



**THE ROLE OF ISLAMIC FINANCE AND INFLATION IN ECONOMIC
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Abstract

This study examines the role of Islamic finance and inflation in economic growth in Indonesia and Malaysia within the finance growth nexus framework. Islamic finance is represented by Islamic Banking Financing and Sukuk Holding, while economic growth is measured by Gross Domestic Product. Using quarterly panel data from 2015Q1 to 2024Q3, this study applies the Panel Vector Error Correction Model to analyse long run equilibrium, short run adjustment, causality, impulse responses, and variance decomposition. The results show that Islamic finance, inflation, and economic growth share a stable long run equilibrium relationship. The Error Correction Term in the GDP equation is negative and significant, indicating that 26.55 percent of short run disequilibrium is corrected in the following quarter. The short run results show that Islamic Banking Financing, Sukuk Holding, and Inflation do not transmit strongly to GDP within one quarter, which indicates a delayed adjustment process. Variance Decomposition shows that Sukuk Holding has the strongest external contribution to long run GDP variation, while Islamic Banking Financing and Inflation contribute more modestly. These findings suggest that Indonesia and Malaysia should strengthen Islamic finance through deeper real sector linkages, productive Islamic banking financing, sukuk based long term investment, and stable inflation management.

Keywords: Economic Growth, Islamic Banking, Sukuk, Inflation, PVECM



INTRODUCTION

Islamic finance has become an important part of financial development in Muslim majority economies. Its growth reflects the increasing demand for financial instruments that support real economic activity, productive investment, and Sharia compliant intermediation. In development economics, financial sector expansion plays a central role in promoting economic growth through savings mobilization, efficient capital allocation, risk management, and investment productivity (Levine, 1997; McKinnon, 1973; *Schumpeter, J. A. (1911)*). Within the Islamic economic framework, this role becomes more specific because Islamic finance requires financial transactions to be connected with real assets, trade, services, or productive business activities. This structure strengthens the link between finance and the real sector and limits excessive speculative activity (Askari, 2012; Iqbal & Mirakhor, 2011).

Indonesia and Malaysia provide a relevant setting for examining the role of Islamic finance and inflation in economic growth. Both countries operate dual banking systems and have developed Islamic banking and Islamic capital market instruments as part of their national financial architecture. Malaysia has built a mature Islamic financial ecosystem and has become one of the leading sukuk markets in the world. Indonesia has experienced rapid growth in Islamic banking financing and sovereign sukuk issuance, especially in supporting infrastructure financing and financial inclusion. These different institutional characteristics make both countries important cases for analysing how Islamic finance interacts with macroeconomic stability and economic growth in Southeast Asia.

The relationship between Islamic finance and economic growth can be explained through the finance growth nexus and the supply leading hypothesis. The supply leading hypothesis states that financial sector development can stimulate economic growth by expanding access to capital, improving investment allocation, and increasing productive activity (Patrick, 1966). Islamic Banking Financing and Sukuk Holding represent two important channels of Islamic financial transmission. Islamic Banking Financing supports economic growth through financial intermediation and the distribution of funds to households, firms, and productive sectors. Sukuk Holding supports growth through long term investment mobilization, capital market deepening, and infrastructure financing. Both instruments have different transmission mechanisms, but they share a common orientation toward real sector development.

Inflation also plays an important role in this macro financial relationship. Price instability can weaken purchasing power, reduce real investment returns, and distort financing decisions. Fischer (1993) argues that high and unstable



inflation can reduce economic growth by increasing uncertainty and weakening capital accumulation. Barro (1990) also shows that inflation can harm economic performance by reducing investment efficiency and increasing transaction costs. In Islamic finance, inflation may affect the real value of profit sharing returns, sukuk income, and financing contracts. Therefore, inflation needs to be analysed together with Islamic financial variables because macroeconomic stability can influence the effectiveness of Islamic finance in supporting economic growth.

Previous studies have examined the relationship between Islamic finance and economic growth, but the findings remain mixed. Furqani and Mulyany (2009) found that Islamic banking development contributes to economic growth in Malaysia. Abduh and Omar (2012) showed that Islamic banking supports economic growth in Indonesia. Imam and Kpodar (2016) reported that Islamic banking can promote growth, especially in countries with stronger financial institutions. More recent studies confirm that Islamic financial development can support economic growth, but its effectiveness depends on institutional quality, financial depth, and the structure of Islamic instruments used (Butt et al., 2023; Smolo & Nagayev, 2024). On the capital market side, Smaoui and Nechi (2017), Tan and Shafi (2021), and Ledhem (2022) found that sukuk can support economic growth through infrastructure financing and long term capital formation.

Despite these findings, several gaps remain. First, many studies examine Islamic banking and sukuk separately. This creates fragmented evidence on the broader role of Islamic finance in economic growth. Second, many previous studies focus on single country analysis, while comparative evidence between Indonesia and Malaysia remains limited. Third, several studies use static or single equation approaches that cannot fully capture long run equilibrium, short run adjustment, and dynamic interactions among macro financial variables. Fourth, inflation is often treated only as a secondary macroeconomic variable, although price instability can affect the transmission of Islamic financial instruments to real economic activity. These limitations matter because Islamic finance, inflation, and economic growth interact within a dynamic system across different time horizons.

This study addresses these gaps by examining the dynamic relationship between Islamic finance, inflation, and economic growth in Indonesia and Malaysia. Islamic finance is represented by Islamic Banking Financing and Sukuk Holding, while economic growth is represented by Gross Domestic Product. Inflation is included as a macroeconomic stability variable within the same empirical system. This study aims to analyse whether Islamic finance and



inflation have a long run equilibrium relationship with economic growth. It also examines short run adjustment dynamics and evaluates the contribution of Islamic financial instruments and inflation to output variation.

This study uses quarterly panel data from Indonesia and Malaysia and applies the Panel Vector Error Correction Model. The analysis includes panel unit root tests, Johansen Fisher panel cointegration tests, error correction estimation, impulse response function, and variance decomposition. This approach allows the study to capture long run relationships, short run adjustments, and dynamic responses in the Islamic finance, inflation, and growth nexus. The findings are expected to contribute to Islamic economics literature and provide policy insights for strengthening Islamic financial development and macroeconomic stability in dual banking economies.

LITERATURE REVIEW

The Theoretical Foundation: Finance-Growth Nexus

The discourse on the relationship between financial development and economic growth has evolved into a central pillar of macroeconomic literature. Rooted in Schumpeter's (1911) thesis, the financial sector is viewed as a gatekeeper of development that facilitates innovation through efficient credit allocation. Within this framework, the Supply-Leading Hypothesis proposed by Patrick (1966) becomes particularly relevant for emerging markets like Indonesia and Malaysia. It posits that the proactive establishment of financial institutions acts as a catalyst, mobilizing savings and transferring resources to productive sectors before real-sector demand fully manifests (Patrick, 1966).

