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The Impact of Inflation on Indonesia's Economic Growth from an Islamic Economic Perspective

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Abstract. *This study aims to examine the influence of inflation on Indonesia's economic growth from the perspective of Islamic economics, by incorporating other macroeconomic variables such as investment, poverty rate, and Islamic banking financing. The research utilizes the Vector Autoregression (VAR) method to explore dynamic relationships between variables and to assess both short- and long-term shock impacts from one variable to another. Annual time-series data from 2005 to 2023 were used, sourced from official publications by BPS and the World Bank. The findings reveal that inflation plays a dominant role in reducing economic growth in the short term. However, in the medium and long term, the roles of investment and poverty become increasingly significant. Islamic banking financing also demonstrates growing contributions over time, even though other macroeconomic variables have yet to reach full feasibility. These findings are reinforced by the Impulse Response Function (IRF) analysis, which shows varied responses to shocks among variables, and by the Forecast Error Variance Decomposition (FEVD), which confirms that interactions among the variables are dynamic and evolve over time. The study concludes that maintaining inflation stability and enhancing investment are vital for supporting sustainable economic growth. Furthermore, strengthening the Islamic financial sector could serve as a strategic foundation for promoting equitable, inclusive, and Sharia-compliant economic development. These insights provide valuable input for government and financial authorities in formulating macroeconomic policies rooted in Islamic values.*

Keywords: *Inflation, economic growth, islamic economics, VAR, islamic financing*

1. Introduction

As a developing nation, Indonesia's economy is consistently challenged by macroeconomic flexibility issues, one of which is inflation. Uncontrolled national inflation can disrupt price stability, erode public purchasing power, and hinder economic growth. In the context of long-term development, inflation stability is a crucial indicator to ensure a healthy economy.

In conventional economic systems, inflation control often relies solely on monetary policy, neglecting aspects such as equitable distribution, justice, and moral considerations. When the economy slows down, Bank Indonesia typically responds with expansionary monetary policies, such as lowering interest rates.

Persistent high and unstable inflation reflects economic instability, leading to a continuous rise in the prices of goods and services. This can exacerbate poverty levels in Indonesia, as higher prices reduce people's ability to meet their daily needs. Over the years, the inflation rate in Indonesia has fluctuated significantly.

In the short term, inflation may benefit producers by raising prices, thereby increasing production volume or quality. However, inflation in Indonesia is often complex, elevated, and unstable. When inflation rises, the monetary authority typically responds with

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contractionary policies, such as increasing interest rates and selling government securities like SBIs. This allows conventional banks to invest in risk-free, high-interest instruments. Open market operations are also employed by Bank Indonesia to control the money supply in circulation (Khotimah, 2022).

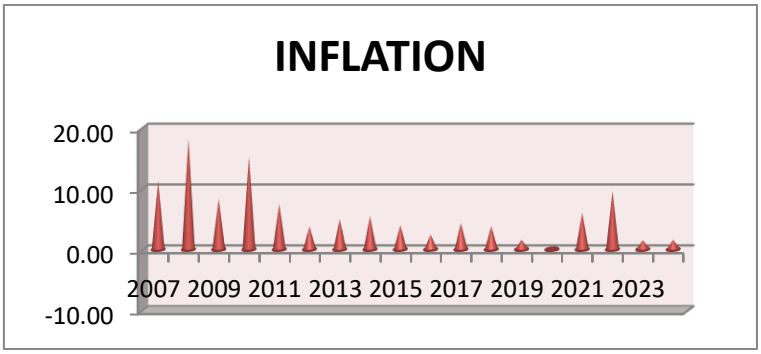

Figure 1. Indonesia's Inflation Data from 2007–2023
Source: https://data.worldbank.org/indicator/NY.GDP.DEFL.KD.ZG

The graphical representation of Indonesia's inflation trends between 2007 and 2023 indicates a pattern marked by considerable fluctuations, particularly during the early years of the observed period. A significant spike in inflation was recorded between 2008 and 2010, a phenomenon likely driven by intense price pressures stemming from the global financial crisis combined with domestic economic adjustments, including fuel subsidy reforms.

