

# The Nexus Between Dynamic Capability and Islamic Financial Literacy Towards Innovation of Small Medium Enterprises (SMEs) in Indonesia

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**Abstract**—This research focuses on exploring the determinants of business model innovations and contributing to research related to business model innovations. The novelty of the research model in the innovation business research model is to include the Islamic financial literacy variable. This research emphasizes dynamic capabilities and sharia financial literacy as independent variables, business model innovation as an intermediate model, and business performance variables as dependent variables, with a focus of research on MSMEs in Indonesia. We used Part Least Square (PLS) method. The results showed that dynamic capabilities and financial literacy through business model innovation had a positive effect on MSME business performance in Indonesia simultaneously or partially.

**Keywords**—Nexus, Dynamic Capability, Financial Innovation, SMEs

## I. INTRODUCTION

In today's millennial era, trade is one thing the state has to do to advance the economy of the country itself, either micro-and macro-trading. According to the Ministry of VAT/Bappenas the rate of economic growth in Indonesia in 2018 increased by 0.10%. The economic growth has a direct impact on the field of employment that has increased. Which means the role of large or small traders supports in increasing economic growth. [1]

Capacity management is a foundation step towards a new theoretical Open innovation. Based on the insight of the variation-selection-retention literature, the framework helps to understand how companies can take advantage of the

open innovation process. Given the high failure rate in open innovations, the framework-based capabilities contribute to explaining the heterogeneity of the interface in financial innovation performance. Although a company can partly affect its environment over time, its processes and evolutionary abilities depend on context. [2]

MSMEs in Law No. 20 of 2008 is a small company that is managed by someone or owned by a small group of people with a minimum amount of wealth and a certain income. SMEs play an important role in economic development and promote Indonesia's economic growth. With the existence of MSME sector makes employment so it can absorb unemployment [3].

The performance of MSMEs in Indonesia is still relatively lower than other ASEAN countries, especially in terms of productivity, export contributions, global and regional production participation and contribution to value added [4]. One of the causes of low performance of MSMEs is due to lack of investor access. This can be caused by lack of knowledge and MSME understanding of the existence of financial institutions. This is known as financial literacy. Based on the survey data conducted by OJK (2013), that there are 4 (four) levels of financial literacy of the Indonesian population, namely (1) well literate of 21.84%, namely have knowledge and know the benefits of financial institutions and have the skills of using financial products; (2) sufficient literate of 75.69%, i.e. have knowledge and know the benefits of financial services institutions; (3) Less

literate of 2.06%, i.e. only having knowledge of financial services institutions; and (4) not literate of 0.41%, i.e. has no knowledge and confidence in financial services institutions. The OJK data feed shows that from 100 residents only about 22 people have financial literacy at the well literate level. The condition shows the financial literacy of Indonesian population is still low [5].

Cfa[6] expressed a bad financial literacy will result in the preparation of the wrong and biased financial plan. Previous researchers have found the term financial literacy which has very important implications for financial regulation. People who do not understand financially, including having lower problems with debt.[7]. This paper will discuss dynamic capabilities and financial literacy through the innovation of business model to the performance of SMES business in Indonesia is systematized.

## II. LITERATURE REVIEW

### A. *Dynamic capability*

The new Dynamic Capability concept is over a decade old. The initial idea has undergone modifications with additional research in it. It requires clarification and empirical research in a less developed field. Dynamic Capability appears as encompasses with resource-based views theory (RBV) in an effort to explain competitive advantage in environmental conditions very rapidly changing with the technological revolution. [8]. Dynamic ability as a company fang to integrate, build, and reconfigure internal and external competencies in order to cope with changing environmental conditions at any time[9].

Winter sees capabilities as ' high-level routines ' and defines dynamic capabilities as operating capabilities to expand, modify, or create ordinary capabilities [10]. Zahra & George defines dynamic capabilities as a change-oriented capability to help companies move and reconfigure their resource bases [11]. Griffith & Harvey sees the dynamic ability difficult to mimic the combination of existing resources in a company [12]. While, Lee et al. saw it as a newer source of competitive advantage [13].

Easterby-Smith et al states that, as such, dynamic capability is the organizational and strategy routine by which the company achieves a new resource configuration when the markets emerge, clash, split, Evolve, and die [14]

### B. *Islamic Financial Literacy*

Failure to manage finances privately can result in serious, long-term social, personal consequences, including bankruptcy, credit problems, foreign exchange savings, impulsive purchases, unpaid arrears, delinquency in debt, and confiscation of homes[15]. With high levels of consumer debt accumulation, low levels of household savings, and increasing complexity of financial information, the public and private sectors are urging the creation of financial education programs to increase consumer knowledge about financial management capabilities[16].