In the Islamic economic paradigm, this nexus is deepened by the principle of *Maqasid al-Shari'ah*. Unlike conventional systems where money often acts as a tradable commodity, Islamic finance operates on an intermediation model tied to real assets (*Asset-Backed Financing*) (Chapra, 1992). The Profit-and-Loss Sharing (PLS) scheme ensures that monetary expansion is inherently linked to productive efforts in the real sector, theoretically minimizing the risk of economic bubbles (Iqbal & Mirakhor, 2011). Consequently, the development of Sharia-compliant instruments is not merely a quantitative expansion of assets but a qualitative shift toward a more resilient and sustainable development model (AAOIFI, 2015).

Instrument Dynamics: Banking Intermediation and the Sukuk Anchor

The effectiveness of financial transmission in a dual banking system depends on the structural characteristics of the instruments used. Islamic Banking Financing (IBF) serves as a primary liquidity channel, yet it often faces the challenge of instrumental pragmatism. Most banking financing in Southeast



Asia is dominated by trade-based contracts like *Murabahah*, which, while secure, offer limited multiplier effects compared to long-term equity investment (Ariff, 1988; Kydland & Prescott, 1982). This creates a maturity mismatch, where banks—constrained by short-term liquidity needs—are often unable to fund the long-gestation infrastructure projects necessary for sustained GDP growth.

In this context, Sukuk emerges as a strategic anchor. As evidence of undivided ownership in real assets, Sukuk bypasses the liquidity constraints of the banking sector by attracting institutional capital for large-scale development (AAOIFI, 2015; Iqbal & Mirakhor, 2011). However, the transmission of both IBF and Sukuk into national output is not instantaneous. The Time-to-Build theory and the concept of the Gestation Period suggest that capital transformation involves technical and operational lags (Kydland & Prescott, 1982). Therefore, the impact of Sharia instruments on GDP must be analyzed through a dynamic lens that accounts for these inherent delays, where capital accumulation requires sufficient time to integrate into the national production function (Hall et al., 1977).

Inflation, Monetary Stability, and Economic Growth

Inflation is a key macroeconomic variable that affects economic growth and financial sector performance. Low and stable inflation creates a predictable economic environment for firms, investors, and financial institutions. High and unstable inflation weakens purchasing power, increases uncertainty, reduces investment efficiency, and distorts financing decisions. Fischer (1993) argues that inflation can reduce economic growth by weakening capital accumulation and productivity. Barro (1995) also shows that inflation may harm economic performance by increasing transaction costs and reducing investment incentives.

In a dual banking system, inflation also affects the transmission of Islamic finance to the real sector. When inflationary pressure rises, conventional monetary policy often responds through higher interest rates. This condition can create a benchmark trap or displaced commercial risk for Islamic financial institutions, because they may need to adjust return expectations to remain competitive even when the underlying real sector projects have not yet generated higher returns (Bacha, 2004; Cevik & Charap, 2011). As a result, inflation can reduce the real value of Islamic banking returns, sukuk income, and profit sharing contracts.

Persistent price instability can also create information problems in Islamic financing. It becomes more difficult for financial institutions to distinguish between genuine productivity gains and nominal gains caused by price



increases. This uncertainty may discourage long term partnership based contracts and push Islamic finance toward shorter term, lower risk instruments (Ascarya, 2012). Therefore, Islamic Banking Financing and Sukuk Holding may support economic growth, but their effectiveness depends on macroeconomic stability.

For this reason, inflation is included as an endogenous macroeconomic variable in the PVECM system. Its inclusion allows this study to examine how price stability interacts with Islamic finance and economic growth in Indonesia and Malaysia. Stable inflation is essential because it protects purchasing power, preserves real financial returns, supports investment confidence, and strengthens the ability of Islamic finance to function as a driver of real economic activity.

Conceptual Framework and Hypothesis Development

This study builds its conceptual framework on the finance growth nexus and the supply leading hypothesis. Islamic Banking Financing and Sukuk Holding represent the main Islamic financial variables. Islamic Banking Financing reflects the role of Islamic banks in channeling Sharia compliant funds into productive sectors. Sukuk Holding reflects the role of the Islamic capital market in mobilizing long term investment through asset based instruments. Both instruments are expected to support economic growth through capital formation, financial intermediation, productive investment, and infrastructure financing.

Economic growth is represented by Gross Domestic Product. GDP captures aggregate economic performance and reflects the capacity of an economy to produce goods and services. In this framework, Islamic finance is expected to influence GDP through two main channels. The first channel is banking intermediation through Islamic Banking Financing. The second channel is capital market financing through Sukuk Holding.

Inflation is included as a macroeconomic variable that interacts with Islamic finance and economic growth. It may influence economic performance through purchasing power, investment expectations, and financial return stability. In the PVECM framework, GDP, Islamic Banking Financing, Sukuk Holding, and Inflation are treated as endogenous variables. This means that each variable may respond to its own past values and the past values of other variables. This structure allows the study to capture long run equilibrium, short run adjustment, and dynamic interactions within the macro financial system.

Based on this theoretical framework, this study proposes five hypotheses. First, there is a long run equilibrium relationship between Islamic finance,



inflation, and economic growth in Indonesia and Malaysia. Second, Islamic Banking Financing has a significant dynamic relationship with economic growth in both countries. Third, Sukuk Holding has a significant dynamic relationship with economic growth in both countries. Fourth, inflation has a significant dynamic relationship with economic growth in both countries. Fifth, Islamic financial instruments and inflation contribute to the long run forecast error variance of economic growth in Indonesia and Malaysia.

RESEARCH METHOD

This study uses a quantitative explanatory research design to examine the dynamic relationship between Islamic finance, inflation, and economic growth in Indonesia and Malaysia. The explanatory design is appropriate because the study tests the interaction among macro financial variables and evaluates how Islamic Banking Financing, Sukuk Holding, and Inflation transmit to Gross Domestic Product. This approach also allows the study to identify long run equilibrium, short run adjustment, and dynamic responses among variables within the dual banking systems of Indonesia and Malaysia (Baltagi, 2021; Sekaran & Bougie, 2016).

This study uses balanced panel data consisting of Indonesia and Malaysia from the first quarter of 2015 to the third quarter of 2024. The dataset contains 39 quarterly observations for each country and 78 total panel observations. The data are obtained from official international databases. Gross Domestic Product and Inflation are sourced from World Bank Open Data, while Islamic Banking Financing and Sukuk Holding are obtained from the Islamic Financial Services Board. The use of international databases supports cross country comparability and reduces measurement differences between domestic statistical sources (Baltagi, 2021).

The variables consist of Gross Domestic Product (GDP), Islamic Banking Financing (IBF), Sukuk Holding (SH), and Inflation (INF). GDP represents economic growth. IBF refers to total financing distributed by Islamic banks. SH refers to Sharia compliant securities held by Islamic financial institutions. INF reflects changes in the Consumer Price Index. Following the empirical model specification, GDP, IBF, and SH are expressed in natural logarithm form, while INF remains in percentage form because inflation is already measured as a rate (Gujarati & Porter, 2009).