In the years that followed, particularly from 2012 to 2019, inflation rates began to show signs of stabilization. This relative stability reflects the success of national monetary and fiscal policy frameworks in managing inflation more effectively through deliberate and coordinated measures.

A sharp decline in inflation levels occurred during 2020 and 2021, closely linked to the economic impacts of the COVID-19 pandemic. The pandemic resulted in widespread economic contraction, a reduction in household purchasing power, and significant disruptions in both supply chains and consumer demand across most sectors of the economy.

Post-pandemic, inflation resumed its upward trajectory, especially in 2022 and 2023. However, this increase remained below the peaks recorded in the earlier years. The renewed rise in inflation was largely fueled by ongoing economic recovery efforts, a resurgence in domestic consumption, and external pressures such as rising global prices for energy and food commodities.

Islamic economics, rooted in the principles of Sharia (Islamic law), emphasizes ethical foundations such as justice, transparency, and long-term sustainability in economic conduct. This economic paradigm spans multiple sectors, including Islamic banking, Sharia-compliant capital markets, takaful (Islamic insurance), and the halal industry. As public awareness and demand for Islamic economic practices increase, significant progress has been made both in Indonesia and in other countries with large Muslim populations.

Indonesia, being home to the largest Muslim population in the world, possesses immense potential to further develop its Islamic economic sector. Nevertheless, like all other economic systems, Islamic economics remains vulnerable to external macroeconomic shocks—chief among them being inflation (Tria Mei Diana, 2023).

Unlike conventional frameworks that prioritize efficiency and output, Islamic economics seeks to harmonize growth with moral imperatives, such as distributive justice, economic balance, and the pursuit of barakah (divine blessing). From this perspective, inflation is not seen merely as a numerical fluctuation but as a distortion in monetary value that leads to transactional injustices, disproportionately affecting the economically disadvantaged. Consequently, the relationship between inflation and economic growth must be examined in a comprehensive manner, particularly through the lens of Islamic economic theory. Given today's increasingly unstable economic environment, this research becomes highly urgent as it offers policy recommendations based on Islamic values that aim to safeguard both economic stability and social justice.

Within Indonesia's economy, the Islamic banking sector has shown consistent and robust growth, even amid persistent inflationary pressures in recent years. The application of profit-and-loss sharing principles and asset-backed financial contracts in Islamic financing presents distinct advantages in inflationary contexts. These contract structures decouple financing obligations from direct price fluctuations in goods and services, thereby reducing inflation's impact on financial performance (Atmaja, 2020).

Inflation is a persistent economic challenge that erodes the real income of households. If left unchecked, it poses serious risks to the stability of national economic systems. A historical case in point is the monetary crisis that affected Indonesia in mid-1997, which led to hyperinflation, significantly diminished consumer purchasing power, and hindered national economic expansion.

Given these consequences, inflation is regarded as a fundamental indicator of macroeconomic equilibrium. Maintaining stable inflation is essential to sustaining long-term economic growth and ensuring public welfare (Amelia, 2023). In the Islamic economic framework, growth is not merely measured by rising Gross Domestic Product (GDP), but also through metrics of equitable development, community prosperity, and sustainability of the real economy. Islamic financial instruments such as zakat (obligatory alms), qard al-hasan (interest-free loans), and waqf (endowments) are not only tools of social welfare but also mechanisms that can cushion the negative impact of inflation while fostering a just and resilient economic system.

