

**THE EFFECT OF FINANCIAL DEEPENING, FDI, AND INFLATION
VOLATILITY ON ECONOMIC GROWTH IN INDONESIA: AN ARDL
APPROACH**



THESIS

**SUBMITTED TO THE FACULTY OF ISLAMIC ECONOMIC AND
BUSINESS**

SUNAN KALIJAGA STATE ISLAMIC UNIVERSITY, YOGYAKARTA

AS ON THE REQUIREMENTS TO THE SUBMIT THESIS

Author:

Berliana Ranti Fara Fauziah

NIM 22108010030

**STATE ISLAMIC UNIVERSITY
SUNAN KALIJAGA**

SHARIAH ECONOMICS STUDY PROGRAM

FACULTY OF ISLAMIC ECONOMICS AND BUSINESS

ISLAMIC STATE UNIVERSITY SUNAN KALIJAGA YOGYAKARTA

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Author:

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NIM 22108010030

SUPERVISOR:

Dr. Abdul Qoyum, S.E.I., M.Sc.Fin.

19850630 201503 1 007

**SUNAN KALIJAGA
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2026

SURAT PENGESAHAN TUGAS AKHIR



KEMENTERIAN AGAMA
UNIVERSITAS ISLAM NEGERI SUNAN KALIJAGA
FAKULTAS EKONOMI DAN BISNIS ISLAM

Jl. Marsda Adisucipto Telp. (0274) 550821, 512474 Fax. (0274) 586117 Yogyakarta 55281

PENGESAHAN TUGAS AKHIR

Nomor : B-516/Un.02/DEB/PP.00.9/05/2026

Tugas Akhir dengan judul : THE EFFECT OF FINANCIAL DEEPENING, FDI AND INFLATION VOLATILITY ON ECONOMIC GROWTH IN INDONESIA : AN ARDL APPROCH

yang dipersiapkan dan disusun oleh:

Nama : BERLIANA RANTI FARA FAUZIAH
Nomor Induk Mahasiswa : 22108010030
Telah diujikan pada : Jumat, 17 April 2026
Nilai ujian Tugas Akhir : A

dinyatakan telah diterima oleh Fakultas Ekonomi dan Bisnis Islam UIN Sunan Kalijaga Yogyakarta

TIM UJIAN TUGAS AKHIR



Ketua Sidang

Dr. Abdul Qoyum, S.E.I., M.Sc.Fin.

SIGNED

Valid ID: 6a0191b78d8fa



Penguji I

Prof. Dr. Misnen Ardiansyah, S.E., M.Si.,
Ak., CA., ACPA.

SIGNED

Valid ID: 69fe82cef1722



Penguji II

Muh. Rudi Nugroho, S.E., M.Sc.

SIGNED

Valid ID: 69f072b9e3448



Yogyakarta, 17 April 2026
UIN Sunan Kalijaga
Dekan Fakultas Ekonomi dan Bisnis Islam

Prof. Dr. Misnen Ardiansyah, S.E., M.Si., Ak., CA., ACPA.

SIGNED

Valid ID: 69fe82ceeca62

SURAT PERSETUJUAN DOSEN PEMBIMBING SKRIPSI

SURAT PERSETUJUAN DOSEN PEMBIMBING SKRIPSI

Judul : Skripsi oleh Berliana Ranti Fara Fauziah

Kepada
Yth. Dekan Fakultas Ekonomi dan Bisnis Islam
UIN Sunan Kalijaga
Di-Yogyakarta

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Nama : Berliana Ranti Fara Fauziah
NIM : 22108010030
Judul Skripsi : **The Effect of Financial Deepening, FDI, and Inflation Volatility on Economic Growth in Indonesia : An ARDL Approach**

Skripsi ini telah layak untuk diajukan kepada Fakultas Ekonomi dan Bisnis Islam, Program Studi Ekonomi Syariah, UIN Sunan Kalijaga Yogyakarta, sebagai salah satu syarat untuk memperoleh gelar sarjana Ekonomi Islam.

Dengan ini, kami berharap skripsi ini dapat segera diujikan. Terima kasih atas perhatian dan pertimbangannya.

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STATE ISLAMIC UNIVERSITY
SUNAN KALIJAGA
YOGYAKARTA

Yogyakarta, 9 Maret 2026
Pembimbing,

Dr. Abdul Qoyumi, S.E., L., M.Sc. Fin.
NIP. 19850630 201503 1 007

SURAT PERNYATAAN KEASLIAN SKRIPSI

SURAT PERNYATAAN KEASLIAN SKRIPSI

Assalamu 'alaikum Warahmatullahi Wabarakatuh

Saya yang bertanda tangan di bawah ini

Nama : Berhiana Ranti Fara Fauziah
NIM : 22108010030
Fakultas : Ekonomi dan Bisnis Islam
Program Studi : Ekonomi Syariah

Menyatakan dengan sebenar-benarnya bahwa skripsi saya yang berjudul **"The Effect of Financial Deepening, FDI, and Inflation Volatility on Economic Growth in Indonesia : An ARDL Approach"** adalah benar-benar hasil karya asli saya sendiri dan bukan merupakan plagiarisme pencurian hasil karya milik orang lain hasil kerja orang lain untuk kepentingan saya karena hubungan material maupun non-material ataupun segala kemungkinan lain yang pada hakekatnya bukan merupakan karya tulis skripsi saya secara orisinal dan otentik.

