by the COVID-19 pandemic. The paper adopts the qualitative method by implementing a critical review of the key literature related to financial literacy, financial inclusion, and MSMEs in Indonesia. Subsequently, the paper reveals several issues and challenges faced by MSMEs, particularly in embracing the Islamic financial literacy concept and suggests several opportunities that may be explored by MSMEs to improve their literacy and consequent inclusion in Islamic financial services in Indonesia.

Keywords: *Financial Literacy, Financial Inclusion, Islamic, MSMEs, Indonesia, COVID-19*

1. Introduction

Financial literacy has been widely recognised as an essential skill for individuals confronting increasingly complex financial scenarios. Despite its critical role, several studies show that the world's population perpetually suffer from poor financial literacy and that putting in place measures to solve this issue are urgently needed (Lusardi & Mitchell, 2011; Atkinson & Messy, 2012; Brown & Graf, 2013; Thaler, 2013; World Bank, 2014; Potrich, Vieira & Kirch, 2015). Many cross-country studies on financial inclusion have thus far focused on the supply-side of financial markets. Nevertheless, is there not the need for financial development to consider other diverse aspects beyond financial infrastructure and legal background? What about the role of the demand-side? It appears plausible that functioning financial markets do not merely depend on sound infrastructure but also informed customers – including customers with high levels of financial literacy. Informed customers are able to make better financial decisions for themselves and their businesses. They are able to boost the effectiveness of the financial system by demanding more sophisticated financial products and services, and they will demand financial inclusion. If indeed the level of financial literacy makes a difference in realising financial inclusion, this seems to have a clear policy message (Grohmann, Klühs, & Menkhoff, 2018), indicating therefore, that the concept of financial literacy is highly crucial in achieving the success of any financial inclusion programme.

Several empirical studies imply that the lack of financial literacy is associated with poor-risk diversification, inefficient portfolio allocation, and low level of savings. Recent experiences in the arena of microfinance have shown that poor people take loans that they have no capacity to service, and farmers take on debt that they are not able to repay. These scenarios indicate that unless financial inclusion goes in tandem with financial literacy, rather than assisting the poor, it will only put them into more trouble. Financial literacy goes beyond the provision of financial information and advice. It entails the capability to know, monitor, and effectively utilise financial resources to promote the well-being and economic security of oneself, one's family, and one's business. Financial literacy can make a difference not only in the quality of life of individuals but also in the integrity and quality of markets. A financially-literate population will translate into a society that makes more efficient use of its financial resources, and a financially-capable population will translate into a civilisation that is more empowered and in control of its financial lives (Ramakrishnan, 2012). With its highly critical role, financial literacy has been known to affect business performance in general, including that of large enterprises and MSMEs. Financial literacy affects how entrepreneurs behave in seeking external and alternative financing, managing business-related financial matters, administering business dealings and investment, and understanding the risks involved in their businesses, hence impacting the sustainability and survivability of their businesses in a never-ending volatile market system.

MSMEs are considered as a key enabler for Indonesia's economic growth since it occupies approximately 99.9% of Indonesia's business ecosystem and contributes substantially to the country's job provisions, GDP, as well as import and export revenues (Ministry of Cooperatives and SMEs, 2017). Unfortunately, the sector is lacking in financial literacy,

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affecting its capability to survive and sustain MSMEs businesses and potential growth into the higher enterprise segment. Indonesia is also widely perceived as the largest Muslim population globally. However, its achievement in Islamic financial literacy and inclusion has so far not been satisfactory. This includes the Islamic financial literacy and Islamic financial inclusion indexes for the MSME sector. A 2017 survey conducted by the Indonesian Financial Services Authority (OJK) revealed that the overall indexes for Islamic financial literacy and Islamic financial inclusion stood at shallow levels of 8.1% and 11.1% respectively (OJK, 2017). Even more severe was the condition for MSMEs Islamic financial literacy and inclusion as the survey also, to some extent, included MSMEs.

Given the aforementioned issues, the primary objective of this paper is to explore and identify the critical issues, challenges and opportunities for Indonesian MSMEs towards improving their Islamic financial literacy levels and eventually influencing their inclusion in Islamic financial services. This study is based on the argument that since Indonesia is mostly occupied by Muslims, allegedly its Islamic financial literacy and inclusion indexes should score higher. Furthermore, the Islamic financial system encourages and embraces entrepreneurship. Hence, arguably, the system and its institutions are supposed to be capable of assisting the MSME sector in sustaining and expanding their businesses due to the fact that MSMEs has the traits and characteristics embraced by the Islamic financial system. This paper also discloses the impact of the COVID-19 pandemic on MSMEs in Indonesia and discusses the importance of financial literacy in reinforcing the position of MSMEs to withstand the uncertainties brought about by the current pandemic.

2. Methodology

This paper adopts a qualitative method by critically reviewing and analysing the pivotal literature related to financial literacy, financial inclusion, and MSMEs, particularly in the context of the Islamic financial system in Indonesia. The paper also utilises secondary data provided by the National Strategy for Financial Literacy issued by OJK to compare the level of financial inclusion and financial literacy between the conventional and Islamic financial sectors in Indonesia.

The paper first discusses the definition and overview of financial literacy. Subsequently, the paper attempts to give insights regarding why financial literacy is critical for achieving financial inclusion of MSMEs, and potentially augment the sector's opportunities in accessing external financing and strengthening its capital base in the long run. Moreover, the paper tries to discuss the issues and challenges that hinder the capacity of MSMEs in improving their financial literacy and what their stakeholders in Indonesia could do to enhance the sector's ability to embrace financial literacy, in particular Islamic financial literacy. The paper then attempts to elaborate on the importance of financial literacy for MSMEs in facing the COVID-19 pandemic and why they should consider this as an important aspect to improve business sustainability amidst these uncertain times. After the problems and issues are identified, this paper will propose several recommendations for all MSME stakeholders – including the government, Islamic financial service providers, academia, and trainers – to elevate the likelihood of MSMEs for embracing Islamic financial literacy.

3. Literature Review

3.1 Financial Literacy: An Overview

Financial literacy is perceived globally as a vital element for stability, economy, and financial growth. Its importance is reflected in the approval of the High-level Principles on National Strategies for Financial Education by the Organisation for Economic Co-operation and Development (OECD), and endorsed by the G20 (OECD, 2013). Nonetheless, there are several gaps in the core aspects involving financial literacy. The first is the fact that the term financial literacy has frequently been used as a synonym for financial education or financial knowledge. However, in reality, the two terms have different concepts, and using them as synonyms may lead to misunderstanding and problems, since financial literacy goes beyond financial education (Potrich et al., 2015). Huston (2010) suggests that financial literacy has two dimensions: the first is understanding, which indicates the individual financial knowledge; and the second is utilisation, which is implementing such knowledge in personal financial management.