This study applies the Panel Vector Error Correction Model (PVECM). PVECM is suitable because the variables are dynamically interdependent and



treated as endogenous within one system. The model addresses simultaneity by allowing each variable to respond to its own lagged values and the lagged values of other variables (Sims, 1980). It also captures long run equilibrium and short run adjustment through the Error Correction Term (Engle & Granger, 1987; Johansen, 1988). The optimal lag length in the VAR level system is two, so the VECM specification in first difference uses one lag.

The endogenous variable vector is specified as follows:

$$Y_{it} = [\ln GDP_{it}, \ln IBF_{it}, \ln SH_{it}, INF_{it}]$$

The general PVECM model is specified as follows:

$$\Delta Y_{it} = \alpha_i + \lambda ECT_{it-1} + \sum_{k=1}^{p-1} \Gamma_k \Delta Y_{it-k} + \varepsilon_{it}$$

where Y_{it} represents the vector of endogenous variables consisting of $\ln GDP$, $\ln IBF$, $\ln SH$, and INF for country i in quarter t . The symbol Δ denotes the first difference operator. α_i represents country specific intercepts. ECT_{it-1} is the lagged Error Correction Term derived from the long run cointegration equation. λ measures the speed of adjustment toward long run equilibrium. Γ_k captures short run dynamic coefficients, and ε_{it} represents the error term. Since the optimal VAR lag is $p = 2$, the VECM uses $p - 1 = 1$ lag in first differences.

The Error Correction Term is derived from the long run cointegration equation normalized on economic growth:

$$ECT_{it-1} = \ln GDP_{it-1} - \theta_0 - \theta_1 \ln IBF_{it-1} - \theta_2 \ln SH_{it-1} - \theta_3 INF_{it-1}$$

The Error Correction Term measures the deviation from long run equilibrium in the previous quarter. A negative and statistically significant adjustment coefficient in the GDP equation indicates that short run disequilibrium is gradually corrected toward the long run equilibrium path.

The analysis is conducted sequentially using EViews 13. First, descriptive statistics are used to identify the basic characteristics of the data. Second, panel unit root tests are applied using Levin, Lin, and Chu, Im, Pesaran, and Shin, ADF Fisher, and PP Fisher tests to examine stationarity and reduce the risk of spurious regression (Levin et al., 2002). Third, the optimal lag length is selected using AIC, SC, and HQ criteria (Lütkepohl, 1991). Fourth, panel cointegration is tested using Pedroni, Kao, and Johansen Fisher procedures to identify the existence of long run equilibrium among the variables (Johansen, 1988; Kao, 1999; Pedroni, 2004). Fifth, PVECM estimation is conducted to examine long run relationships and short run adjustment. Finally, Granger causality, Impulse Response Function, and Variance Decomposition are used to analyse causal direction, shock



responses, and the contribution of each variable to economic growth variation (Granger, 1969; Pesaran & Shin, 1998).

RESULTS AND DISCUSSION

The result of descriptive statistics

The diagnostic analysis of descriptive statistics was conducted to identify the fundamental characteristics, distribution patterns, and preliminary relationships between the research variables—Gross Domestic Product (GDP), Islamic Banking Financing (IBF), Sukuk Holding (SH), and Inflation (INF).

Table 1.

The result of descriptive statistics and the correlation matrix

	GDP Growth	Islamic Banking Financing	Sukuk Holding	Inflation
Descriptive Statistics				
Mean	4.064	2.024	8.036	2.633
Median	4.995	1.735	7.915	2.775
Maximum	9.390	4.030	17.030	8.100
Minimum	-6.110	0.480	-3.000	-1.420
Observations	78	78	78	78
Correlation Matrix				
GDP Growth	1.000			
Sukuk Holding	0.038	1.000		
Islamic Banking Financing	-0.111	-0.578	1.000	
Inflation	0.591	-0.076	-0.276	1.000

Source: Author’s Computation using E-views 13.

The descriptive results show that GDP recorded an average growth rate of 4.064 percent, with a maximum value of 9.390 percent and a minimum value of -6.110 percent. This wide range indicates that Indonesia and Malaysia experienced substantial macroeconomic fluctuations during the observation period. Such variation is reasonable because the period covers pre-pandemic conditions, the COVID-19 shock, and the post-pandemic recovery phase. In macroeconomic modelling, this kind of fluctuation supports the need for a dynamic estimation approach because economic growth may respond differently across short run and long run horizons (Gujarati & Porter, 2009; Brooks, 2019).



Sukuk Holding shows the highest average growth among the variables, with a mean value of 8.036 percent. It also records the widest range, from -3.000 percent to 17.030 percent. This indicates that sukuk is the most volatile Islamic financial variable in the dataset. The volatility may reflect the sensitivity of sukuk instruments to capital market conditions, fiscal financing needs, and institutional investment behaviour. This pattern is consistent with the nature of sukuk as a capital market instrument that often supports long term investment and infrastructure financing (Smaoui & Nechi, 2017; Tan & Shafi, 2021). In contrast, Islamic Banking Financing has a lower mean value of 2.024 percent and a narrower range between 0.480 percent and 4.030 percent. This indicates that Islamic banking financing is more stable than sukuk and reflects the regular intermediation role of Islamic banks in channeling funds to the real sector (Abduh & Omar, 2012; Ledhem & Mekidiche, 2021).

Inflation records an average value of 2.633 percent, with a maximum value of 8.100 percent and a minimum value of -1.420 percent. This range shows that inflation remained generally moderate but still experienced sharp movements in certain periods. Inflation matters in this study because price instability can affect purchasing power, investment expectations, and the real value of financial returns. Fischer (1993) argues that high and unstable inflation can weaken capital accumulation and reduce economic growth. Barro (1995) also shows that inflation may reduce growth by increasing uncertainty and reducing investment efficiency. Therefore, inflation is relevant in the PVECM system because it captures the macroeconomic stability dimension within the relationship between Islamic finance and economic growth.

The correlation matrix provides preliminary evidence of association among the variables. Inflation has a positive correlation with GDP growth at 0.591. This may indicate that higher growth periods are associated with stronger price movements. However, this relationship should not be interpreted as causality because correlation only shows a static association. Sukuk Holding has a weak positive correlation with GDP growth at 0.038, while Islamic Banking Financing has a weak negative correlation with GDP growth at -0.111. These weak correlations do not necessarily mean that Islamic finance has no effect on economic growth. Islamic financial instruments may influence output with time lags because financing and investment need time to move through production, project execution, and capital formation processes (Iqbal & Mirakhor, 2011; Smaoui & Nechi, 2017).

The negative correlation between Islamic Banking Financing and Sukuk Holding at -0.578 suggests a possible substitution pattern between Islamic



banking and Islamic capital market instruments. When Islamic banking financing grows more slowly, sukuk may become a stronger alternative source of long term funding, especially for infrastructure and public investment. This preliminary pattern supports the use of PVECM because static descriptive and correlation analysis cannot explain long run equilibrium, short run adjustment, or shock transmission among GDP, IBF, SH, and INF. Therefore, further econometric testing is required to identify whether the variables move together in the long run and how they adjust after short run disturbances.