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Yogyakarta, 9 Maret 2026

Penulis,

STATE ISLAMIC UNIVERSITY
SUNAN KALIJAGA
YOGYAKARTA



Berhiana Ranti Fara Fauziah
NIM. 22108010030

HALAMAN PERSETUJUAN PUBLIKASI UNTUK KEPENTINGAN AKADEMIK

Sebagai civitas akademik UIN Sunan Kalijaga Yogyakarta. Saya yang bertanda tangan di bawah ini:

Nama : Berliana Ranti Fara Fauziah
NIM : 22108010030
Program Studi : Ekonomi Syariah
Fakultas : Ekonomi dan Bisnis Islam
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SUNAN KALIJAGA
YOGYAKARTA


Berliana Ranti Fara Fauziah

22108010030

MOTTO

“Tugas kita di dunia ini adalah ikhtiar semaksimal kita, perkara hasil itu Allah yang menentukan. Dan percayalah, bahwa rencana yang Allah berikan untuk hambanya pasti yang terbaik. Meskipun nantinya harus melewati kesedihan dan kesulitan dahulu.”

(Berli)

“ Apabila hamba-hamba-Ku bertanya kepadamu (Nabi Muhammad) tentang Aku, sesungguhnya Aku dekat. Aku mengabulkan permohonan orang yang berdoa apabila dia berdoa kepada-Ku. Maka, hendaklah mereka memenuhi (perintah)-Ku dan beriman kepada-Ku agar mereka selalu berada dalam kebenaran.”

(Al-Baqarah :186)



TRANSLITERASI ARAB LATIN

Transliterasi kata-kata Arab yang dipakai dalam penyusunan skripsi ini berpedoman pada Surat Keputusan Bersama Menteri Agama dan Menteri Pendidikan dan Kebudayaan Republik Indonesia Nomor: 158/1987 dan 0543b/U/1987.

A. Konsonan Tunggal

Huruf Arab	Na ma	Huruf Latin	Keterangan
ا	alif	tidak dilambangkan	tidak dilambangkan
ب	bā'	b	be
ت	tā'	t	te
ث	ṣā'	ṣ	es (dengan titik di atas)
ج	jīm	j	je
ح	ḥā'	ḥ	ha (dengan titik di bawah)
خ	khā'	kh	ka and ha
د	dāl	d	de
ذ	ẓāl	ẓ	zet (dengan titik diatas)
ر	rā'	r	er
ز	zāi	z	zet
س	sīn	s	es
ش	syīn	sy	es and ye
ص	ṣād	ṣ	es (dengan titik di bawah)
ض	ḍād	ḍ	de (dengan titik di bawah)
ط	ṭā'	ṭ	te (dengan titik di bawah)
ظ	ẓā'	ẓ	zet (dengan titik di bawah)
ع	'ain	'	koma terbalik di atas
غ	gain	g	ge

ف	fā'	f	ef
ق	qāf	q	qi
ك	kāf	k	ka
ل	lām	l	el
م	mīm	m	em
ن	nūn	n	en
و	wāwu	w	w
هـ	hā'	h	ha
ء	hamza h	,	apostrof
ي	yā'	Y	ye

B. Konsonan Rangkap karena Syaddah ditulis Rangkap

مُتَعَدِّدَةٌ	ditulis	<i>muta'addidah</i>
عِدَّةٌ	ditulis	<i>'iddah</i>

C. Tā' Marbutāh pada Akhir Kalimat

a. Ditulis dengan *h* jika dibaca *Sukun*

حِكْمَةٌ	ditulis	<i>hikmah</i>
جِزْيَةٌ	ditulis	<i>jizyah</i>

(Ketentuan ini tidak berlaku untuk kata-kata Arab yang telah diserap ke dalam bahasa Indonesia, misalnya zakat, kecuali bila dikehendaki kata aslinya)

b. Bila diikuti dengan kata sandang 'al' serta bacaan kedua kata itu terpisah, maka ditulis dengan *h*.

كَرَامَةُ الْوَلِيَاءِ	ditulis	<i>karāmah al-auliya'</i>
------------------------	---------	---------------------------

c. Bila *Tā'marbutāh* hidup dengan *fathāh*, *kasrah*, or *dāmah* dengan demikian dituliskan *ny t or h*.