Lusardi and Mitchell (2011) argue that although assessing and measuring the level of people's financial literacy has its benefits, in practice, it is a complex procedure to explore the way people – based on their respective financial knowledge – manage and process financial information and make financial decisions. This complexity occurs as financial literacy covers many concepts, including financial awareness, financial knowledge, financial skills, and financial capability. It is hard to capture all of these aspects for a reasonable length time to research. Although several studies have been conducted in the area of financial literacy and it is increasing over the years, there is low consistency in the way financial literacy is defined where different researchers address the topic differently and assign different connotations to it (Hung, Parker, & Yoong, 2009). Moreover, several studies disclosed the ambiguous usage of term financial literacy, particularly in capturing the differences between the concepts – such as financial education or financial knowledge. In this respect, Robb, Babiarz & Woodyard (2012) show the distinction between the terms. They suggest that financial literacy involves the ability to understand financial information and make effective decisions in implementing the respective information. In contrast, financial education means simply to recall a set of facts such as financial knowledge or information. In other words, the key focus of financial education is knowledge, while financial literacy goes beyond knowledge, into the individual's financial attitude and financial behaviour (Potrich et al., 2015). Hence, as mentioned by Mccormick (2009) and Huston (2010), the realm of financial literacy goes beyond the primary concept of financial education.

One definition that decently covers the concept of financial literacy is a definition proposed by the OECD, which defines financial literacy as a combination of awareness, skill, knowledge, attitude, and behaviour that are required to make sound financial decisions and ultimately realise individual financial well-being (OECD, 2013). Therefore, the OECD addresses the financial literacy concept based on three dimensions – financial knowledge, financial attitude, and financial behaviour. In this respect, Indonesia's OJK adopted a similar concept of financial literacy as proposed by OECD, and this is reflected in their updated version of National Strategy for Financial Literacy in which OJK defines financial literacy as knowledge, skills, and confidence in financial matters that affect financial attitude and behaviour to increase the quality of decision making in financial management to improve financial well-being and prosperity (OJK, 2017).

3.2 Financial Literacy and MSMEs Performance: Augmenting the Chance of the Sector's Financial Inclusion

Several studies suggest that financial literacy positively affects MSMEs performance and vice versa. This denotes the critical function of financial skills and education for MSMEs owners to achieve enterprise financial inclusion, and further develop MSMEs to reach the upper-levels of the enterprise segment. The sector's performance and growth have always been a great concern throughout the nation by economists, entrepreneurs, government, financial institutions, venture capital firms, and non-government organisations alike (Eniola & Entebang, 2014). The performance management of the MSME sector involves the establishment of shared understanding regarding what is to be achieved, and how is it going to be achieved? Subsequently, it includes an approach to manage the personnel thereby increasing its chances of attaining success within an approved framework of planned targets, standards, and individual and group ability necessities (Armstrong & Baron, 1998).

Financial literacy from the perspective of business reality is the capacity to soundly oversee financial resources throughout the business' life cycle and connect it effectively with financial products and services. Financial literacy is about sound judgment and making effective decisions and use of financial management (Gavigan, 2010). Enterprises, specifically, require knowledge, attitude, skill, and experience with goals and objectives to ensure its survival and sustainability, profit maximisation, sales expansion, capturing a particular market share, and minimising the staff turnovers and internal conflicts, as well as maximising wealth (Jacobs, 2001).

One of the significant obstacles hindering the performance, growth and sustainability of MSMEs in the developing world and emerging economies is the lack of knowledge, skills, attitude, and awareness to cope and manage the finances of the organisation in a hardy, transparent, and professional way (Eniola & Entebang, 2015a). Joo and Grable (2000) revealed that the reasons why entrepreneurs make inappropriate, inadequate and ineffective financial decisions are because of poor financial knowledge, lack of time to learn personal financial management, complexities in financial transactions, and the substantial variety of choices in financial products and services. Poor business management skills could amplify financial barriers for MSMEs, and low levels of financial literacy could hinder the performance of MSMEs from sufficiently assessing and understanding the various financing provisions to navigate complex and strict loan application procedures.

As described by Eniola and Entebang (2015b), in the context of an enterprise, performance is commonly described as a measure of an organisation's health over a dedicated period. Hence, this puts performance as one of the critical issues of MSMEs. The capacity to handle change in the management of perceived market opportunities, adapt to the environment and have in place specific managerial factors – such as creativity, product innovation, attentiveness, pro-activeness, technological development, and networking – are vital determining factors in bringing about strategic improvements in performance. Performance encompasses different meanings – including growth, success, survival, and competitiveness, which could be characterised as the enterprise's ability to create acceptable outcomes and actions (Eniola & Entebang, 2015b).

According to some studies, there are positive relationships between financial literacy and performance (Lusardi, Mitchell, & Curto, 2010; Hilgert et al., 2003; Kidwell & Turrisi, 2004; Huston, 2010; Piprek, Dlamini & Coetzee, 2004). Furthermore, in the realm of business and enterprise, the concept of financial literacy also comprises three dimensions – knowledge (Lusardi & Scheresberg, 2013), attitude (Sabri & MacDonald, 2010), and awareness (Rahmandoust, Shah, Norouzi, Hakimpoor, & Khani, 2011). Lusardi and Scheresberg (2013) studied the impact of financial literacy and high-cost borrowers. The findings signified that there is a relationship between financial literacy and low-cost borrowers. The study showed that most high-cost borrowers display shallow financial literacy levels and poor knowledge of basic financial concepts, both of which affect their performance level in a business. Tamimi and Kalli (2009) analysed the impact of financial literacy on financial knowledge; the results implied that the field of individual activities affects financial literacy levels and people who invest in financial awareness have a higher degree of financial literacy. Interestingly, a study conducted by Kidwell and Turrisi (2004) indicated that organisations with better financial knowledge keep detailed financial records and have a more competitive advantage in accessing external financing than their competitors with no financial records, while Hilgert et al. (2003) revealed a strong link between financial knowledge and financial behaviours.

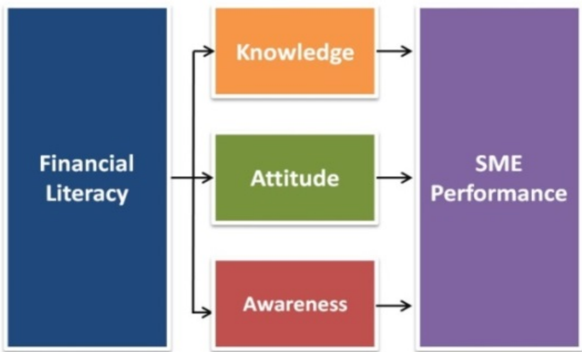


Figure 1: Three Dimensions of Financial Literacy Affecting SMEs Performance

Source: Adopted from Eniola & Entebang (2015a)

The first dimension of financial literacy, which is financial knowledge, can potentially increase an organisation's total sources of financing (Marcolin & Abraham, 2006). Moore (2003) explained that literacy or knowledge is obtained through practical experience and active integration of knowledge; in other words, people will tend to become more sophisticated in regard to finance when they are more literate. However, as mentioned by Eniola & Entebang (2015a), researchers agreed that there is no established instrument applied to measure financial literacy and that financial literacy cannot be measured directly. The second dimension, which is financial attitude, is related to the risk-taking behaviour. The organisation intentionally commits resources to projects with a chance of higher returns but it may also involve a higher possibility of failure (Lumpkin & Dess, 1996). Nonetheless, risk-taking is also typically linked with entrepreneurial behaviour, and that mainly successful entrepreneurs are risk-takers (Kuratko & Hodgetts, 2001). The third dimension, which is financial awareness, comes under the managerial aspect, where the manager has to oversee and supervise the organisation's business well-being. Financial awareness is the ability to read, analyse, manage, and discuss the various financial conditions that will eventually lead to an individual's economic prosperity (Rahmandoust et al., 2011). Audet and St-Jean (2007) discovered that SME owners who more aware of the services by external service providers, utilised and benefited more from those services than the SME owners who did not have any information regarding these services.