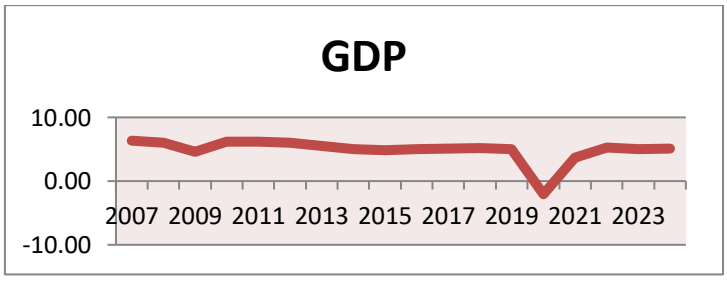

Figure 2. Indonesia's GDP Data from 2007–2024
Source : https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

The GDP trend of Indonesia from 2007 to 2023 generally shows stable national economic growth, averaging around five percent per year. However, several fluctuations mark the graph, reflecting domestic and global economic dynamics.

In the earlier period, despite a temporary dip likely due to the 2008 global crisis, Indonesia's economy quickly recovered, with growth rebounding in the following years.

During the mid-2010s, growth began to flatten slightly this may be due to structural issues such as slowed investment, global trade pressures, and continued dependence on commodities.

The most striking change appears in 2020, when GDP sharply dropped into negative territory. This dramatic decline was a direct result of the COVID-19 pandemic, which severely weakened real sectors, disrupted trade and industry, and reduced household consumption.

In subsequent years (2021 to 2023), the GDP trend indicates a consistent recovery. Growth returned to positive levels and gradually approached pre-pandemic figures, suggesting the effectiveness of national economic recovery policies.

The financial sector plays a central role in driving a country's economic growth by supporting the expansion of the real sector. In Indonesia, two banking systems operate concurrently: conventional banking and Islamic (Sharia) banking. These dual systems coexist to meet the diverse financial service needs of the population and support funding across the national economy.

The parallel existence of both systems provides the public with broader financial options. Essentially, the roles of Islamic banks are similar to conventional banks (Ningsih, 2020). However, the magnitude of economic growth in Indonesia is influenced by multiple factors. Direct influences include macroeconomic indicators such as gross domestic income and per capita consumption. Indirect influences, often associated with credit or financing, also play a substantial role.

The distribution of funds by banks through credit or financing significantly impacts not only large and small entrepreneurs but also the broader public (Nasir, 2020). Access to financing enables businesses to grow and innovate, thereby stimulating overall economic development.

The urgency of this research stems from the growing volatility of macroeconomic conditions, which demands alternative economic frameworks—such as Islamic economics—that emphasize fairness, social justice, and resilience against inflation-driven inequality.

This study is also aligned with the objectives of the Sustainable Development Goals (SDGs), particularly Goal 8, which promotes decent work and sustainable economic growth, and Goal 10, which focuses on reducing inequality. It emphasizes the importance of maintaining inflation stability, enhancing investment, and strengthening Islamic financial instruments as a means to foster inclusive and equitable economic development.

And the novelty of this research lies in its integrated approach, which simultaneously examines the dynamic relationship between inflation, Islamic banking financing, investment, and poverty using a VAR model within the framework of Islamic economics—an area that has received limited attention in previous macroeconomic studies.

2. Methods

This study utilizes secondary data, which is obtained indirectly from its original sources. Specifically, the data is sourced from the World Bank, covering the period from 2007 to 2024. The analysis is conducted using EViews software and applies the Vector Autoregression (VAR) model.

According to Manurung (2009), when simultaneity exists among several variables, it becomes difficult to distinguish between endogenous and exogenous variables. In such cases, the VAR method is appropriate, as it allows researchers to examine simultaneous

relationships and the degree of long-term integration among variables. Based on this rationale, the authors chose VAR as a robust and empirical approach to capture the dynamic, reciprocal relationships between macroeconomic variables over time.