زكاة الفطرة	ditulis	<i>zakatā al-fitrāh</i>
-------------	---------	-------------------------

D. Vokal Pendek dan Penerapannya

Semua *tā'marbūṭah* ditulis dengan *h*, baik berada pada akhir kata tunggal ataupun berada di tengah penggabungan kata (kata yang diikuti oleh kata sandang “al”). Ketentuan ini tidak diperlukan bagi kata-kata Arab yang sudah terserap dalam bahasa Indonesia, seperti shalat, zakat, dan sebagainya kecuali dikehendaki kata aslinya.

-----	fathah	ditulis	a
-----	kasrah	ditulis	i
-----	ḍammah	ditulis	u

فَعَلَ	fathah	ditulis	<i>fa'ala</i>
ذَكَرَ	kasrah	ditulis	<i>zakira</i>
يَذْهَبُ	ḍammah	ditulis	<i>yazhabu</i>

E. Vokal Panjang

1	fathah + alif	ditulis	<i>ā</i>
	جاهلية	ditulis	<i>jāhiliyah</i>
2	fathah + yā'mati	ditulis	<i>ā</i>
	تنسى	ditulis	<i>tans ā</i>
3	kasrah + yā'mati	ditulis	<i>i</i>
	كريم	ditulis	<i>karim</i>
4	ḍammah + wāwu mati	ditulis	<i>ū</i>
	فروض	ditulis	<i>furūd</i>

F. Vokal Rangkap

1	fathah + yā' mati	ditulis	<i>ai</i>
	بينكم	ditulis	<i>bainakum</i>
2	fathah + wāwu mati	ditulis	<i>au</i>
	قول	ditulis	<i>qaul</i>

G. Vokal Pendek yang berurutan dalam Satu Kata Dipisahkan dengan Apostrof

أَنتُمْ	ditulis	<i>a'antum</i>
أُحَدِّثُ	ditulis	<i>u'iddat</i>
لَعْنُ شُكْرَتُمْ	ditulis	<i>la'in syakartum</i>

H. Kata Sandang alif + Lam

a. Bila diikuti huruf *Qamariyyah* maka ditulis dengan menggunakan huruf awal “al”

القرآن	ditulis	<i>al-Qur'ān</i>
القياس	ditulis	<i>al-Qiyās</i>

b. Bila diikuti huruf *Syamsiyyah* ditulis sesuai dengan huruf pertama *Syamsiyyah* tersebut

السماء	ditulis	<i>al-Samā'</i>
الشمس	ditulis	<i>al-Syams</i>

I. Penulisan Kata-kata dalam Rangkaian Kalimat

Ditulis menurut penulisannya

ذو الفروض	ditulis	<i>ẓawi al-furūd</i>
أهل السنة	ditulis	<i>ahl as-sunnah</i>

ARABIC transliteration

The system of Arabic transliteration used in this thesis is based on Joint Circulating Letter of Minister of Religious Affairs and Minister of Education and Cultural Affairs of The Republic of Indonesia No. 158/1987 and 0543b/U/1987.

J. Single Consonant

Arabic Letter	Na me	Letter of Latin	Assertions
ا	alif	not symbolized	not symbolized
ب	bā'	b	be
ت	tā'	t	te
ث	ṣā'	ṣ	es (with point on top)
ج	jim	j	je
ح	ḥā'	ḥ	ha (with point below)
خ	khā'	kh	ka and ha
د	dāl	d	de
ذ	ẓāl	ẓ	zet (with point on top)
ر	rā'	r	er
ز	zāi	z	zet
س	sīn	s	es
ش	syīn	sy	es and way
ص	ṣād	ṣ	es (with point below)
ض	ḍād	ḍ	de (with point below)
ط	ṭā'	ṭ	te (with point below)
ظ	ẓā'	ẓ	zet (with point below)
ع	'ain	'	comma reversed from above
غ	gain	g	ge
ف	fā'	f	ef

ق	qāf	q	qi
ك	kāf	k	ka
ل	lām	l	el
م	mīm	m	em
ن	nūn	n	En
و	wāwu	w	W
هـ	hā'	h	ha
ء	hamza h	,	apostrophe
ي	yā'	Y	Ye

K. Double Consonant Caused by *Syaddah* Written in Double

ممتددة	written	<i>muta'addidah</i>
عدة	written	<i>'iddah</i>

L. *Tā' Marbutāh* on The End of Word

- d. Written by *h* if Read in *Sukun*

ح ك ة	written	<i>hikmah</i>
ح ز ية	written	<i>jizyah</i>

(This stipulation is not required on Arabic words that has been assimilated into English Language e.g. zakah etc, except if the original word is wished)

- e. When followed by article 'al' and the second word is separated thus it is written by *h*.

كرامة الولايا	written	<i>karāmah al-aulyā'</i>
---------------	---------	--------------------------

f. If Tā' *marbutāh* lives by *fathāh*, *kasrah*, or *dāmah* thus it is written *ny t* or *h*.