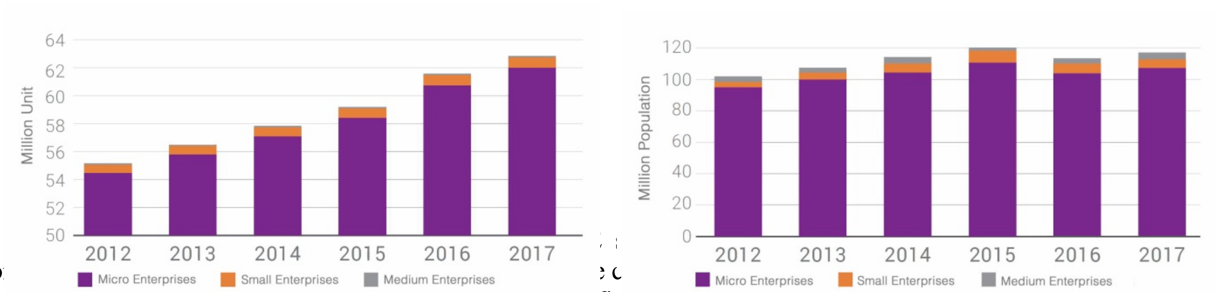
Evidence from Indonesia also revealed that the higher the financial literacy level, the greater the demand for financial services. An empirical study conducted by Soedarmono and Prasetyantoko (2017) suggested that individuals with higher financial literacy are associated with higher demand for bank credit. Nonetheless, the study showed that the positive impact of financial literacy on demand for bank credit is more pronounced in the younger generation and the highly educated population. Demand for bank credit is also higher for individuals who stay in close vicinity of post offices, suggesting that the development of hybrid bank lending products integrated with post office services might be worth considering. The study highlighted that the higher demand for formal financial services is positively driven by the availability of disseminated information about these formal financial services, signifying the importance of broadening public awareness programmes related to the financial literacy and financial inclusion across Indonesia.

Moreover, an empirical study conducted on MSMEs located in the Makassar region implied that the financial literacy of MSMEs would inevitably affect the strategic impact of enterprises and improve the competitiveness of the companies that are moderated by the capital structure. Financial literacy also influences risk management through the capital structure and rational financial decision. This study suggests that MSMEs competitiveness is influenced by financial literacy, rational financing decisions, and sound risk management (Nohong, Ali, Sohilauw, Sobarsyah & Munir, 2019).

3.3 The Essential Role of MSMEs for the Indonesia Economy

The total number of MSMEs in Indonesia is substantial and holds a significant position in the Indonesian business ecosystem. According to the data obtained from a Ministry of Cooperatives and SMEs (MoCSMEs) report, until 2017, the total number of micro, small, and medium enterprises reached 62,106,900, 757,090, and 58,627 units, respectively. Meanwhile, large enterprises merely accounted for 5,460 units (Ministry of Cooperatives and SMEs [MoCSMEs], 2017).

The MSME sector in Indonesia is continuously growing and expanding. It remains solid as it is geographically widespread evenly across Indonesia and dominates the business sectors. MoSCMEs data showed that in 2017, MSMEs made up to 99.99% out of the total enterprises in Indonesia, with a total of 62,922,617 units in the micro-segment (or 98.70%), while the small and medium segment contributed up to 1.20% and 0.09% respectively (Ministry of Cooperatives and SMEs, 2017). MSMEs were argued to have more advantages than the larger enterprise segment due to their lower-cost nature, higher flexibility, more specific sectors, as well as faster innovation ability (Incubator, 2018).



[illegible] the Indo[illegible] vital role in driving economic growth as well as contribute significantly to the country's GDP (Incubator, 2018). Furthermore, MSMEs are able to employ a considerable amount of the country's workforce. It was mentioned that MSMEs absorb up to 97.02% out of the total workforce compared to larger entities which merely account for 2.98% of the total workforce (Ministry of Cooperatives and SMEs, 2017). Due to this ability to absorb an extensive workforce, MSMEs tend to increase job opportunities and subsequently improve the earnings of the society. With these antecedent facts, the growth of the MSME sector will surely help foster Indonesian economic growth, increase job creation, and promote the effectiveness of the fiscal and monetary policies, and consequently, contribute in enhancing financial and economic stability.

Unfortunately, even with its crucial position as one of the critical factors driving the growth and development of the Indonesian economy, the MSME sector is still confronted with numerous issues and challenges – from access to finance, competition, legal status, high cost of materials and labour, lack of space, unskilled staff, and political instability – that inhibit the sector's development and expansion. As disclosed by an International Labour Organisation (ILO) report (2019), a significant issue confronting MSMEs in Indonesia is access to finance. The importance of finance varies from study to study but it is consistently a feature. In one survey, 15% of MSMEs mentioned lack of finance as one of the top three business challenges. Informal MSMEs (19%) are obviously more affected, but semi-formal (10%) and formal MSMEs (11%) also face this challenge. Challenges that MSMEs consider more severe than access to finance were stated to be competition (66%), high costs of materials or labour (37%) and lack of space (22%), in addition to the lack of skilled staff or difficulties in retaining skilled staff (23%) (IFC, 2016; ILO, 2019).

According to the World Bank (2008), the lack of access to finance can lead to perpetual income inequality, continuous poverty traps, and decreasing economic growth. The World Bank mentioned that this lack of access could be classified into two: voluntary and involuntary exclusion. While the Indonesian government is trying to minimising the involuntary exclusion of MSMEs by implementing specific credit guarantee schemes, interest rate subsidies, and even mandating the banks to provide 20% minimum credit ratio for MSMEs to improve the inclusion of the sector, many Indonesian MSMEs are still facing financial constraints as its primary issue. This could be attributed to the demand-side circumstances of the MSME sector itself, and they could be excluding themselves from the formal financial services voluntarily. ILO (2019) also reported that the majority of Indonesian MSMEs are financially illiterate; and hence, potentially lowering their chances of getting external financing, and reducing the effectiveness of the government's financial inclusion programmes.

4. Issues, Challenges and Opportunities For MSMEs in Embracing Islamic Financial Literacy and Inclusion in Indonesia

4.1 Islamic Financial Literacy and Islamic Financial Inclusion: The Current Condition in Indonesia

Taking from the above sections, which have provided the definition of financial literacy in general, Islamic Financial Literacy can therefore be described as a combination of Islamic financial awareness, skills, knowledge, attitudes, and behaviours that are needed to make sound financial decisions and ultimately achieve individual financial well-being that could eventually extend to the well-being of the public/Ummah. Going a step further, Islamic financial literacy extends beyond this definition – where Muslims or the individuals that practice Islamic finance should also not neglect the elements that are strictly prohibited in Islamic transactions, such as the riba, gharar, maysir, and deception. Furthermore, they need to understand the mandatory and encouraged elements within Islamic finance, such as the payment of zakat, doing sadaqah, infaq, and practising waqf. It can be said that the concept of Islamic financial literacy places more emphasis on the public well-being rather than personal/group wealth maximisation.