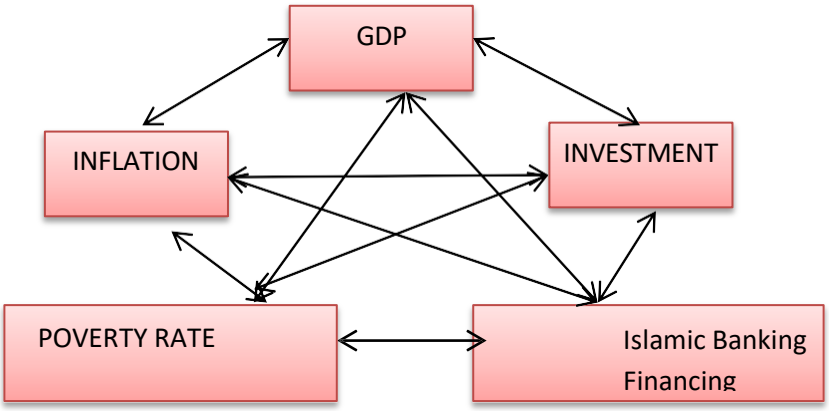

Figure 3. Conceptual Framework of the VAR Model

The basic VAR equations used are:

PDBt = β10PDBt-p + β11INVt-p + β12INFt-p + β13PPSt-p + β14TKt-p + et1
INVt = β10PDBt-p + β11INVt-p + β12INFt-p + β13PPSt-p + β14TKt-p + et1
INFt = β10PDBt-p + β11INVt-p + β12INFt-p + β13PPSt-p + β14TKt-p + et1
PPSt = β10PDBt-p + β11INVt-p + β12INFt-p + β13PPSt-p + β14TKt-p + et1
TK = β10PDBt-p + β11INVt-p + β12INFt-p + β13PPSt-p + β14TKt-p + et1

Where :

PDB = Economic Growth (%)
INV = Investment (Million Rupiah)
INF = Inflation (%)
PPS = Islamic Banking Financing (Million Rupiah)
TK = Poverty Rate (%)
Et = Random error term
P = Lag length

2.1. Model Impulse Response Function (IRF)

According to Ariefianto (2012), the Impulse Response Function (IRF) traces how a shock to one variable affects the entire system over time. Similarly, Manurung (2005) explains that IRF is a tool to observe the direction and magnitude of each variable's reaction to changes in other variables.

The goal of IRF analysis is to determine whether the transmission variables are co integrated in the short and long term. It allows the researcher to visualize how one standard deviation shock to a variable (e.g., inflation) will impact other variables over a forecast horizon.

2.2. Model Forecast Error Variance Decomposition (FEVD)

FEVD is used to assess the relative contribution of each shock to a given variable's forecast error variance both from itself and from other variables. As stated by Manurung (2005), FEVD helps determine how much each variable contributes to the variation in another.

EtX t + 1 = A0 + A1X1
Et Xt+n = et + n + A1
2et+n-2 + + A1
n-1 et+1

The total FEVD is always 100%, and the higher the value of FEVD, the greater the proportion of variance explained by the contributing variable..

2.3. Unit Roots Test

To test data stationarity, the Augmented Dickey-Fuller (ADF) test is used. This determines whether a time series variable contains a unit root (non-stationary) or is stationary. If the calculated ADF statistic is more negative than the critical value from the MacKinnon table, then the null hypothesis (that the data has a unit root) is rejected, meaning the data is stationary. In this study, all variables became stationary after the first differencing, as indicated by their significantly negative ADF values and p-values below standard thresholds (1%, 5%, or 10%).

2.4. Johansen Cointegration Test

This test is applied to assess whether a long-term equilibrium relationship exists among the variables. If the variables are cointegrated, then the regression does not suffer from spurious results. In this study, the Johansen cointegration test results indicate that at least one of the five variables shares a long-term equilibrium relationship with the others. This means variables like inflation, GDP, investment, and poverty rate move together consistently over time.