زكاة الفطرة	written	<i>zakatā al-fitrāh</i>
-------------	---------	-------------------------

M. Short Vowels

-----	fathah	written n	a
-----	kasrah	written n	i
-----	damamah	written n	u

N. Long Vowels

1	fathah + alif جاهلية	written written	ā <i>jāhiliyah</i>
2	fathah + yā' dead تنسى	written written	ā <i>tans ā</i>
3	kasrah + yā' dead كريم	written written	i> <i>kari>m</i>
4	damamah + wāwu dead فروض	written written	ū <i>furūd</i>

O. Double Vowels

1	fathah + yā' dead بينكم	written written	ai <i>bainakum</i>
---	----------------------------	--------------------	-----------------------

2	fathah + wāwu dead	written	au
	قول	written	<i>qaul</i>

P. Consecutive Short Vowels in a Word Separated by Apostrophe

أنتم	written	<i>a'antum</i>
اعدت	written	<i>u'iddat</i>
البن شكرتم	written	<i>la'in syakartum</i>

Q. If Article *alif lam* is Followed by Letter of *Qomariyyah* or *Syamsiyyah*, Thus it is written by '*al*'

القرآن	written	<i>al-qur'ān</i>
القياس	written	<i>al-qiyās</i>
السماء	written	<i>al-samā'</i>
الشمس	written	<i>al-syams</i>

R. Writing Words in Sentence

ذوى الفروض	written	<i>ẓawī al-furūd</i>
اهل السنّة	written	<i>ahl as-sunnah</i>

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In conclusion, the author realizes that this thesis is still far from perfect. Therefore, the author greatly hopes for constructive criticism and suggestions for improvement in the

future. Hopefully, this thesis can provide benefits for the author in particular and for readers in general.

Yogyakarta, 24 Mei 2026

Berliana Ranti Fara Fauziah

22108010030



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ABSTRACT

This study aims to analyze the effects of Financial Deepening, FDI and Inflation Volatility on economic growth in Indonesia during the period 2009-2024. By using the Autoregressive Distributed Lag (ARDL) method to examine the short-term and long-term relationships between the variables. The research results show that in the short term, financial deepening has a negative and significant effect on economic growth, FDI has a negative and significant effect on economic growth, and inflation volatility has a negative and significant effect on economic growth. In the long term, similar results are shown for financial deepening and FDI. Meanwhile, inflation volatility is not significant for economic growth. These findings indicate that increases in financial sector indicators and foreign investment flows have not fully driven the productivity of the real sector, and inflation instability exerts pressure on the economic performance in Indonesia.

Keywords: *Financial Deepening, FDI, Inflation Volatility, Economic Growth, ARDL.*



ABSTRAK

Penelitian ini bertujuan untuk menganalisis pengaruh Financial Deepening, FDI, dan Volatilitas Inflasi terhadap pertumbuhan ekonomi di Indonesia pada periode 2009-2024. Dengan menggunakan metode Autoregressive Distributed Lag (ARDL) untuk menguji hubungan jangka pendek dan jangka panjang antar variabel. Hasil Penelitian menunjukkan bahwa dalam jangka pendek menunjukkan bahwa financial deepening berpengaruh negatif dan signifikan terhadap pertumbuhan ekonomi, FDI berpengaruh negatif dan signifikan terhadap pertumbuhan ekonomi, serta volatilitas inflasi berpengaruh negatif dan signifikan terhadap pertumbuhan ekonomi. Dalam jangka panjang, menunjukkan hasil yang serupa untuk financial deepening dan FDI. Sedangkan inflation volatility tidak signifikan terhadap pertumbuhan ekonomi. Temuan ini menunjukkan bahwa peningkatan indikator sektor keuangan dan arus investasi asing belum sepenuhnya mendorong produktivitas sektor riil, serta ketidakstabilan inflasi memberikan tekanan terhadap kinerja ekonomi di Indonesia.

Kata kunci: *Financial Deepening, FDI, Volatilitas Inflasi, Pertumbuhan Ekonomi, ARDL.*