In the Indonesian context, the Islamic financial literacy index was measured and assessed for the first time in the Indonesian Survey of National Financial Literacy and Financial Inclusion in 2016. This assessment of Islamic financial literacy index was highly needed to assess the issues of low market share and penetration of Islamic financial services compared to its conventional counterpart. From the outset, the potential growth of the Islamic financial services industry is projected to be high and rapid, due to the vast majority of Indonesia's population being Muslim. Therefore, the provision of this survey is critical for Islamic financial system development in Indonesia.

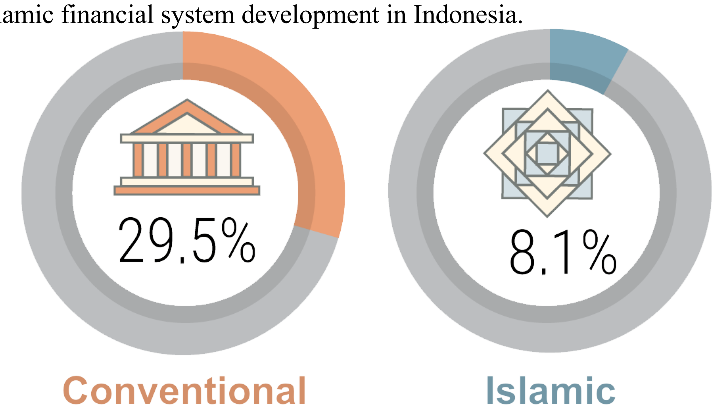


Figure 4: Financial Literacy Index - Conventional vs Islamic
Source: OJK (2016)

As disclosed in the 2016 Survey of National Financial Literacy and Financial Inclusion report, the Islamic financial literacy index of Indonesia's population stands at a mere 8.1%. In other words, for every 100 Indonesian, only eight people are considered to be literate on the Islamic financial industry and its services. This percentage is significantly lower compared to the index of conventional financial literacy, which stands at 29.5% (OJK, 2016).

At the provincial level, the Islamic financial literacy index shows different results. East Java scored the highest Islamic financial literacy index, recording 29.4%; whereas East Nusa Tenggara scored the lowest at 0% (refer to graph in Appendix 1). On average, the vast majority of Sumatera and Java Island provinces recorded higher Islamic financial literacy compared to provinces on other islands. Due to these varying levels of literacy among Indonesian provinces, the provisions of varying and unique strategies are needed to increase the Islamic financial literacy index, particularly in the Muslim-majority provinces.

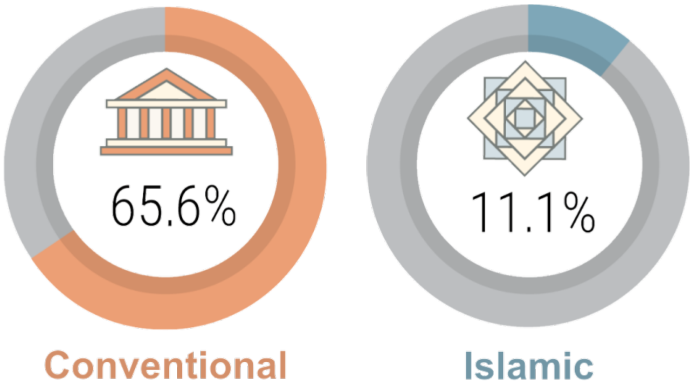


Figure 5: Financial Inclusion Index - Conventional vs. Islamic
Source: OJK (2016)

In terms of the financial inclusion index, Indonesia scored 67.8% in general (conventional and Islamic); while for the Islamic financial inclusion index, the number stood at a mere 11.1% (OJK, 2017). This low percentage of Islamic financial inclusion index is a stark contrast against the 87.2% Muslim population of Indonesia (Badan Pusat Statistik [BPS], 2010). Although Indonesia has the highest Muslim population globally, its population does not extensively utilise, nor benefit from, Islamic financial products and services. The inclusion of Islamic financial services in Indonesia is significantly lower than the inclusion of the conventional financial services index which stands at 65.6% (OJK, 2016).

For Islamic financial inclusion at the provincial level, Aceh showed the highest index for the utilisation of Islamic financial services at 41.5%, whereas East Papua scored the lowest at a mere 2.18%. Based on the data provided by OJK (2016), many Indonesian provinces that showed higher scores for Islamic literacy index, scored low on its Islamic inclusion index, and vice versa. Examples of these cases are such as is in the East Java province which recorded the highest Islamic financial literacy index (29.4%); however, its Islamic financial inclusion index was only 12.2%. Meanwhile, Aceh showed the highest Islamic financial inclusion index (41.5%); nonetheless, its Islamic financial literacy index stood at only 21.1% (refer to graph in Appendix 2).

On average, based on the statistics published by OJK (refer to graph in Appendix 2), the Islamic financial inclusion index showed a higher trend compared to the Islamic financial literacy index. This phenomenon can lead to the presumption that the Indonesian population may be utilising Islamic financial products and services without proper and balanced knowledge on them; they solely use the products and services without knowing the intricacies of its characteristics, benefits, risks, penalties, nor the rights and obligations to purchase and obtain particular products and services.

Furthermore, the varying levels of financial literacy and financial inclusion indexes indicate that the government of Indonesia needs different strategies and plans relevant to each province to address its Islamic financial literacy and inclusion problems. For example, a province with a high inclusion but low literacy index may need specific programmes to increase their awareness and knowledge pertaining to Islamic financial products and services, as well as the detailed characteristics of such services to allow the community to better utilise and benefit from them. Whereas a province with a high literacy and low inclusion index would need extensive promotion and product expansion to increase both access and availability of Islamic financial products and services, so their high literacy can be balanced with greater access and a wider selection of Islamic financial products and services.

4.2 Issues of Exceptionally Low Level of Islamic Financial Literacy among Indonesian MSMEs

Since the MSMEs contribution is vital for the stability and sustainability of Indonesia's economy, the sector is included within the framework of Indonesia's National Strategy on Financial Literacy issued in 2013 and updated with several amendments in 2017. The MSME sector is included within the targeted groups for financial education activities/initiatives along with women, students, retirees, workers and professionals residing in urban and rural locations.

Unfortunately, as reported by an OJK survey (2017), Indonesia's population categorised as well-literate on financial matters stands at a mere 29.7%; a slight increase from 21.8% in the 2013 survey. This particular survey measures and assesses the financial literacy levels of household, and hence, to some extent, covers MSMEs. As affirmed by an ILO report (2019), many MSMEs in Indonesia are still considered financially illiterate, which profoundly impacts their performance and growth as financial literacy levels affect the chances of enterprises in accessing external financing. This means that the lower a business' financial literacy level, the lower the likelihood of the business in accessing and obtaining external financing.

The situation is more severe with regard to the Islamic financial literacy index – which stands at only 8.1% for Indonesia's entire population (OJK, 2016). Therefore, the index of Islamic financial literacy for MSMEs is assumed to be exceptionally low. This assumption was confirmed based on an empirical study conducted by Djuwita and Yusuf (2018) that measured the Islamic financial literacy level among micro-enterprises located in the Cirebon area. The study used street vendors and stores located at At-Taqwa Mosque in Cirebon as a sample. The results implied that most street vendors and store owners have an unexpectedly low, some even zero, levels of Islamic financial literacy. This phenomenon contradicted the study's assumption that since the vendors and shops are located within the vicinity of a mosque; hence, they should have, to some degree, knowledge regarding Islamic financial products and services. However, the findings stated otherwise.