Financial literacy is a set of financial knowledge, financial behavior, and financial attitudes needed to make careful financial decisions for the achievement of one's life goals to achieve individual welfare [17]. Antara et al.[18] posited, Islamic financial literacy is the level at which an individual has a set of knowledge, awareness, and skills

to master the basics of information and services about Islamic finance that influences his attitude to make Islamic financial decisions appropriately. He proposed measurements for Islamic financial literacy: the interest-free Islamic financial method; Gharar refers to uncertainty and fraud and is not permitted in Islamic finance; The preservation of wealth is one of Islamic financial objectives; Islamic financial institutions can invest with you in accordance with the method for the outcome (Mudarahah); Islamic financial institutions lend money in accordance with the method for the outcome/loss (Musharakah); Islamic Financial institutions provide lease financing (IJARAH); Islamic financial institutions provide a trading financing method called Murabahah; Islamic Financial institutions provide industrial financing (ISTISNA); Islamic financial institutions can provide a good loan called Qard Hassan; In Mudarahah, the provider of capital is the only party to bear loss; In order for the Istisna to be valid, the price must be set early; In Qard Hassan, customers are only required to repay the initial amount when borrowing.

### C. *Innovation of SMEs in Indonesia*

Studies of open innovations in small and medium enterprises (SMES) have experienced rapid growth over the last few years [19]. Brunswicker & Vanhaverbeke[20], A creative form of innovation that empirically opens SMEs to conceptualize the typology of strategic types of external sources of knowledge, which are minimal, supply chain, technology-oriented, application-oriented, and full scope sources. Spithoven, Vanhaverbeke, & Roijackers[21] expressed an open innovation impacting the innovative performance of SMES compared to large corporations. That the effects of open innovation practices in SMES are often different from those in large corporations. SMES can be productive in using various open innovation practices simultaneously when the owner promotes new products in the market, while this is rare in general corporations.

The turnover of new products in SMES is driven by intellectual property protection mechanisms, while large corporations in this regard benefit more from their search strategy [22]. SMES can achieve a close balance between exploratory and exploitative innovations through the establishment of an appropriate international organizational structure and adopt proper leadership style. SMES can take advantage of both innovations with relatively available resources.

## III. METHODS

The method used in this study is the explanatory survey method. Researchers tested the hypotheses that have been formulated. This research Model will reveal great free variable influence over non-free variables. Research will collect primary data with questionnaires (data ordinal) to MSMEs in Indonesia. This research analysis Unit is the SMES actors. As the initial findings of the previous study, this research examines 4 variables. There are two main variables that are examined as variable business performance-forming, and innovation of business models, namely: dynamic capabilities and Sharia financial literacy, both are variable free. Its dependent variables are business model innovation (Y) and business Performance (Z).

In the early stages, the questionnaire was tested with validity and reliability tests. At Analysis PLS, the validity of the indicators/items of the latent variable forming is based on the significance value of T count. Once collected, data is then processed and analyzed. The analytical methods used in this study are the simultaneous equation models, which are Partial Least Square (PLS). The statistical tool used to test the hypothesis is SmartPLS.

The process of statistical data with PLS is done with 2 approaches, namely (i) Estimation of measurement model and (ii) estimation of structural model. Measurement of the test model is done by conformity tests such as Chi-Square, Root mean Square residual (RMR), Roor Mean Square Error of Approximation (RMSEA), Adjusted good of Fit index (AGFI), and so on. In structural model tests, the influence of the exogenous latent variables to the direct and indirect latent endogenous variables can be determined, as determined the direct and indirect influences of the pathway analysis. The direct effect shows the direct influence of a variable to another variable. Indirect effects indicate the indirect influence of a variable against another variable through the other variables. Total effect is a summation of direct effects and indirect effects. RESULTS AND DISCUSSION

This paper focuses on the influence of dynamic capability (X1) and Sharia financial literacy (X2) on Business Model Innovation (Y) to business Performance (Z) in MSMES in Indonesia which is analyzed based on research data using Structural Equation Modeling (SEM) analysis with Smart PLS software. The validity and reliability tests were conducted to measure the validity and reliability of the variables proposed by the researchers, overall, the validity test determines whether the outer loading of each indicator exceeds 0.4 (the standard value), while the reliability test determines whether the value exceeds the Cronbach 0.6 alpha, indicating acceptable reliability.