CHAPTER I

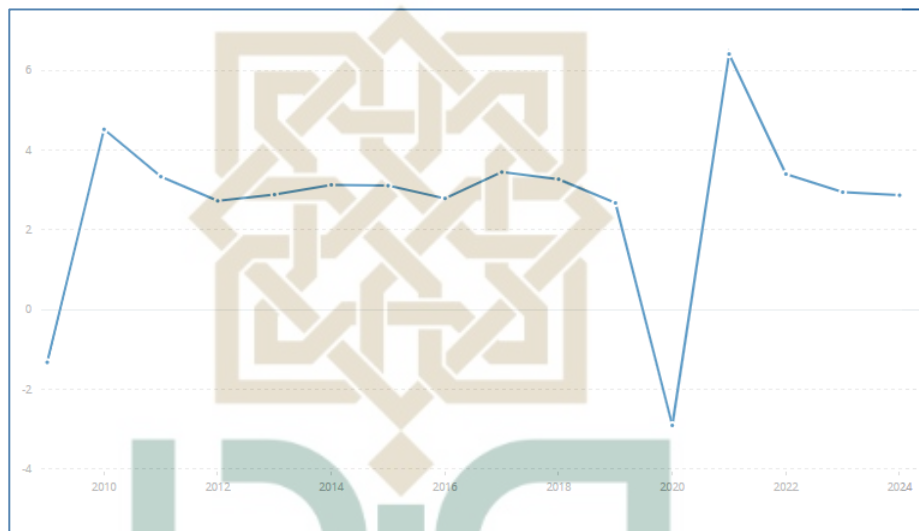
INTRODUCTION

A. Background

A country's economic growth can be seen from the increase in gross domestic product (GDP) backed by stability in the financial sector. Appropriate and efficient government policies are very important for national economic development, especially monetary policy, which facilitates the distribution and allocation of finance in various sectors (N. V. K. Putri & Mubin, 2021). By acting as an intermediary, the financial sector plays a key role in stabilizing and advancing economic activity (Mishkin & Eakins, 2009). Thus, financial deepening is often considered an important factor in supporting economic growth, although its impact depends on how effectively financial resources are allocated to productive sectors. From a theoretical standpoint, the financial system comprises institutions, instruments, and regulators that interact continuously to enhance this sector's effectiveness in sustaining growth and development (Osinachi & Lilian, 2022).

Globally, financial deepening and increased domestic credit to the private sector have been shown to drive GDP per capita growth. Furthermore, monetary policy has contributed to maintaining the financial stability of Indonesia's banking sector (Sugiyanto & Yolanda, 2020). Furthermore, monetary-fiscal coordination supports post-crisis economic resilience, as evidenced by the IMF's projection of 5.1% growth in Indonesia by 2026 (Bank Indonesia, 2026).

The following graph illustrates global economic growth from 2009 to 2024. This graph shows the recovery after the 2008 global financial crisis, which was marked by a sharp contraction of -1.32% in 2009, followed by very high economic growth of 6.42% in 2021 due to the post-COVID-19 pandemic recovery, before finally stabilizing at 2.86% in 2023 and 2024 (World Bank, 2025).



Source : World Bank (2024)

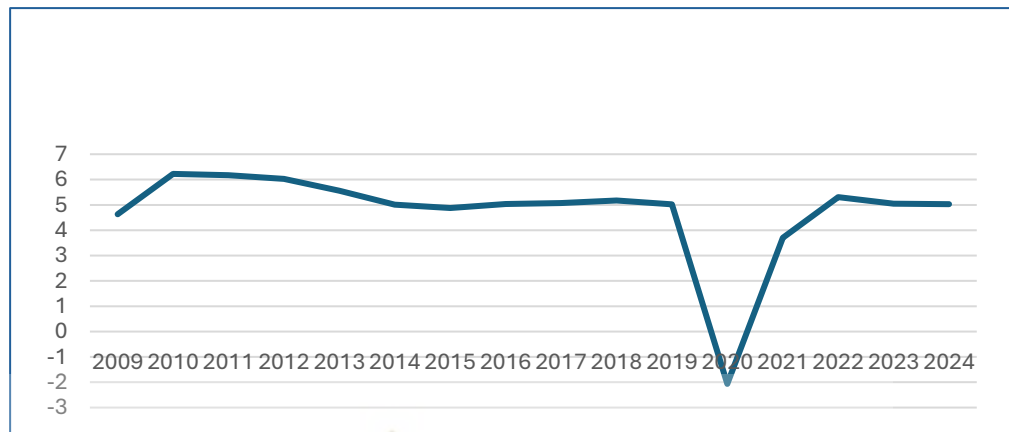
Picture 1.1 Economic Growth of the World 2009-2024

Based on the global economic growth chart for the period 2009-2024, the global economy experienced significant fluctuations that were greatly influenced by various global economic shocks (UNCTAD, 2024). In 2009, global economic growth contracted due to the 2008–2009 global financial crisis, which caused a widespread decline in economic activity, a weakening of the financial sector, and a contraction in international trade. However, in 2010, there was a sharp increase in global economic growth, signaling a phase of global recovery as a result of the implementation of

expansive fiscal and monetary stimulus policies in various countries, both developed and developing.

In the period 2011-2019, global economic growth tended to be relatively stable, at around 2.5 to 3.5 percent, despite facing various structural challenges such as the debt crisis in Europe, the slowdown in China's economic growth, increased international trade tensions, and global geopolitical uncertainty. Nevertheless, the global economy was generally able to maintain positive growth, supported by the contribution of developing countries and the recovery of the international trade sector.