4.3 Identifying the Needs of Indonesian MSMEs to Improve their Islamic Financial Literacy Level

The low Islamic financial literacy levels indirectly show that although Islamic financial services has existed in Indonesia since the 1990s, in the context of MSMEs, the sector's Islamic financial literacy and inclusion is still at its beginning phases, with much room for improvement. Therefore, identifying the needs of the MSME sector, particularly in aspects related to Islamic financial services is highly needed, so that the sector could greater utilise and benefit from Islamic financial services. Ultimately, both sectors (MSMEs and Islamic financial services sector) could contribute to the improvement of the Ummah's well-being in the long run – where MSMEs can provide substantial job provisions and contribute significantly to the country's GDP, while Islamic financial services can provide a reliable and robust capital basis for MSMEs.

In summary, several aspects need to be explored and identified to improve the Islamic financial literacy as well as Islamic financial inclusion of the MSME sector in Indonesia. These aspects include:

4.3.1 Enabling Environments

An economically sound, stable, and business-friendly environment promotes investment, stimulates entrepreneurship, and boosts MSMEs growth, development and activities. Reliability of the legal and regulatory environment, restructuring and resolution framework, stable and transparent tax framework, and availability of financing options are deemed as enabling factors for MSMEs growth (Atkinson, 2017).

a) Regulation

While regulation intends to remedy market failures and information asymmetries as well as to improve the balance between the goals of different stakeholders, regulatory barriers could pose a constraint for businesses, especially for the MSME sector. Regulatory, complex administrative and bureaucratic requirements create a burden, and result in additional costs, for enterprises to enter the market. Such mentioned costs are significantly higher for micro and smaller enterprises as regulation typically entails a fixed cost. With no dedicated personnel nor resources to deal with the regulatory requirements, an entrepreneur may end up reallocating the time needed to manage the business in order to handle the regulatory burden (European Commission, 2007; Nassr, Robano & Wehinger, 2016)

Therefore, to promote the utilisation of Islamic financial services as well as improve the financial literacy of MSMEs, the government of Indonesia needs to allocate additional efforts towards increasing the MSMEs awareness on Islamic financial products and services, as well as expanding the latter's access by reducing specific regulations and bureaucracies that encumber MSMEs from benefitting from them. This could include, for example, the government giving incentives to MSMEs that utilise Islamic financial services – this could be in the form of tax reduction, decreased licensing fees, or providing a specific place for their business, etc. In terms of Islamic financial service providers, the government could mandate the industry to provide training programmes and workshops for MSMEs and potential entrepreneurs prior to applying for financing. With regard to business start-ups, the government could prioritise these groups in applications for Islamic KUR[1] programmes (Islamic credit guarantee schemes) so that the government acts as a safety net for MSMEs utilising Islamic financial services; and thus, encouraging Islamic financial institutions to offer financing to, as well as partner with, MSMEs. The government's involvement in the execution of the Islamic financial inclusion and literacy programmes is of paramount importance since the government has the power to enforce policies, while at the same time, protect the MSMEs and Islamic financial services sectors in conducting their activities.

b) Access to Islamic Banks and other Islamic Financing Alternatives for MSMEs

Access to finance (to establish or grow a business) is often recognised as one of the primary barriers to entrepreneurship and small business development. Nevertheless, this lack of access to formal financial services for MSMEs is not necessarily attributed to the low levels of consumer financial inclusion. Difficulties in accessing finance is a common challenge for entrepreneurs, where options for obtaining financing appear to be limited. A cross-country study conducted by Atkinson (2017) shows that awareness and knowledge of the financing options available to MSMEs can create challenges for enterprises at different stages, denoting that low levels of financial literacy could potentially hamper businesses in strengthening their capital base.

When looking for external financing (as opposed to utilising retained earnings or sales of assets), evidence suggests that MSMEs and potential entrepreneurs rely heavily on traditional bank financing and tend to approach their local banks, with which they already have a relationship for financing. These local banks may have the infrastructure and know-how that allows them to deal with small financing origination, monitoring, sourcing, and credit analysis (Nassr & Wehinger, 2015). These local banks may also have a decent understanding of the specific attributes of the local market and networks as well as the capacity to reach out to MSMEs at the local level. In emerging markets, banks act as a bridge to informal MSMEs and can therefore play an essential role in connecting them with the formal economy and the markets. Nonetheless, as banking operations become more centralised, bank branches have less autonomy to assess documentation and make decisions on the provisions of credit, therefore negating the potential benefits of local knowledge and networks (Atkintson, 2017).

In this respect, to address these issues and expand financial access in the rural and remote regions, the government of Indonesia started an initiative to introduce the branchless banking programmes. OJK (2017) defines branchless banking as the delivery of financial services outside the bank's office by taking advantage of agent services based on information technology and communication in sending the transaction details. Branchless banking has great potential in reducing costs of delivery channels and improving convenience to customers, especially in rural and faraway areas. It is therefore appropriate, to accomplish the goals of the Islamic financial inclusion programmes, for the Indonesian government to promote Islamic financial products and services via this branchless banking mechanism. Agents may also play a greater role by providing financial education services through the use of booklets, brochures, or simple information explaining Islamic financial products and services. With Indonesia's geography spanning thousands of islands, it is costly to establish new

[1] Kredit Usaha Rakyat (People's Business Credit)

banking branches. Branchless banking could be one of the answers to expanding financial services in the country due to its lower cost and fast transaction time.

With regard to the existing local branches, policymakers need to review their regulations to possibly allow the branches authority in the districts or rural areas to decide or approve financing facilities. This is especially beneficial for branches of Islamic banks, as this relaxation could potentially lessen the time and procedures needed, and thus, increase the chances of MSMEs to obtain financing from their local or regional banks. Since local banks know their customers and their area better, giving them autonomy for the financing decisions could strengthen their partnership with local MSMEs. Subsequently, this could potentially affect the MSMEs financial literacy levels, encouraging them to approach their local banks more often and with requests and demands for financial products and services that meet their needs.

Shari'ah-based peer to peer (P2P) lending could also be an alternative for MSMEs in obtaining Islamic financing due to its simplicity and fast procedures. So far, in March 2019, there are seven registered P2P industries that offer Shari'ah-based lending in Indonesia, namely: Investree, Ammana, Danasyariah, Danakoo, Alamisharia, Syarfi and Duha Syariah (Quiserto, 2019). In the context of P2P lending, the role of financial education is double, covering both the receiving end of the financing (MSMEs as a borrower) and as the supplier (the investor as the provider of funds, especially the retail investor). There is a need for investors to have sufficient financial literacy skills to understand the risks involved in being on the borrower's side in such funding. This is specifically relevant for equity crowdfunding, where investors are faced with information asymmetry between themselves and the entrepreneur (Atkintson, 2017).