Evaluation of the outer model is done by examining two elements, namely: the validity of convergent and the validity of discrimination. In general, convergent validity is determined by examining the loading factors and the average variance extracted (AVE), whereas discriminant validity is measured by examining cross-loading values. In this study, all loading factors met the standard value of 0.4, while all AVE values exceeded 0.5, thus indicating that convergent validity was reached. Based on cross-payload value checks, the validity of discrimination also Increases the Model in evaluated according to R-square for endogenous latent variables and line coefficient values.

TABLE I. R-SQUARE RESULTS

	<i>R-Square</i>
Dynamic capability	-
Sharia Financial Literacy	-
SME Performance	0.643

*Source: Output partial least squares structural equation modeling (2020)*

According to table I, R-square for MSME performance is 0.643, which indicates that it is influenced by the dynamic capabilities and financial literacy of Sharia. The inner Model is also measured through the predictive relevance of Q-

square. Because Q-square is greater than 0, the model has predictive relevance in the exogenous and endogenous variables. After evaluating the outside and inside models, Bootstrap was performed to determine the impact of each of the variables in MSME performance. The dynamic capabilities and financial literacy of SMES in the SME performance are shown

TABLE II. RESULTS OF THE PATH COEFFICIENT TEST

	<i>P-Value</i>
capability ->SME Performance	<i>P = 0.345</i>
Financial Literacy ->SME Performance	<i>P = 0.298</i>

*Source: Output PLS (2020)*

According to table II, dynamic capability has a positive coefficient value of 0.345, indicating that it has a significant effect on MSME performance. In addition, the higher the dynamic capability, the better the SME performance. Therefore, dynamic capabilities have a significant impact on MSME performance. The Sharia financial literacy variable has a positive coefficient value of 0.298 Therefore, both dynamic capabilities and financial literacy have a significant influence on MSME performance.

Overall, the majority of respondents show that dynamic capabilities increase resources in running their businesses. According to Winter [10], see capabilities as ' high-level routines '. Similarly, Zahra & George [11] found that dynamic capabilities as a change-oriented ability to help companies move and reconfigure their resource base dynamic capabilities also emphasize the importance of increasing the productivity of other resources The company has to increase profitability.

Based on modelling of the smallest structural equations (PLS-SEM) In this study, Sharia financial literacy has a positive impact on MSME performance. According to his research Antara [18]posited, Islamic financial literacy is a level in which individuals have a set of knowledge, awareness, and skills to understand the fundamentals of Islamic financial information and services that influence its attitude to make the right Islamic financial decisions. However, the SMES in the vicinity of Unisba still have a low financial lietracy that makes them harder to get capital to Sharia banking. This is according to the blessings of Shaleh[23] The community has a low level of financial literacy. In this case, Coad & Tamvada[24] indicates that lack of knowledge and access to financial resources can impede the company's ability to achieve its objectives and increase the value of its company. So in line with Lusardi& Mitchell [25] financial literacy refers to the financial knowledge used to achieve prosperity, as well as Volpe[26] suggests that knowledge can be used to manage finances for future prosperity

Meanwhile, from the results of the study gained that the influence given by variable dynamic capability (X1), Sharia financial literacy (X2) on Business Model Innovation (Y) is 64.3% and the influence of other variables not included in this research is 35.7%. While the influence of the given business Model innovation variable (Y) to business performance (Z) is 75.7% and the influence of other

variables not incorporated into this study is 24.3%. Hence the accepted hypothesis, the dynamic capabilities and literacy of sharia finance through the innovation of business models, positively affect the business performance of SMES in Indonesia simultaneously and partially.

The results of the study showed that companies trying to improve their sustainability performance should change their business model. Changes in business models can be incremental or radical can change to a deciding factor (i.e. limiting or supporting) to successfully create one or more business cases for sustainability (regarding the intensity of modification and innovation of different business models[21], [22].

#### IV. CONCLUSION

Overall, the dynamic and financial literacy capabilities of sharia have an influence on the innovation of SMES business models in Indonesia. Based on the research results, the dynamic capability and Sharia financial literacy of business model innovations have an impact of 64.3% and business model innovation has an impact of 75.7% on business performance. This shows that the dynamic capabilities and Sharia financial literacy through the innovation of business models, positively affect the business performance of SMES in Indonesia simultaneously and partially. Thus, to improve the performance of SMES, it is necessary to improve the dynamic capability to increase the resources in conducting the business, as well as understanding of Sharia financial literacy to overcome the problem of lack of access to capital.

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