3. Results and Discussion

The unit root test using the Augmented Dickey-Fuller (ADF) method yielded the following results:

Table 1. Root Test with Augmented Dickey Fuller (ADF)

Variable	*Augmented Dickey Fuller*	
	t-statistic	**Stasioneritas**
INF	**0.0022****	**1(I)**
INV	**0.0296****	**2(II)**
PDB	**0.0336****	**1(I)**
PPS	**0.0042****	**2(II)**
TK	**0.0105****	**2(II)**

Source: Data analysis using EViews 10

These results confirm that all variables become stationary after being differenced, making them suitable for further VAR analysis.

3.1. Johansen Cointegration Test Results

Tabel 2. Cointegration Test

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.999669	221.8132	69.81889	0.0000
At most 1 *	0.944944	93.57877	47.85613	0.0000
At most 2 *	0.902651	47.18828	29.79707	0.0002
At most 3	0.296698	9.917113	15.49471	0.2872
At most 4 *	0.234978	4.285614	3.841466	0.0384
Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.999669	128.2344	33.87687	0.0000
At most 1 *	0.944944	46.39049	27.58434	0.0001
At most 2 *	0.902651	37.27117	21.13162	0.0001
At most 3	0.296698	5.631499	14.26460	0.6608
At most 4 *	0.234978	4.285614	3.841466	0.0384

Source: Data analysis using EViews 10

The cointegration test results indicate a long-term stable relationship among several variables. Both the trace statistic and maximum eigenvalue statistic exceeded their critical values at the 5% significance level. This suggests that variables like inflation, GDP, investment, and poverty rate are cointegrated, meaning they move together over the long run.

Table 3. Optimal Lag Length Determination

Vector Autoregression Estimates LAG 1	
Akaike information criterion	33.70401
Schwarz criterion	35.17439
Number of coefficients	30
Vector Autoregression Estimates LAG 2	
Akaike information criterion	25.33156
Schwarz criterion	27.98734
Number of coefficients	55

The Schwarz Criterion (SC) and Akaike Information Criterion (AIC) are both utilized to determine the optimal lag length in the VAR model. The optimal lag is identified by comparing the AIC and SC values the lower the value, the more optimal the lag.

Based on the lag determination results presented in Table 3, the AIC value for lag 2 is 25.33156, which is significantly lower than the AIC value for lag 1, which stands at 33.70401. This finding indicates that lag 2 is more optimal. Consequently, the analysis proceeds by using lag 2 in the VAR estimation. The next analytical step involves evaluating the stability of the lag structure, which is detailed in the following table and graph.

Table 4. Lag Structure Stability Test Results

Roots of Characteristic Polynomial
Endogenous variables: TK INF INV PDB PPS

Exogenous variables: C

Lag specification: 1 2
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Root	Modulus
1.130162	1.130162
0.518518 - 0.884161i	1.024989
0.518518 + 0.884161i	1.024989
0.855563	0.855563
-0.172164 - 0.793845i	0.812299
-0.172164 + 0.793845i	0.812299
-0.710582	0.710582
-0.248744 - 0.345650i	0.425849
-0.248744 + 0.345650i	0.425849
0.309918	0.309918

Warning: At least one root outside the unit circle.

VAR does not satisfy the stability condition.

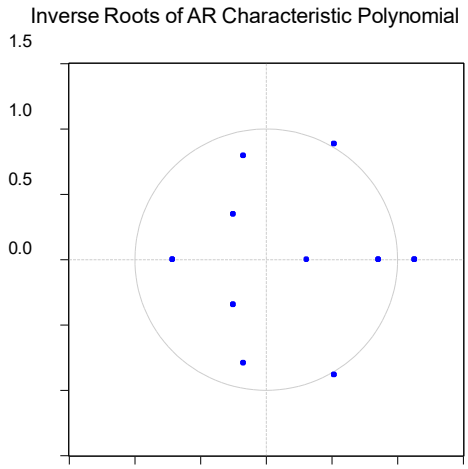

Figure 4. Inverse Roots of AR Characteristic Polynomial
Source: Data analysis using EViews 10

The accompanying graph visually represents the inverse roots of the autoregressive (AR) characteristic polynomial. Ideally, all roots should lie within the unit circle to indicate a stable system.