4.3.2 Knowledge, Skills, and Confidence of MSMEs Entrepreneurs

While the business landscape could create a macro-environment that supports or hinders the establishment and growth of enterprises, the personal characteristics of the MSME owners and potential entrepreneurs also generate micro-level challenges and opportunities. MSME owners need to know how to best utilise their resources, and strategically navigate through any challenges they may encounter.

a) Islamic Financial Literacy

As described before, better financial literacy levels could empower MSMEs and affect their performance levels; hence, improving the opportunities for the sector's financial inclusion. In the context of MSMEs in Indonesia, since the majority of Indonesia's population are Muslims, the MSME sector is presumably dominated by Muslim entrepreneurs. As such, Muslim entrepreneurs should increase their knowledge on Islamic finance and will thus be more inclined to utilise Islamic financial products and services.

Islamic financial literacy is of paramount importance, especially for the Muslims entrepreneurs, and for the development of Ummah in general, due to several reasons:

- Well-informed entrepreneurs on Islamic financial matters may have a better understanding, or a shift in their perception of how profits and money are perceived in Islam. Money and wealth are all seen as an Amanah (trust from God), and having better knowledge and understanding of this concept will influence how they administer their wealth and their businesses. This shift will entail the view that their businesses become acts of ibadah (worship), losses in business become tests to their faith, and their success and wealth become a means to improve the Ummah and society's well-being, through means such as zakah, waqf, sadaqah and other charitable activities.
- Better financial literacy could also potentially reduce market failures due to asymmetric information between the provider and the receiver of financing. In the context of Islamic financial literacy, it will prevent Muslims entrepreneurs from becoming heavily indebted (gharim) due to financing misuse and business misconduct. Thus, hopefully, Islamic financial literacy could convert individuals from being beneficiaries of zakat to becoming contributors of zakat and charitable causes, and ultimately improve social welfare in general.
- Better financial analysis and reporting capabilities also will augment the ways Muslim entrepreneurs define their financial profiles to potential financiers during the financing application process, thereby improving the chances of obtaining financing for their businesses.
- Also as important, more financially-literate entrepreneurs are more likely to understand the importance of servicing their financing (without missing the capital/profit-sharing payments to their financier or breaking any terms and conditions in the contract) and develop the skills to make this possible.

b) Entrepreneurial Skills and Confidence

As discussed earlier, the Indonesian government needs to review and remove the regulatory barriers related to MSMEs business activities and increase their financing options and incentives for utilising Islamic financial services. However, Muslim entrepreneurs are still in need of education and advice to grow their businesses, and potential Muslim entrepreneurs need to be given the confidence and encouragement to take the first step in establishing their first enterprises.

In this respect, entrepreneurial training has the potential to substantially increase the number of healthy enterprises as well as improve their efficiency and their productivity. Furthermore, information and guidance could help MSMEs understand the regulatory requirements and minimise the compliance burden with regard to complicated insurance, taxes, and pension issues. Subsequently, adequate guidance could also potentially motivate MSMEs to enter into the formal economy and augment MSMEs' overall compliance levels (Atkinson, 2017).

It has to be noted that one of the significant constraints that inhibit the growth of MSMEs in Indonesia is the reluctance of the entrepreneurs to approach formal financial services. Djuwita and Yusuf (2018) mentioned in their study that many store owners and street vendors are reluctant to obtain external financing to strengthen their capital basis. The majority only use their retained earnings and their own capital; hence, significantly limiting their business growth. As such, the provision of attractive and straightforward information regarding Islamic financial products and services also has the potential to motivate Muslim entrepreneurs to approach Islamic financial service providers and obtain the much-needed financing.

c) Business Know-how

MSMEs need a broad range of skills – including those that will enable them to negotiate and operate effectively within a business atmosphere, the ability to manage a business and its people and other sector-specific skills – that could assist them in succeeding in a competitive and volatile environment. The needs of MSMEs vary in accordance with the life stage of the enterprise. Cross-country studies recognised that the lack of management skills is a problem for a potential and newly-established business, whereas the lack of knowledge on financing options remains an issue for the mature business (Atkinson, 2017).

Furthermore, Muslim entrepreneurs need to also understand the halal requirements and certification for their business. However, many neglect this aspect since getting halal certification is perceived as an expensive and complicated process, which does not guarantee any improvements in their product saleability nor increase in their profits. The government of Indonesia, recognising this issue, decided to make this certification free and simplify its procedures (Bappenas, 2018). Unfortunately, many Muslim entrepreneurs in Indonesia are unaware of this free option and unwillingly apply for halal certification due to the high-cost and complex procedure perception. Hence, the government of Indonesia and KNEKS[2] should cooperate in disseminating the information regarding this free certification option to increase the awareness and convince the MSME entrepreneurs of this great opportunity.

5. The Covid-19 Pandemic: Its Impact on MSMEs and The Importance of Financial Literacy

As at early 2021, people the world over are still experiencing the spread of Coronavirus Disease 2019 (or more commonly known as COVID-19), which has altered the global landscape and impacted our social and financial environments. The sudden disruptions caused by this outbreak present unprecedented economic challenges with growing repercussions. While several factors influencing financial well-being are beyond individual control, financial literacy could assist people in better managing their financial matters during times of hardship and times of prosperity. This section will explore how the COVID-19 pandemic is impacting the MSME sector in Indonesia and discuss how financial literacy capacity could strengthen the MSMEs' position in sustaining their businesses amidst the COVID-19 pandemic.

5.1 Impact of the COVID-19 Pandemic on the MSME Sector in Indonesia

As reported by KNEKS (2020), domestic consumer demand has decreased primarily due to the travel and movement restrictions, quarantines, curfews, and lockdowns imposed by most countries across the world. These measures have disrupted global supply chains and inevitably forced many companies to decrease production and shrink employment. An immense number of people have lost their jobs, and global unemployment has risen. The MSME sector is not spared from the harsh environment and disruptions caused by this pandemic. The sector is struggling to survive during this period, as they need to continue paying business costs and expenses, including repayment of any financing facilities from any financial institution. As a consequence, the disturbances in the MSME sector will potentially affect the soundness of the financial industry that serves the MSME segment (KNEKS, 2020).

During the 1998 and 2008 crises, while many large corporations in Indonesia resorted to closing down and filing for bankruptcy due to the financial crisis, the MSME sector remained intact and was able to rescue Indonesia's economy from the bigger impact of the global crisis. As argued by Simanjorang (2020), this phenomenon occurred as the MSMEs had strong and reliable economic roots; hence, the sector was able to help the Indonesian economy by protecting the community's purchasing power. On the other hand, in the current conditions brought about by COVID-19, the MSME sector is paralysed and vulnerable. This is due to the decrease in people's demands and daily necessities during the mobility restrictions. As the MSME market share is greatly dependant on the movement of people who serve as their customer base, these circumstances have a huge impact on the MSME market share. The lockdown and curfew measures have forced most people to stay at home and work from their houses. This mobility restriction consequently affects the MSME's survivability as it significantly decreases the MSME customer demands and potentially impacts their business incomes and revenues (Simanjorang, 2020).

Nevertheless, this restriction is essential and comprehensible to reduce the spread of the disease as it safeguards the health of the people (who are economic agents) from getting ill, protects the healthcare systems from collapsing thus preserving economic activities in the long run. As an initiative to assist the MSME sector during this restrictive period, the Indonesian government has issued several economic stimulus packages that primarily target the MSME segment to facilitate their business sustainability – from credit stimulus, loan instalment relief, deferment of loan repayment, as well as other relaxation packages (Anjaeni & Mahadi, 2020).