In 2020, global economic growth experienced another sharp decline, turning negative due to the COVID-19 pandemic. The pandemic caused major disruptions to global supply chains, a decline in consumption and investment, and restrictions on economic activity in almost all countries . However, in 2021, there was a high surge in global economic growth as a form of post-pandemic recovery (United Nations, 2024). Entering the 2022-2024 period, global economic growth is once again showing growth. This condition is an important context for developing countries, including Indonesia, which are also affected by the dynamics of global economic growth, investment, and stability.



Source : World Bank (2024)

Picture 1.2 Economic Growth of Indonesia 2009-2024

Based on the data, during the 2009-2012 period, economic growth was on a relatively high and stable trend, even reaching above 6% at the beginning of the period. This indicates a fairly strong economic condition after the 2008 global crisis. Entering the 2013–2019 period, economic growth slowed and tended to stabilize at around 5%. The most significant change occurred in 2020, when economic growth plummeted sharply to a negative figure. This drastic decline reflects the impact of major disruptions to national economic activity. In the 2021-2022 period, there was a fairly strong recovery, marked by a return to positive economic growth of close to 5%. This indicates a relatively rapid economic recovery process. In addition, in the 2023–2024 period, economic growth is expected to stabilize (World Bank, 2025).

Based on the graph of Indonesia's economic growth from 2009 to 2024 above, many developing countries, including Indonesia, face challenges where economic growth is slowing due to global pressures such as supply chain disruptions, high inflation, and geopolitical tensions (Brata,

2024 ; Syam & Amaliah, 2024). Following the pandemic, Indonesia is also vulnerable to a similar slowdown, as evidenced by its economic sensitivity to external shocks, such as the weakening of the Rupiah exchange rate due to monetary tightening policies in the United States (Rezki et al., 2025). These conditions indicate the need for stronger economic fundamentals and effective macroeconomic management to sustain long-term economic growth.

Therefore, strengthening the economic structure is crucial for Indonesia, given its relatively stable economic growth trend, yet its vulnerability to external shocks, as seen in the 2009-2024 graph above (World Bank, 2025) . One strategic effort is financial deepening, which is expected to accelerate more effective allocation of funds to productive sectors such as industry and infrastructure (IMF, 2024). Furthermore, FDI is often regarded as an important source of external financing that can increase production capacity and support economic growth. However, its impact is not always positive, particularly in developing countries where weak institutional quality, regulatory inefficiencies, or external shocks may cause FDI to contribute less optimally or even negatively to economic growth (OECD, 2024). However, the success of financial deepening and FDI flows is inseparable from macroeconomic stability, particularly inflation volatility. High inflation fluctuations can create economic uncertainty, hinder investment activity, and slow overall growth. Therefore, these three factors are interrelated and require further in-depth analysis.

According to Sanjaya et al., (2017), financial deepening is considered an effort aimed at optimizing asset accumulation and increasing funding accessibility to increase financial assets, thereby enabling real economic expansion. This is achieved by increasing total investment and production financing through formal or specialized markets (Husna & Soebagiyo, 2023). According to Shaw (1974), Financial deepening refers to the proportion of a country's financial assets relative to its gross domestic product.. The higher this ratio, the deeper the country's financial sector. Therefore, it can be interpreted that the higher the ratio, the more effective the financial system is in distributing and coordinating assets to drive the country's economic growth (N. V. K. Putri & Mubin, 2021). However, the relationship between financial deepening and economic growth is not always straightforward. When credit expansion is not accompanied by optimal allocation to productive sectors, excess liquidity can emerge without generating real economic output, potentially resulting in a negative effect on growth (Astutik & Nugroho, 2024).

Financial deepening refers to the expansion and improvement of the financial system in mobilizing funds for productive investment. In this study, financial deepening is measured using Domestic Credit to the Private Sector (DCPS) and Broad Money (M2). This condition is ultimately expected to drive economic growth. These two indicators illustrate the extent to which a country's financial system has developed the greater the volume of credit and the money supply, the more robust its economic structure.

According to Harisuddin & Hartono (2019), Domestic Credit to the Private Sector is a key indicator of financial deepening, which measures the volume of credit provided by financial institutions to the private sector relative to GDP, reflecting the depth and efficiency of the financial system in supporting productive activities such as investment and consumption. A high GDP ratio indicates broader access to credit for businesses, thus encouraging optimal resource allocation and long-term economic growth, as evidenced by a panel analysis of Indonesian provinces for the period 2001-2016, where the increase in DCPS is significantly positively correlated with GDP per capita. However, in Indonesia, the Domestic Credit per Private Sector (DCPS) ratio started at a relatively low level of around 27% in 2010, gradually rising to a peak of approximately 40% in 2016, before stabilizing in the range of 36–38% in the 2020-2024 period, indicating limited credit distribution that hinders the multiplier effect on economic output (Astutik & Nugroho, 2024).