The result of the panel unit root test

The panel unit root test was conducted to examine the stationarity properties of GDP, Islamic Banking Financing, Sukuk Holding, and Inflation before estimating the PVECM model. This step is necessary because macroeconomic and financial variables often contain stochastic trends that may produce spurious regression if estimated directly without testing their order of integration (Gujarati & Porter, 2009; Baltagi, 2021). This study applies four panel unit root methods, namely Levin, Lin, and Chu (LLC), Im, Pesaran, and Shin (IPS), ADF Fisher, and PP Fisher. The use of several tests provides a more robust assessment because LLC assumes a common unit root process, while IPS, ADF Fisher, and PP Fisher allow individual unit root processes across countries (Levin et al., 2002).

Table 2.
The result of the panel unit root test

Variables	Test for a unit root in	Include in test equation	Test Type			
			LLC	IPS	ADF-Fisher	PP-Fisher
GDP	Level	Intercept	[-0.897] (0.184)	[-1.971] (0.024)	[10.554] (0.032)	[6.083] (0.193)
		Intercept & trend	[-0.168] (0.433)	[-0.917] (0.179)	[5.794] (0.215)	[2.699] (0.609)
	1 st difference	Intercept	[0.250] (0.599)	[-2.112] (0.017)	[11.318] (0.023)	[18.965] (0.000)
		Intercept & trend	[1.231] (0.891)	[-1.114] (0.132)	[6.575] (0.160)	[12.895] (0.011)
IBF	Level	Intercept	[0.223] (0.588)	[0.613] (0.730)	[1.865] (0.760)	[1.167] (0.883)



SH	Intercept & trend	[-0.827]	$\begin{matrix} [- \\ 0.850] \end{matrix}$	[5.727]	[2.264]	
		(0.204)	(0.197)	(0.220)	(0.687)	
	1 st difference	Intercept	[0.315]	$\begin{matrix} [- \\ 1.933] \end{matrix}$	[10.489]	[17.323]
		(0.623)	(0.026)	(0.033)	(0.001)	
	Intercept & trend	[1.323]	$\begin{matrix} [- \\ 1.005] \end{matrix}$	[6.250]	[11.981]	
		(0.907)	(0.157)	(0.181)	(0.017)	
	Level	Intercept	[0.053]	[0.200]	[3.113]	[2.466]
		(0.521)	(0.579)	(0.539)	(0.650)	
	Intercept & trend	[-0.592]	$\begin{matrix} [- \\ 0.020] \end{matrix}$	[2.928]	[1.454]	
		(0.276)	(0.491)	(0.570)	(0.834)	
	1 st difference	Intercept	[0.338]	$\begin{matrix} [- \\ 1.396] \end{matrix}$	[7.734]	[13.491]
		(0.632)	(0.081)	(0.101)	(0.009)	
Intercept & trend	[1.133]	$\begin{matrix} [- \\ 0.406] \end{matrix}$	[4.263]	[8.479]		
	(0.874)	(0.342)	(0.371)	(0.075)		
INF	Level	Intercept	[-0.610]	$\begin{matrix} [- \\ 1.601] \end{matrix}$	[8.866]	[11.593]
		(0.270)	(0.054)	(0.070)	(0.020)	
	Intercept & trend	[-0.149]	$\begin{matrix} [- \\ 0.747] \end{matrix}$	[5.221]	[5.901]	
		(0.440)	(0.227)	(0.265)	(0.206)	
1 st difference	Intercept	[-0.254]	$\begin{matrix} [- \\ 2.086] \end{matrix}$	[11.176]	[16.648]	
	(0.399)	(0.018)	(0.024)	(0.002)		
Intercept & trend	[0.875]	$\begin{matrix} [- \\ 0.773] \end{matrix}$	[5.327]	[9.900]		
	(0.809)	(0.220)	(0.255)	(0.042)		

Source: Author's Computation using E-views 13.

Note: Values outside parentheses are test statistics, while values in parentheses are p values.

The results in Table 2 show that most variables are not stationary at level, especially under the intercept and trend specification. IBF and SH consistently show p values above the 0.05 significance level at level, indicating the presence of unit roots. GDP and INF show mixed evidence under the intercept specification, but their intercept and trend specifications mostly indicate non



stationarity. This pattern suggests that the variables should not be estimated directly in level form because they may contain stochastic trends.

After first differencing, the evidence of stationarity becomes stronger. GDP, IBF, and INF show significant results in several tests, particularly IPS, ADF Fisher, and PP Fisher. SH also shows stronger stationarity evidence after first differencing, especially through the PP Fisher test. Overall, these results support the conclusion that the variables are generally integrated of order one, I(1). This finding is consistent with the PVECM requirement because the model is designed for variables that are non stationary at level but share a long run equilibrium relationship after cointegration testing (Engle & Granger, 1987; Johansen, 1988).

Thus, the unit root test provides a valid basis for proceeding to the panel cointegration test. Since the variables show non stationary behaviour at level and stronger stationarity after first difference, the next step is to test whether GDP, IBF, SH, and INF move together in the long run. This procedure is necessary before estimating the PVECM system.

Optimal Lag Length Selection

The optimal lag length test was conducted to determine the appropriate lag structure for the PVECM estimation. Lag selection is important because it determines how far the historical values of GDP, Islamic Banking Financing, Sukuk Holding, and Inflation explain the current movement of the system. A lag length that is too short may omit relevant dynamic information, while a lag length that is too long may reduce degrees of freedom and weaken estimation efficiency (Lütkepohl, 1991; Enders, 2004).

Table 3.

Optimal Lag Length Selection

A	LogL	LR	FPE	AIC	SC	HQ
0	-585.3946	NA	241.8570	16.8398	16.9683	16.8908
1	-254.2315	615.0172	0.029737	7.8351	8.4776	8.0903
2	-206.3220	83.4995*	0.0120*	6.9234*	8.0798*	7.3828*
3	-200.7475	9.07845	0.0163	7.2213	8.8916	7.8848
4	-197.7101	4.5994	0.0242	7.5917	9.7759	8.4593

Source: Authors' computation using EViews 13, 2026.

Note: * indicates lag order selected by the criterion. LR: sequential modified LR test statistic at the 5 percent level. FPE: Final Prediction Error. AIC: Akaike Information Criterion. SC: Schwarz Criterion. HQ: Hannan Quinn Criterion.

Table 3 shows that all selection criteria identify Lag 2 as the optimal lag length. The LR statistic records 83.4995, while FPE records 0.0120. The AIC, SC,



and HQ values at Lag 2 are 6.9234, 8.0798, and 7.3828, respectively. Since all criteria select the same lag, Lag 2 provides the most suitable temporal structure for the dynamic model. This result indicates that the PVECM should account for the influence of previous quarterly movements in the macro financial system.

Economically, the selection of Lag 2 suggests that the transmission of Islamic finance and inflation to economic growth is not immediate. Islamic Banking Financing needs time to move from financing approval to fund distribution, production activity, sales, and income generation. Sukuk also commonly finances long term investment and infrastructure projects, which require an implementation period before affecting aggregate output. This time lag is consistent with the finance growth nexus because financial development affects growth through investment, capital formation, and productive sector expansion rather than instant output changes (Levine, 1997; Iqbal & Mirakhor, 2011).