5.2 The Importance of Financial Literacy for MSME Amidst COVID-19 Pandemic

As the COVID-19 outbreak disrupts global economics and social environments, Indonesia also faces economic challenges as many Indonesian people are not adequately equipped to face the economic paralysis (Yuesti, Rustriarini & Suryandari, 2020). This unexpected situation and unpreparedness of its people are partially caused by the low level of financial literacy.

[2] Komite Nasional Ekonomi dan Keuangan Syariah (Indonesia National Islamic Economic and Finance Committee)

Several studies suggest that financially-illiterate individuals are vulnerable to exploitation by formal and informal institutions (Muñoz-Murillo, Álvarez-Franco & Restrepo-Tobón, 2020) and hence, may end up incurring higher financing costs (Choi, Laibson & Madrian, 2010). Furthermore, the lack of financial literacy is associated with the inability to assess and make an effective decision with regard to personal finances (Chinen & Endo, 2012).

As suggested by Stolper and Walter (2017), financial literacy is not intended to curb or complicate people from enjoying their lives and utilising their wealth; rather, the financial literacy serves as a mechanism for individuals or households to enjoy their lives through appropriately utilising their financial resources to attain their respective financial goals (Stolper & Walter, 2017). Proper financial management is a critical key to achieving a healthy financial condition. Financial problems are not merely caused by the errors in credit usage, but are often due to the lack of financial planning. As discussed by several studies, sound financial management combined with a decent financial literacy capacity will result in maximum financial benefit and improved financial well-being (Shim, Xiao, Barber & Lyons, 2009; Gerrans, Speelman & Campitelli, 2014; Coskuner, 2016).

As elaborated earlier, since many MSMEs in Indonesia have low levels of financial literacy, let alone the Islamic financial literacy, the sector is hugely susceptible to the uncertain conditions caused by this pandemic. As disclosed by Kurnia (2020), since many MSME in Indonesia has low financial literacy skills, they do not have any knowledge to manage their business financing properly, and merely focusing on the business revenues and profits. During this COVID-19 outbreak, many entrepreneurs have recently been made aware of the importance of financial knowledge and proper financial management, as they need to provide their financial reports or bookkeeping records as part of the requirements to apply for financial support or collaborate with third-party institutions. However, since many MSMEs do not have any financial statements, this situation renders them helpless as they are unable to apply for financial aid or stimulus packages – whether from the government or private institutions. In the enterprise segment, financial literacy is not merely about a standardised financial statement; financial literacy also includes internal business management, proper allocation of responsibilities, and transparent business activities. These elements serve to ensure the business soundness and minimise immoral and fraudulent behaviour that will certainly decrease revenues (Kurnia, 2020).

6. Conclusion & Recommendations

The aforementioned discussion explaining the importance of financial literacy for MSMEs growth and the vital position of MSMEs for the stability and sustainability of Indonesian economy, clearly signifies that the sector needs extensive attention to improve their financial literacy capacity, so the sector will become more aware and understand the financial aspects and business management skills, hence improve their efficiency and productivity. Unfortunately, even with its significant role and potential, Indonesia's MSMEs have exceptionally poor financial literacy, which is even more excruciating in the context of Islamic financial literacy. These indexes indicate that the sector still in its beginning phases to embrace Islamic financial literacy and Islamic financial inclusion.

The inclusion of MSMEs into the Islamic financial services should be a top priority for the Indonesian government – considering that most of the MSME entrepreneurs in Indonesia are Muslims, and that Islam encourages entrepreneurship. The Islamic financial system could hopefully provide MSMEs with better financing services and products compared to its conventional counterparts.

Consequently, several approaches and strategies need to be addressed for this promising sector to improve their Islamic financial literacy and eventually achieve the goals of MSMEs Islamic financial inclusion. These approaches include:

1) Full involvement and support from the government to improve Islamic financial literacy and promote Islamic financial inclusion are highly critical, especially for MSMEs. This is crucial as the government has the ability to create a supportive environment for MSMEs by enforcing policies, reducing regulatory barriers, and at the same time protecting them from market volatilities.
2) Bank Indonesia and OJK should conduct a specific survey to assess the level of Islamic financial literacy and Islamic financial inclusion among the MSMEs. This is crucial as an accurate and updated assessment could provide better information on the sector's opportunities and measure the severity of problems and challenges.
3) Islamic financial services providers should improve the information dissemination of their services to MSMEs – preferably through attractive and straightforward advertising. This will encourage and motivate the MSMEs to approach them. At minimum, approaching the providers and asking them questions pertaining to their services could increase MSME's knowledge and alter their perception towards Islamic financial institutions as well as their products and services.
4) All stakeholders need to be involved in efforts to improve the Islamic financial literacy of MSMEs – this includes local governments, PLUT KUMKM[3], SMESCO[4], KNEKS, MSMEs trainers, academia, and non-profit organisations that are involved in MSME-related activities.
5) With regard to the COVID-19 disruption, all parties involved in MSMEs development, including public and private institutions, should assist MSMEs to improve their financial literacy skills, with particular focus on Islamic financial literacy. These initiatives could be divided into short-term and long-term financial literacy plans.
    a. The short-term plan may consist of setting-up an emergency business fund, creating a budget to prioritise and assess financial resources, postponing any business expansions during this period, and putting focus on what the business can control in the short-term.

[3] Pusat Layanan Usaha Terpadu Koperasi dan UMKM (Integrated Support Center for Cooperatives and MSMEs)
[4] Small, Medium and Cooperatives Indonesian Company

b. The long-term plan may consist of revisiting a long-term budget to manage their businesses under the new conditions caused by the pandemic, proactively participate in public and private financial support programme, taking advantage of online technology to amplify business revenues and marketing, benefitting from lower financing costs, and increasing involvement in charitable activities to assist other MSMEs and the vulnerable segments of society.

A combination of these approaches could hopefully improve the levels of Islamic financial literacy and financial knowledge of MSMEs in general. However, these approaches are not conclusive, nor inclusive, and there is much room for improvement. There may also be a need for specific strategies targeted at particular segments of MSMEs. In conclusion, augmenting the MSME sector's Islamic financial literacy will intensify the chances of the MSMEs Islamic financial inclusion, and ultimately empower enterprises to become a major contributor towards improving the prosperity of the Ummah, well-being of the society, and overall economy of Indonesia.