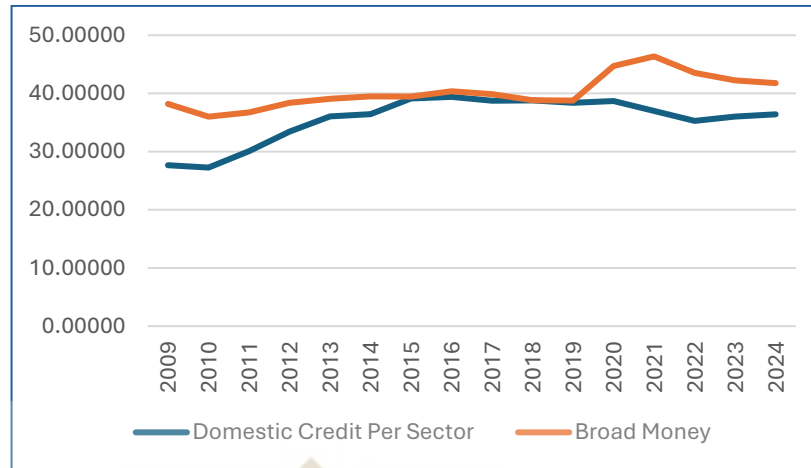
The DCPS indicator is also useful for identifying systemic risks in the financial deepening process, as excessively rapid credit growth without supervision can trigger asset bubbles and instability (The World Bank, 2022). Therefore, DCPS is an important indicator in this thesis analysis to evaluate the effectiveness of Indonesia's monetary policy in strengthening the economic structure in the face of global shocks.

The development of the financial sector in Indonesia, particularly the ratio of DCPS to GDP, shows a positive trend despite fluctuations from year to year. Based on historical data from the World Bank, this ratio reached

its lowest point of around 27.25% in 2010, then rose significantly to a peak of 39.40% in 2016, and remained in the range of 36-38% in the 2020-2024 period. This trend reflects the banking sector's ongoing efforts to expand credit access to the private sector, which is a key indicator of financial intermediation (World Bank, 2024).

Another indicator of financial deepening is measured through the Broad Money. According to Bank Indonesia in the metadata of Statistik Ekonomi dan Keuangan Indonesia (SEKI), broad money or M2 is defined as money in circulation in a broad sense, consisting of narrow money (M1) plus quasi money such as time deposits and less liquid deposits, as well as non-equity securities owned by domestic private entities (Bank Indonesia, 2021).

According to Nopirin, the total money supply is determined by the central bank, households (as money holders), and banks. The money supply includes banknotes, coins, and demand deposits (S. A. Putri et al., 2025). Increasing the money supply can encourage investment and consumption, which ultimately drives economic growth. The role of financial institutions in determining the volume of money in circulation as a source of funds is a crucial supporting factor for the effectiveness of the financial deepening process. A larger quantity of money circulating in society provides greater momentum for the success of financial deepening (N. V. K. Putri & Mubin, 2021).



Source : World Bank (2024)

Picture 1.3 Financial Deepening in Indonesia 2009-2024

The development of Indonesia's financial sector during 2009-2024 period can be seen through two main indicators, namely Domestic Credit to the Private Sector (DCPS as a percentage of GDP) and Broad Money Supply (M2 as a percentage of GDP), which are widely used to measure the depth of the financial sector. DCPS describes the extent to which financial institutions such as banks channel funds to productive activities in the private sector, while broad money supply represents overall economic liquidity, including cash in circulation and various types of deposits that reflect the accessibility of financial instruments. These two variables provide an in-depth picture of how the financial system supports economic growth in Indonesia (The World Bank, 2022).

Based on the graph above, the DCPS ratio shows a gradual upward trend from around 27% in 2009 to nearly 40% in 2016, indicating an improvement in financial intermediation after the 2008 global crisis, when Indonesia managed to maintain macroeconomic stability and restore

banking confidence, supported by strong credit growth thanks to a stable economy and controlled inflation, according to Bank Indonesia. However, this ratio is still relatively low compared to other ASEAN countries such as Malaysia 138% and Thailand 162% in 2023, indicating that Indonesia's financial sector is still in the development stage. In the 2017-2019 period, DCPS growth stagnated at 38-39% due to tight global financial conditions and banks' cautious stance in the face of external uncertainty, before slowing further in 2020-2021 in line with the decline in credit demand due to the COVID-19 pandemic (Subkhan & Hutajulu, 2023).

In addition, broad money supply indicators rose significantly in the 2020-2021 period, reaching more than 45% of GDP, driven by Bank Indonesia's expansionary monetary policy, such as BI rate cuts and liquidity injections for financial recovery and stability during the pandemic. This increase in liquidity was not accompanied by a proportional increase in DCPS, resulting in excess liquidity in the banking system where funds were available but not yet fully allocated to productive loans (Astutik & Nugroho, 2024).