The selected lag structure also supports the use of PVECM. In the thesis model specification, the VAR system in levels uses $p = 2$, so the VECM in first differences uses $p - 1 = 1$. This means that the PVECM estimates one lag of differenced variables while retaining the Error Correction Term to capture adjustment toward long run equilibrium. Thus, the lag selection result provides a valid basis for the next stage of analysis, namely panel cointegration testing among GDP, Islamic Banking Financing, Sukuk Holding, and Inflation.

The result of panel vector error correction model

After confirming the integration properties of the variables and selecting the optimal lag length, the next step is to examine whether GDP, Islamic Banking Financing, Sukuk Holding, and Inflation share a stable long run equilibrium relationship. Cointegration testing is required because PVECM is only appropriate when non stationary variables are linked by a long run equilibrium relationship (Engle & Granger, 1987; Johansen, 1988). This study applies Pedroni, Kao, and Johansen Fisher panel cointegration tests to ensure the robustness of the long run relationship.

Table 4.
Pedroni and Kao Panel Cointegration Test Results

Test Methods			
Panel Cointegration Statistics (Within-Dimension)			
Pedroni's Test	Test statistics	Trend assumption	
		No deterministic trend	Deterministic intercept and trend



	t-statistics	p-value	t-statistics	p-value
V-Statistic	1.0465	0.1476	0.0302	0.4879
Rho-Statistic	-0.2651	0.3954	0.9415	0.8268
PP-Statistic	-0.3887	0.3487	1.0595	0.8553
ADF-Statistic	-1.3758	0.0844	-0.0685	0.4727
Group Mean Panel Cointegration Statistics (Between-Dimension)				
Rho-Statistic	0.3716	0.6449	1.5521	0.9397
PP-Statistic	-0.0575	0.4771	1.4900	0.9319
ADF-Statistic	-1.4301	0.0763	0.4244	0.5492
Kao's Test	Null Hypothesis	T-Statistic	P-value	
	No cointegration	-3.3175	0.0004*	
	Residual Variance	1.1980		
	HAC variance	2.5077		

Source: Authors' Computation using E-views 13 (2026)

Note: indicates the rejection of null hypothesis of no cointegration at the 1% significance level (p-value < 0.01). All minus signs (–) use a consistent mathematical dash format.

Table 4 shows mixed results from the Pedroni test. Most Pedroni statistics do not reject the null hypothesis of no cointegration at the 5 percent level. However, the Kao residual cointegration test provides strong evidence of cointegration, with an ADF t statistic of -3.3175 and a p value of 0.0004. This result rejects the null hypothesis of no cointegration at the 1 percent significance level. The Kao test is important because it provides residual based evidence that GDP, Islamic Banking Financing, Sukuk Holding, and Inflation move together in the long run.

Table 5. Johansen Fisher Panel Cointegration Test Results

Null Hypothesis	Alternative Hypothesis	Fisher Stat. (from trace test)*		Fisher Stat. (from max-eigen test)*	
		Trace test	P-value	Max-eigen test	P-value



Deterministic trend specification: intercept no trend					
$r = 0$	$r \neq 0$	25.7945	0.0000*	15.8010	0.0032*
$r \leq 1$	$r > 1$	13.1645	0.0104*	8.7964	0.0663
$r \leq 2$	$r > 2$	8.3258	0.0803	8.6188	0.0713
Deterministic trend specification: intercept & trend					
$r = 0$	$r \neq 0$	33.9129	0.0000*	16.0908	0.0028*
$r \leq 1$	$r > 1$	20.3363	0.0004*	7.9398	0.0938
$r \leq 2$	$r > 2$	16.9581	0.0019*	8.3239	0.0804

Source: Authors' Computation using E-views 13 (2026)

Note: * denotes significance at the 1% level for $p < 0.01$ and 5% level for $p < 0.05$.

Table 5 confirms the presence of panel cointegration through the Johansen Fisher test. Under the intercept no trend specification, the trace test rejects the null hypothesis of no cointegration with a Fisher statistic of 25.7945 and a p value of 0.0000. The max eigen test also rejects the null hypothesis with a Fisher statistic of 15.8010 and a p value of 0.0032. Under the intercept and trend specification, the trace test and max eigen test also provide significant evidence of cointegration. These results confirm that at least one cointegrating relationship exists among GDP, Islamic Banking Financing, Sukuk Holding, and Inflation.

Economically, the cointegration result indicates that Islamic finance, inflation, and economic growth are not disconnected in the long run. Islamic Banking Financing and Sukuk Holding move within the same macro financial system as GDP and Inflation. This finding supports the finance growth nexus because financial development is structurally linked with economic performance through intermediation, investment, and capital formation (Levine, 1997). It also supports the Islamic finance perspective, where financial activities should remain connected to real sector transactions and productive economic activity (Iqbal & Mirakhor, 2011).

The presence of long run equilibrium confirms that Islamic finance, inflation, and economic growth are structurally connected in Indonesia and Malaysia. This result justifies the use of PVECM because the model estimates short run adjustment while preserving the long run equilibrium structure. In practical terms, the finding suggests that shocks to Islamic finance or inflation may create temporary deviations, but the system has a long run tendency to return toward equilibrium.

PVECM Estimation and Error Correction

The PVECM estimation was conducted after the cointegration tests confirmed the existence of long run relationships among GDP, Islamic Banking



Financing, Sukuk Holding, and Inflation. This stage identifies the long run equilibrium structure and short run adjustment mechanism through the Error Correction Term. In a valid VECM framework, the error correction coefficient must show how quickly short run deviations return to the long run equilibrium path (Engle & Granger, 1987; Johansen, 1988).

Table 6.

Cointegrating Equations and Error Correction Terms

	Co-integrating Equation	Error Correction
CointEq1	$\Delta GDP = 1.000 - 0.765(INF_{t-1}) - 2.021$	$(-0.2655)[-4.0488]$ **
CointEq2	$\Delta IBF = 1.000 - 3.813(INF_{t-1}) + 7.840$	$(-0.0276)[-2.5509]$ **
CointEq3	$\Delta SH = 1.000 - 0.133(INF_{t-1}) - 7.834$	$(0.0403)[0.7006]$

Source: Authors' computation using EViews 13, 2026.

Note: Estimated coefficient in parentheses; t-statistics in brackets; * indicates significance at the 95 percent level; ** indicates significance at the 99 percent level.

The estimation confirms the presence of a long run adjustment mechanism among GDP, Islamic Banking Financing, Sukuk Holding, and Inflation. The most important result appears in the GDP equation, where the Error Correction Term records a coefficient of -0.2655 with a t-statistic of -4.0488. The negative and statistically significant coefficient confirms that economic growth adjusts toward the long run equilibrium after short run shocks. The coefficient implies that approximately 26.55 percent of disequilibrium is corrected in the following quarter. This means that the system requires about 3.8 quarters, or almost one year, to return fully to its long run equilibrium path.