Although the warning notes that one root is marginally outside the unit circle, the majority of the roots lie well within the boundary. Therefore, the model is still considered sufficiently stable to continue with VAR analysis, especially when interpreted in the context of empirical data.

This confirms that the stability condition has largely been met, and the VAR model can proceed with further analyses, such as Impulse Response Function (IRF) and Forecast Error Variance Decomposition (FEVD).

Table 5. Summary of VAR Estimation Results

Variable	Kontribusi Terbesar	
	I	II
Inflation	Inflation	Tingkat Kemiskinan
Investment (INV)	Inflation	Investment
Economic Growth (PDB)	Investasi	Inflation
Islamic Banking Financing (PPS)	Inflation	Islamic Banking Financing (PPS)
Poverty Rate (TK)	Poverty Rate (TK)	Inflation

Source: Data analysis using EViews 10

From the results in Table 3.5, it can be concluded that inflation plays a dominant role in the short term, especially in influencing various other macroeconomic variables such as:

- Investment,
- Economic growth (GDP/PDB)
- Islamic banking financing (PPS)
- Poverty rate (TK)

This shows that inflation acts as a main trigger or initial shock, which rapidly affects other economic indicators within Indonesia's macroeconomic structure.

However, moving into the medium and long term (period II), the pattern of contribution shifts:

- The poverty rate becomes a key determinant in influencing inflation and Islamic financing. This suggests that socioeconomic conditions, particularly poverty, begin to affect the stability of both prices and the Islamic financial system.
- Investment consistently appears as a significant contributor to the variation in economic growth (GDP), highlighting the central role of investment in sustaining economic performance over time.
- Islamic banking financing, while not always the most dominant variable, maintains a significant self-contribution, meaning it remains relatively autonomous and stable in the long term.