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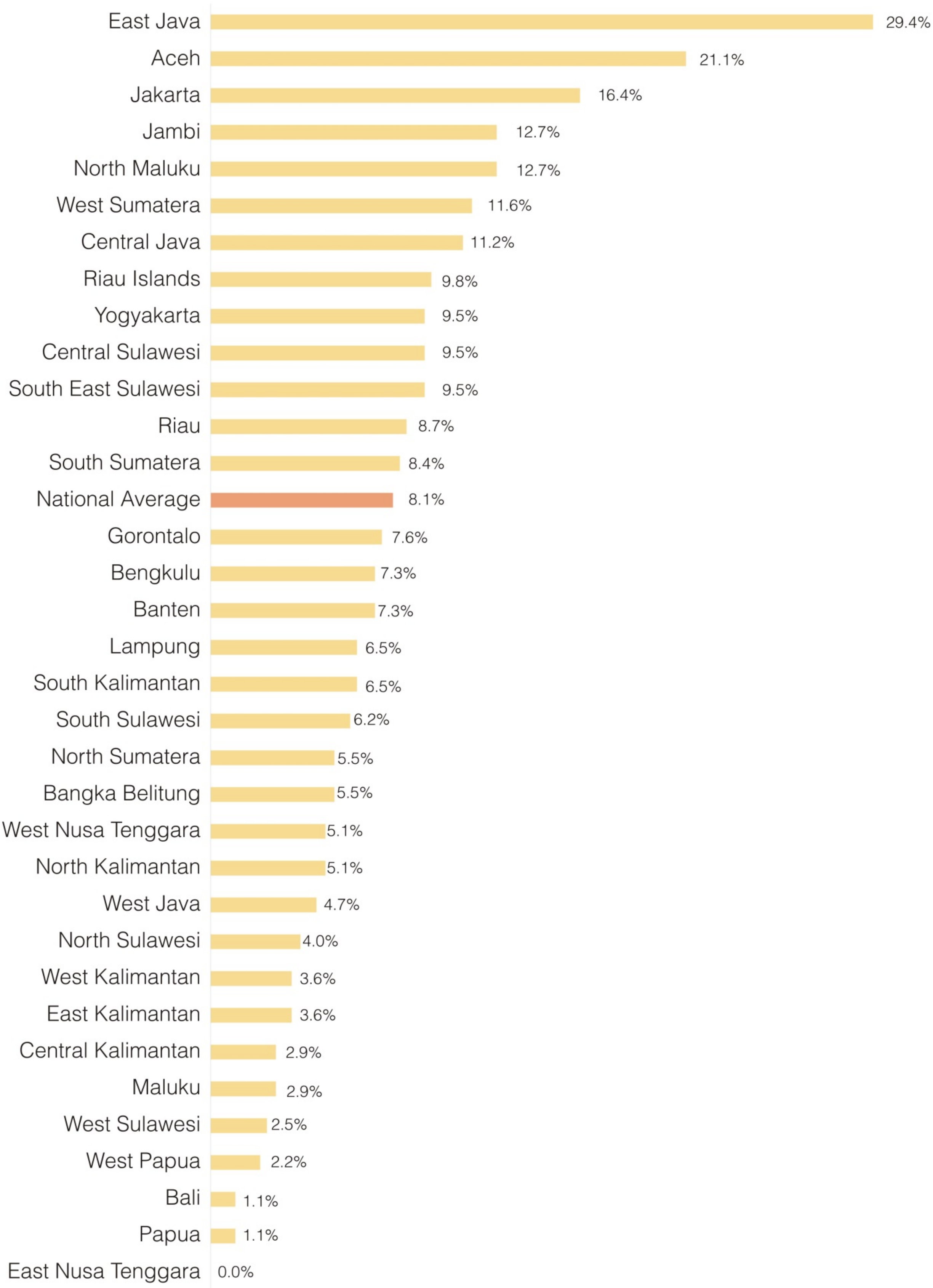
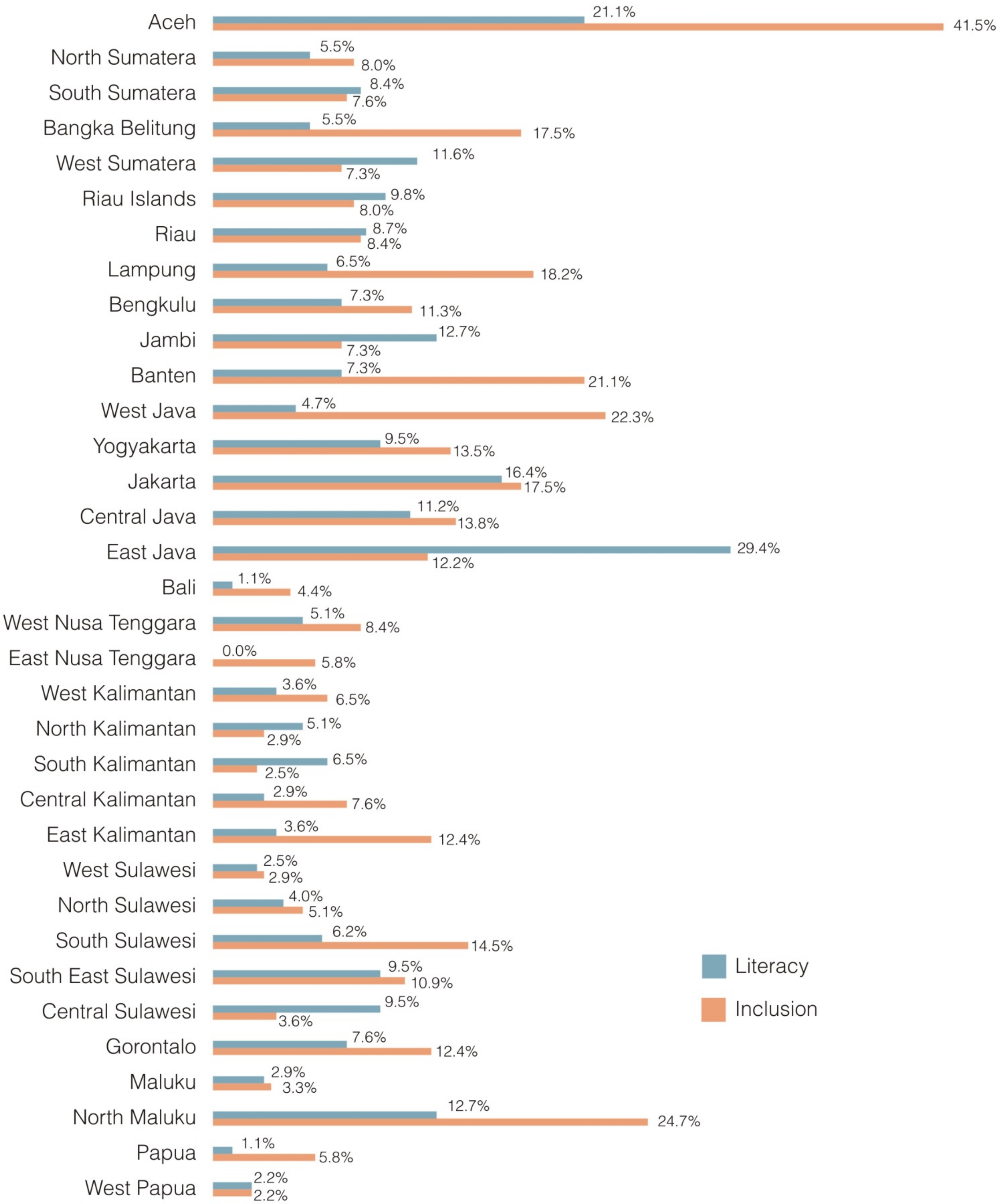
Appendix 1: Islamic financial literacy index rank of Indonesia's provinces



Source: OJK (2016)

Appendix 2: Islamic financial literacy index compared to Islamic financial inclusion index of Indonesia's provinces



Source: OJK (2016)