This result has an important economic meaning. The adjustment speed shows that the relationship between Islamic finance, inflation, and economic growth is not instantaneous. Islamic Banking Financing and Sukuk Holding influence output through investment, production, infrastructure, and capital formation processes. These processes require time before they generate measurable effects on GDP. The significant ECT supports the finance growth nexus because Islamic financial development and macroeconomic stability are structurally connected to economic growth in the long run. This finding also aligns with the Islamic finance principle that financial expansion should be linked to real sector activity rather than speculative transactions (Levine, 1997; Iqbal & Mirakhor, 2011).



Table 7.
The Summary of PVECM

Exogenous Variable	$\Delta(\text{GDP})$	$\Delta(\text{IBF})$	$\Delta(\text{SH})$	$\Delta(\text{INF})$
$\Delta(\text{GDP}(-1))$	0.5751 (0.1483) [3.8771]	-0.0090 (0.0244) [-0.3682]	-0.0398 (0.1303) [-0.3054]	0.0177 (0.0548) [0.3238]
$\Delta(\text{IBF}(-1))$	-0.3725 (0.8773) [-0.4246]	0.5079 (0.1448) [3.5068]	0.2137 (0.7709) [0.2772]	0.0016 (0.3241) [0.0050]
$\Delta(\text{SH}(-1))$	0.1251 (0.1369) [0.9141]	0.0032 (0.0226) [0.1456]	0.5420 (0.1203) [4.5057]	0.0413 (0.1471) (3.3789)
$\Delta(\text{INF}(-1))$	-0.1022 (0.3982) [-0.2568]	0.0371 (0.0657) [0.5649]	0.07979 (0.3499) [0.2280]	0.4971 (0.1471) [3.3789]
C	0.0452 (0.1504) [0.3007]	0.0248 (0.0248) [0.9997]	-0.0482 (0.1321) [-0.3650]	-0.0226 (0.0555) [-0.4080]
R²	0.4245	0.3465	0.4414	0.4299
Adj. R²	0.3635	0.2772	0.3822	0.3694
F – statistic	6.9569	5.0011	7.4528	7.1106
Akaike AIC	3.3852	-0.2170	3.1267	1.3940
Schwarz SC	3.6343	0.0320	3.3758	1.6430
Akaike information criterion	6.9074			
Schwarz criterion	8.2774			

Source: Authors' computation using EViews 13, 2026.

Note: Values in parentheses are standard errors, while values in brackets are t-statistics.

Table 7 shows the short run dynamics among GDP, Islamic Banking Financing, Sukuk Holding, and Inflation. In the GDP equation, $\Delta(\text{GDP}(-1))$ has a positive coefficient of 0.5751 with a t-statistic of 3.8771. This indicates strong internal persistence in economic growth. Past GDP growth significantly influences current GDP growth. However, the short run coefficients of Islamic Banking Financing, Sukuk Holding, and Inflation on GDP are not statistically strong within one quarter. $\Delta(\text{IBF}(-1))$ records -0.3725 with a t-statistic of -0.4246,



$\Delta(\text{SH}(-1))$ records 0.1251 with a t-statistic of 0.9141, and $\Delta(\text{INF}(-1))$ records -0.1022 with a t-statistic of -0.2568.

These results indicate that the effects of Islamic finance and inflation on economic growth do not occur instantly in the short run. Islamic Banking Financing needs time to move from financing disbursement to production, sales, and income generation. Sukuk Holding also reflects long term investment and infrastructure financing, which require an implementation period before contributing to aggregate output. Inflation may also affect GDP gradually through purchasing power, production costs, and investment expectations. Therefore, the weak short run coefficients do not mean that Islamic finance and inflation are irrelevant. Instead, they show that the main relationship operates through long run equilibrium and gradual adjustment.

The results also show strong persistence in the Islamic financial and inflation variables. $\Delta(\text{IBF}(-1))$ significantly affects $\Delta(\text{IBF})$, with a coefficient of 0.5079 and a t-statistic of 3.5068. $\Delta(\text{SH}(-1))$ significantly affects $\Delta(\text{SH})$, with a coefficient of 0.5420 and a t-statistic of 4.5057. $\Delta(\text{INF}(-1))$ significantly affects $\Delta(\text{INF})$, with a coefficient of 0.4971 and a t-statistic of 3.3789. This indicates that each variable follows its own adjustment path in the short run before transmitting broader effects to economic growth.

Overall, the PVECM estimation shows that Islamic finance and inflation are more relevant to economic growth through long run adjustment than immediate short run effects. This supports the use of a dynamic framework because Islamic financial transmission works through investment cycles, project implementation, and macroeconomic adjustment. The significant ECT in the GDP equation confirms the existence of a stable long run correction mechanism, while the short run coefficients indicate that the effects of Islamic Banking Financing, Sukuk Holding, and Inflation require time before they are reflected in output growth.

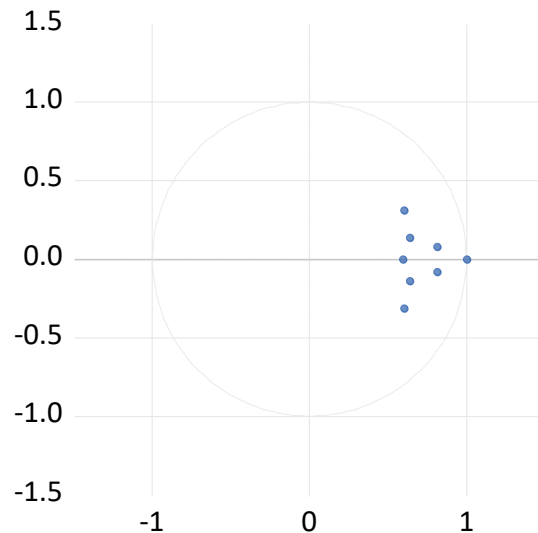
VECM Stability Test

The VECM stability test was conducted to ensure that the estimated model is valid for further dynamic analysis. Stability is an important requirement before interpreting Granger causality, Impulse Response Function, and Variance Decomposition. A stable VECM indicates that the dynamic system does not produce explosive responses and that shocks to GDP, Islamic Banking Financing, Sukuk Holding, and Inflation remain within a convergent path over time.

Figure 1. VECM Stability Test Results.



Inverse Roots of AR Characteristic Polynomial



Source: Authors' computation using EViews 13, 2026.

The stability test shows that the inverse roots of the AR characteristic polynomial are located within the unit circle. This result confirms that the PVECM system is stable. A stable model means that the interaction among GDP, Islamic Banking Financing, Sukuk Holding, and Inflation follows a valid dynamic structure and can be used for further interpretation. Therefore, the model is appropriate for analysing short run causality, shock responses, and variance decomposition.

Economically, this result indicates that the macro financial system in Indonesia and Malaysia does not show explosive behaviour during the observation period. Shocks from Islamic finance or inflation may affect economic growth, but the system remains dynamically controlled and tends to move back toward equilibrium. This finding is consistent with the earlier cointegration and error correction results, which show that the variables share a long run adjustment mechanism. The stability result also strengthens the validity of the next analysis because IRF and VD require a stable dynamic system to produce meaningful interpretations.