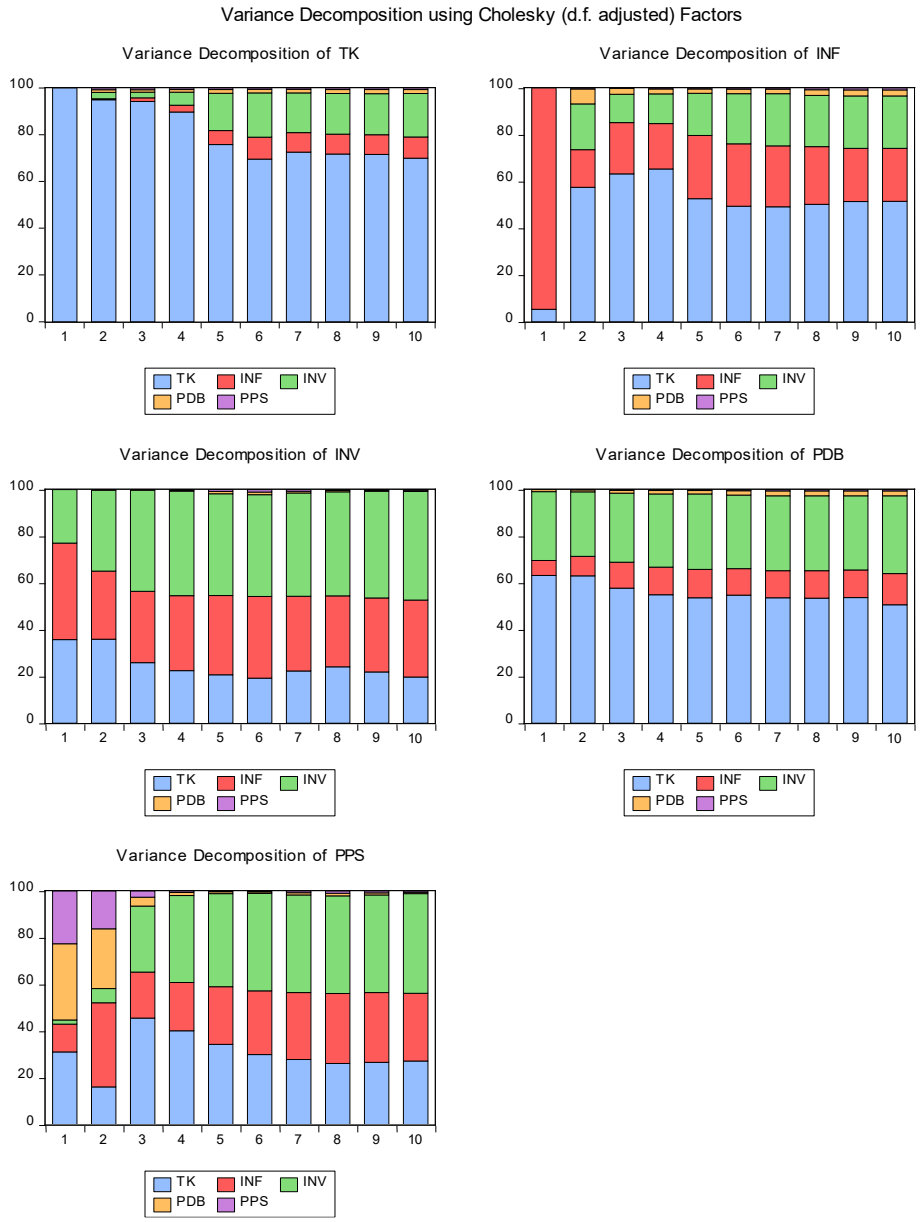

Figure 5. Summary Chart of FEVD (Forecast Error Variance Decomposition) Test Results

Source: Data analysis, EViews 10

The results of the variance decomposition analysis reveal that, in the initial periods, each variable is predominantly influenced by its own past values. However, over time, the influence of other variables such as Islamic financing, GDP, investment, and the poverty rate begins to increase. This reflects the dynamic interrelationship among variables in the long run, where a change in one variable can gradually affect others within the broader economic system.

The Forecast Error Variance Decomposition (FEVD) analysis also demonstrates the presence of multiple interconnections among variables such as inflation, investment, GDP, Islamic banking financing, and poverty levels. Through this method, the variables with the most significant and effective influence are identified. One such example is the impact of inflation on economic growth in Indonesia, viewed through the lens of Islamic economics.

Table 6. Interaction Between Inflation, Investment, GDP, Islamic Banking Financing, and Poverty Rate

Variable	Poverty, Inflation, Investment, GDPP and Islamic Financing					Period
	TK	INF	INV	GDP	GDP	
Poverty Rate (TK)	100.00%	-	-	-	-	short term.
	75.79%	5.94%	15.96%	1.61%	0.68%	mid term
	69.95%	9.08%	18.53%	1.71%	0.70%	Long term
Inflation	5.28%	94.71%	-	-	-	short term.
	52.64%	26.96%	18.07%	1.83%	0.46%	mid term
	51.51%	22.62%	22.43%	2.60%	0.81%	Long term
Investment	35.77%	41.30%	22.91%	-	-	short term.
	20.64%	33.98%	43.53%	0.97%	0.86%	mid term
	19.71%	32.97%	46.44%	0.38%	0.48%	Long term
GDP	63.32%	6.34%	29.475	0.95%	-	short term.
	53.64%	12.16%	32.24%	1.53%	0.40%	mid term
	50.66%	13.34%	33.31%	2.08%	0.59%	Long term
Islamic Financing (PPS)	31.13%	11.86%	1.80%	32.55%	22.64%	short term
	34.32%	24.66%	39.83%	0.79%	0.38%	mid term
	27.22%	28.98%	42.65%	0.56%	0.58%	Long term

Source: Author's data analysis, 2024

: Highest Contribution

: Second Highest Contribution

This table presents the results of Forecast Error Variance Decomposition (FEVD) across three time horizons: short-term, medium-term, and long-term. It shows the percentage of influence each variable receives from itself and others.