VEC Granger Causality Test

The VEC Granger causality test was conducted to identify the short run predictive relationships among GDP, Islamic Banking Financing, Sukuk Holding, and Inflation. This test evaluates whether the past movement of one variable helps explain the current movement of another variable within the VECM framework. In the context of this study, the test is useful for examining whether



Islamic financial variables and inflation transmit immediate short run effects to economic growth. The result is presented in Table 8.

Table 8.

VEC Granger Causality Tests

Endogenous Variables	ΔGDP	ΔIBF	ΔSH	ΔINF
ΔGDP	-	(0.1356) [0.7126]	(0.0932) [0.7600]	(0.1049) [0.7460]
ΔIBF	(0.1803) [0.6710]	-	(0.0768) [0.7815]	(0.0000) [0.9960]
ΔSH	(0.8356) [0.3606]	(0.0212) [0.8841]	-	(0.6692) [0.4133]
ΔINF	(0.0659) [0.7973]	(0.3191) [0.5721]	(0.0519) [0.8196]	-

Source: Authors' computation using EViews 13, 2026.

Note: Values in parentheses are chi-square statistics. Values in brackets are p-values.

Table 8 shows that there is no significant short run Granger causality among GDP, Islamic Banking Financing, Sukuk Holding, and Inflation at the 5 percent significance level. All p-values are above 0.05. For the GDP equation, Islamic Banking Financing records a p-value of 0.6710, Sukuk Holding records 0.3606, and Inflation records 0.7973. These values indicate that IBF, SH, and INF do not Granger-cause GDP in the immediate short run. Similarly, GDP does not Granger-cause IBF, SH, or INF within the same short run lag structure.

This result does not mean that Islamic finance and inflation have no relationship with economic growth. Rather, it indicates that the relationship does not operate through immediate one-quarter predictive causality. This finding is consistent with the earlier PVECM results, where the short run coefficients of IBF, SH, and INF in the GDP equation were not statistically strong, while the Error Correction Term showed a significant long run adjustment mechanism. In other words, the effect of Islamic finance and inflation on economic growth appears stronger through long run equilibrium than through short run causal shocks.

Economically, this result is reasonable. Islamic Banking Financing requires time to move from financing approval to real sector production, sales, and income creation. Sukuk also often supports long term investment and infrastructure projects, which require a longer implementation period before affecting aggregate output. Inflation may influence growth through purchasing power, production costs, and investment expectations, but these effects may not appear instantly within one quarter. This delayed transmission is consistent with the finance



growth nexus, where financial development supports growth through investment, capital formation, and productivity channels rather than immediate output changes (Levine, 1997; Iqbal & Mirakhor, 2011).

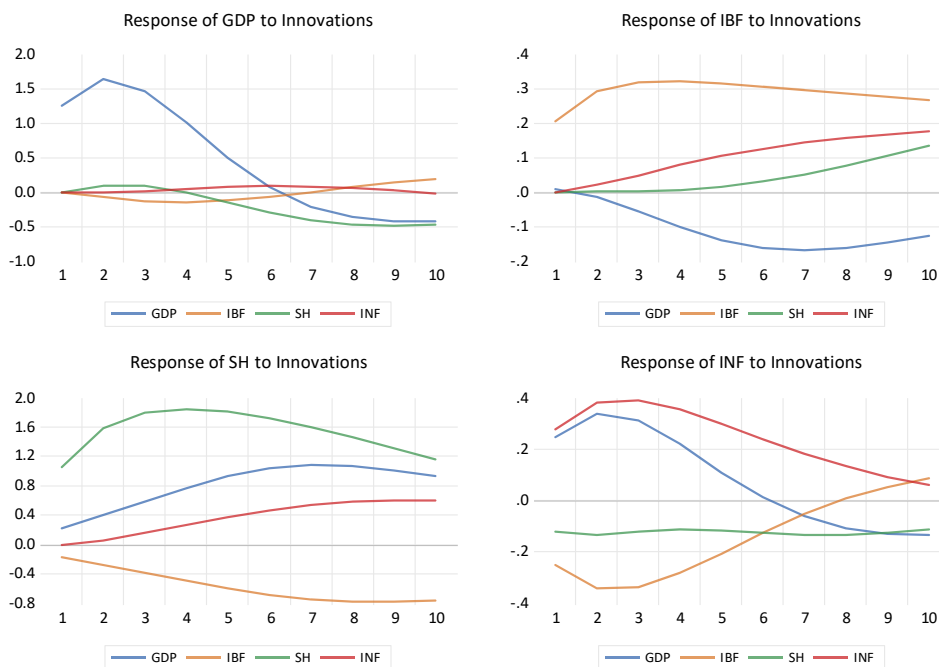
The absence of short run causality also reinforces the importance of using PVECM. A static model or a simple short run causality test may fail to capture the structural role of Islamic finance in economic growth. The previous cointegration and ECT results show that GDP, IBF, SH, and INF are linked in the long run, while the Granger causality test shows that their immediate short run predictive power is limited. Therefore, the relationship between Islamic finance, inflation, and economic growth in Indonesia and Malaysia should be understood as a gradual macro financial adjustment process rather than an instant causal mechanism.

Impulse Response Function Analysis

Impulse Response Function analysis was conducted to trace the dynamic response of each variable to a one standard deviation shock in other variables over a ten quarter horizon. This analysis complements the VEC Granger causality test because it does not only identify predictive relationships, but also shows the direction, timing, and persistence of shock transmission within the PVECM system. In this study, IRF is useful for observing how economic growth responds to shocks from Islamic Banking Financing, Sukuk Holding, and Inflation.

Figure 2. Result of Impulse Response Function.

Response to Cholesky One S.D. (d.f. adjusted) Innovations



Source: Authors' computation using EViews 13, 2026.



Figure 2 shows that GDP responds strongly to its own shock in the early period. The response reaches its highest level in the second quarter, then gradually declines after the following periods. This pattern indicates that economic growth has strong internal momentum in the short run, but this momentum weakens over time. The declining response suggests that long run growth cannot rely only on past output performance. It requires support from external drivers, including financial intermediation, capital market financing, and macroeconomic stability.

The response of GDP to Islamic Banking Financing shows a delayed adjustment pattern. In the early quarters, GDP responds negatively to an IBF shock. The response then improves gradually and turns positive after the sixth period. This pattern indicates that Islamic banking financing does not generate an immediate output effect. Financing requires time to move from approval, disbursement, production, sales, and income generation. This result supports the concept of a gestation period in Islamic financing. It also aligns with the finance growth nexus, where financial development affects growth through investment and productive capital formation rather than instant output movement (Levine, 1997; Iqbal & Mirakhor, 2011).

The response of GDP to Sukuk Holding shows a different pattern. GDP responds positively in the early periods, but the response begins to decline after the fourth period and becomes negative in later quarters. This pattern suggests that sukuk shocks may initially support economic activity through capital market funding, but their effect may involve a liquidity absorption process before reaching a new equilibrium. Since sukuk is commonly used for long term investment and infrastructure financing, its economic effect may not appear immediately in GDP. The result indicates that sukuk transmission depends on how quickly sukuk funds move from financial markets to productive projects.

The response of GDP to inflation is relatively small compared to its response to its own shock. Inflation produces a mild positive response in the middle period, but the response weakens and turns negative by the tenth period. This pattern suggests that inflation may coexist with economic expansion in the short run, but price pressure can weaken growth over a longer horizon. Economically, this result is consistent with the view that moderate inflation may accompany growth, while prolonged inflation can reduce purchasing power, increase uncertainty, and weaken investment incentives (Fischer, 1993; Barro, 1995).



Overall, the IRF results confirm that the relationship among Islamic finance, inflation, and economic growth is dynamic and time dependent. Islamic Banking Financing shows a delayed positive effect, Sukuk Holding reflects a more complex long term adjustment process, and inflation creates limited but relevant macroeconomic pressure on output. These findings strengthen the previous PVECM results, where the short run coefficients were weak but the Error Correction Term was significant. Therefore, Islamic finance and inflation affect economic growth more through gradual adjustment and long run transmission than through immediate short run shocks.

Variance Decomposition Analysis

Variance Decomposition was used to measure the percentage contribution of each variable to the forecast error variance of GDP. This analysis complements the Impulse Response Function because it does not only show the direction of shock responses, but also quantifies the relative contribution of GDP, Islamic Banking Financing, Sukuk Holding, and Inflation to economic growth variation over time. In this study, Variance Decomposition is important to identify which variable has the strongest structural role in explaining GDP fluctuations in Indonesia and Malaysia. The method is also consistent with the research procedure, where VD is used to measure the contribution of Islamic financial instruments to GDP variation.

Table 9.
Variance Decomposition of GDP (%)

Period	S.E.	GDP	IBF	SH	INF
1	1.2495	100	0	0	0
2	2.0679	99.7011	0.1349	0.1626	0.0012
3	2.5365	99.3918	0.3804	0.2262	0.0014
4	2.7314	99.1390	0.6461	0.1956	0.0190
5	2.7841	98.5943	0.8351	0.4945	0.0759
6	2.8038	97.2873	0.8906	1.6595	0.1624
7	2.8437	95.1225	0.8659	3.7769	0.2345
8	2.9091	92.4868	0.8876	6.3647	0.2607
9	2.9854	89.8599	1.0529	8.8350	0.2521
10	3.0585	87.5247	1.3841	10.8468	0.2442

Source: Author's computation using EViews 13, 2026.

Table 9 shows that GDP variation is fully explained by its own shock in the first period. GDP accounts for 100 percent of its forecast error variance, while Islamic Banking Financing, Sukuk Holding, and Inflation contribute 0 percent.



This result indicates that economic growth is highly self driven in the immediate short run. In the early period, shocks from Islamic financial instruments and inflation do not directly explain GDP variation. This finding is consistent with the previous Granger causality and IRF results, where short run transmission from Islamic finance and inflation to GDP was limited.

The contribution of external variables starts to increase gradually after the second period. Islamic Banking Financing contributes 0.1349 percent in period 2 and rises to 1.3841 percent in period 10. This shows that Islamic banking financing has a growing, but relatively small, contribution to GDP variation over the ten quarter horizon. Economically, this pattern is reasonable because Islamic banking financing often supports short and medium term business activities. Its effect on output depends on how fast financing moves into production, trade, consumption, and income generation.

Sukuk Holding shows the strongest external contribution to GDP variation. Its contribution increases from 0.1626 percent in period 2 to 10.8468 percent in period 10. This sharp increase indicates that sukuk plays a more important role in explaining long run GDP variation than Islamic Banking Financing and Inflation. The finding supports the view that sukuk has a stronger long term growth channel because it is often linked to infrastructure financing, capital market deepening, and long term investment mobilization. This result is also aligned with the nature of sukuk as an asset based instrument that supports productive investment over a longer horizon.

Inflation contributes only a small share to GDP variation. Its contribution increases from 0.0012 percent in period 2 to 0.2442 percent in period 10. This suggests that inflation is relevant as a macroeconomic stability variable, but it is not the dominant source of GDP fluctuations in this model. Inflation may influence growth through purchasing power, cost pressure, and investment expectations. However, its direct contribution to GDP variance remains limited compared to the contribution of Sukuk Holding.

Overall, the Variance Decomposition results show a gradual structural shift in GDP determinants. In the short run, GDP is mainly explained by its own shocks. In the longer horizon, Islamic financial variables begin to explain a larger share of GDP variation, with Sukuk Holding emerging as the strongest external contributor. This finding strengthens the argument that the role of Islamic finance in economic growth operates more strongly through long term investment and capital formation than through immediate short run effects. It also confirms that sukuk has a strategic role in supporting growth dynamics in Indonesia and



Malaysia, especially when linked to infrastructure financing and productive public investment.

Policy Synthesis

The findings show that Islamic finance, inflation, and economic growth in Indonesia and Malaysia are connected through a long run equilibrium mechanism. The significant error correction result indicates that short run shocks are gradually corrected toward a stable macro financial path. This means that Islamic finance should not be evaluated only through immediate short run effects, but also through its long run contribution to investment, production, and economic stability.

The results suggest that Islamic Banking Financing needs stronger linkage with productive sectors to increase its growth impact. Islamic banks should expand financing to sectors with higher multiplier effects, such as manufacturing, agriculture, halal industry, and small and medium enterprises. At the same time, the strong contribution of Sukuk Holding to GDP variation shows that sukuk can become a strategic instrument for long term development financing. Indonesia and Malaysia should strengthen sukuk market depth, improve project based sukuk issuance, and direct sukuk funds toward infrastructure and real sector investment.

Inflation remains important because price instability can weaken purchasing power, reduce real financial returns, and affect investment decisions. Therefore, Islamic financial development should be supported by stable macroeconomic policy. Coordination between monetary authorities, fiscal authorities, and Islamic financial regulators is needed to ensure that Islamic banking and sukuk expansion contributes to sustainable economic growth without increasing macroeconomic vulnerability.

CONCLUSION

This study confirms that Islamic finance, inflation, and economic growth in Indonesia and Malaysia have a stable long run equilibrium relationship. The significant and negative Error Correction Term shows that short run deviations are gradually corrected toward equilibrium, which means the relationship among GDP, Islamic Banking Financing, Sukuk Holding, and Inflation works dynamically rather than instantly. The short run results indicate that Islamic Banking Financing, Sukuk Holding, and Inflation do not strongly affect GDP within one quarter because financial transmission needs time to move through financing distribution, investment realization, project implementation, and capital formation. Variance Decomposition shows that Sukuk Holding has the



strongest external contribution to long run GDP variation, while Islamic Banking Financing and Inflation contribute more modestly. These findings imply that Indonesia and Malaysia should strengthen Islamic finance through deeper real sector linkages. Islamic banking should expand productive financing, sukuk should support infrastructure and long term investment, and macroeconomic stability should be maintained because inflation affects purchasing power, real returns, and investment confidence.

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