Short-Term (Period 1):

- Each variable is almost entirely influenced by itself.
- Example: Poverty rate (TK) is 100% explained by its own past values.
- Inflation is 94.71% self-explained.
- Investment is influenced most by inflation (41.3%) and poverty (35.7%).

Medium-Term (Period 5):

- Cross-variable influences begin to strengthen.
- Poverty is now influenced significantly by investment (15.96%) and inflation (5.94%).
- Inflation starts being influenced by poverty and investment.
- Investment shifts toward being increasingly explained by itself (43.5%) and inflation (34%).

Long-Term (Period 10):

Mutual dependencies among variables are prominent:

- Poverty rate continues to be heavily influenced by investment and inflation.
- Inflation is almost equally influenced by itself, investment, and poverty.
- Investment becomes even more self-determined (46.44%) while still impacted by inflation.
- GDP (PDB) is now largely driven by investment (33.3%) and poverty (50.6%).

- Islamic banking financing (PPS) becomes increasingly responsive to investment (42.65%) and inflation (28.98%).

In the short run, each macroeconomic indicator behaves inwardly, mostly influenced by its own past values. In the long run, inflation, investment, and poverty emerge as interconnected influencers, shaping the dynamics of economic growth and Islamic financing. The results reinforce the importance of macroeconomic coordination in policymaking, particularly when viewed from an Islamic economics perspective, where social equity (poverty) and productive investment play central roles.

One limitation of this study is its reliance on secondary data and the use of the VAR model, which may not capture all behavioral nuances of macroeconomic actors. Future research should consider incorporating primary data or panel data approaches to further validate and expand these findings.

Conclusions

One limitation of this study is its exclusive reliance on secondary time-series data and the use of a VAR model, which may not fully capture the behavioral aspects and micro-level dynamics of economic agents. For future research, it is recommended to incorporate primary data collection, panel data analysis, or mixed-method approaches to gain deeper insights. Long-term studies could also explore the role of Islamic financial instruments, such as zakat, waqf, and sukuk, in stabilizing macroeconomic variables and enhancing economic resilience under sustained inflationary pressures.

This study reveals that inflation holds a very significant and dominant role in influencing various macroeconomic variables, including investment, GDP, Islamic banking financing, and the poverty rate, particularly in the short term. However, in the medium and long term, the pattern of variable contributions begins to shift:

- Investment and poverty increasingly take on more substantial roles in influencing the dynamics of other economic indicators.
- The Impulse Response Function (IRF) analysis confirms that each variable's response to shocks from inflation, investment, Islamic financing, and poverty is dynamic. These responses tend to shift direction (from positive to negative or vice versa) within different timeframes, indicating complex interactions across the macroeconomic system.
- The Forecast Error Variance Decomposition (FEVD) shows that initially, most variables are self-influenced, but as time progresses, the influence from other variables grows, proving a deep interdependence among them.

These findings support the notion that the relationships among the examined macroeconomic indicators are simultaneous and mutually reinforcing, and that these connections become stronger over time. From an Islamic economics perspective, the study highlights the following points:

- Islamic banking financing plays an increasingly important role in supporting stable and equitable economic growth.
- Although it may not dominate all aspects of macroeconomic dynamics, its contribution is becoming more apparent in the long run.

- Because Islamic economics emphasizes real-sector development and the principles of fairness and justice, it offers an alternative economic framework that can cushion the effects of inflation and reduce economic disparities.
- Islamic finance, when properly developed, can serve as a strategic instrument to promote sustainable, inclusive, and Sharia-compliant growth This research is also aligned with the Sustainable Development Goals (SDGs), particularly Goal 8: Decent Work and Economic Growth, and Goal 10: Reduced Inequalities. This study offers novelty by integrating inflation with Islamic banking financing and poverty as a simultaneous macroeconomic framework from a Sharia perspective.

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