Overall, the development of these two indicators demonstrates that financial deepening in Indonesia has improved over time, although structural limitations remain. The relatively moderate level of credit to GDP compared to regional peers indicates that the Indonesian financial system still has significant room for further development. Furthermore, the divergence between the movement of broad money and domestic credit during the pandemic highlights challenges in the effectiveness of monetary

transmission. Therefore, the figure suggests that while Indonesia's financial sector has become more resilient and liquid, strengthening the intermediation function remains essential to enhance its contribution to sustainable economic growth.

FDI is often associated with positive contributions such as capital inflows, technology transfer, and job creation. However, this relationship is not always guaranteed, as the effectiveness of FDI depends on domestic conditions such as institutional quality, regulatory environment, and the ability of the economy to absorb foreign investment. In some cases, FDI may not contribute significantly to economic growth and can even have adverse effects when it is not aligned with national development priorities. This creates a mutually reinforcing positive effect, which is very important for long-term development (Emako, 2022). However, according to Merian, FDI flows in Indonesia are not always positive for economic growth. Foreign investment declined in 2016 and 2020, before finally increasing again in 2022 (Amalia & Prasetyo, 2025). These fluctuations are influenced by global situations such as economic crises or geopolitical conflicts, as well as domestic factors such as legal certainty, ease of doing business, and the effectiveness of government reforms.

In addition, another important factor affecting Indonesia's economic growth is inflation volatility. Inflation volatility describes the level of instability or price fluctuations over time, which is more informative than just the average inflation rate. This is important for identifying the risks of uncertainty that cause companies and investors to delay investment

decisions (Egi, 2025). Unlike the average inflation rate, which only shows the general price level, inflation volatility provides a comprehensive picture of price fluctuations, such as exchange rate depreciation or sudden spikes in food prices, which have been shown to have a significant negative impact on output growth of 1.4-1.7% per one basis point increase in Indonesia during the 2000-2022 period (Meilianna, 2020). By understanding inflation volatility, policymakers can anticipate its impact on foreign direct investment (FDI) flows, household consumption, and labor absorption, thus encouraging the economy to support sustainable growth (Kuncoro et al., 2024). Although inflation volatility is generally associated with negative economic impacts, its effect may differ between the short run and long run depending on macroeconomic stability and policy responses.

Indonesia is a developing country that plays a strategic role in the global economy with relatively stable economic growth in the range of 4.8-5.4% per year since 2020 (WorldBank, 2024). However, this growth is still hampered by various macroeconomic problems, particularly inequality in the development of the financial sector, dependence on FDI, and fluctuations in inflation volatility from time to time due to the depreciation of the rupiah and food price volatility. Imbalances in the development of the financial sector, dependence on FDI, and price instability can affect economic growth performance in both the short and long term, as reflected in the OECD's projection that without structural reforms, Indonesia's growth is likely to stagnate below its potential of 6% until 2027 (OECD, 2024). Thus, Indonesia serves as the focus of this study to examine the interplay

among financial sector development, FDI, and inflation volatility in influencing economic growth. This analysis employs the Autoregressive Distributed Lag (ARDL) approach, which effectively captures both short-term and long-term relationships.

In recent years, Indonesia's financial services sector has shown a growth trend in bank financing, which is one indicator of financial deepening, with credit growth as of December 2024 reaching more than 10% on an annual basis (Keuangan, 2024). However, the ratio of private credit to Indonesia's GDP is still relatively low compared to the ASEAN-5 countries, indicating that financial deepening remains a challenge for the national economy (Direktorat Jenderal Strategi Ekonomi dan Fiskal, 2025).

Several research have shown mixed results regarding the impact of financial deepening on Indonesia's economic growth. Research conducted by Astutik & Nugroho (2024) discovered that financial deepening measures, including the M2/GDP ratio and bank credit, exert a significant negative effect on economic growth, because Indonesia's low level of financial deepening (around 40%) causes excess liquidity without optimal allocation to productive sectors. Conversely, (Harisuddin & Hartono, 2019), in a provincial panel analysis for the period 2001-2016, concluded that there is a positive relationship between an increase in DCPS and GRDP per capita, where every 1% increase in the private credit ratio drives regional output by up to 0.8%. (Wijayanti & Hisyam, 2025) also confirmed the negative impact of financial depth in ASEAN, including Indonesia, as financial development

that exceeds actual productive capacity increases crisis vulnerability and inequality.

Meanwhile, the relationship between FDI and economic growth shows both positive and negative findings in several studies. Research conducted by Wijayanti & Hisyam (2025) proves that FDI has a significant positive impact on GDP growth in ASEAN because it brings capital, technology, and management expertise that increase domestic productivity, with an elasticity coefficient of 0.45 in Indonesia. However, research conducted by S. A. Putri et al., (2025) using the VECM model for the 2010-2022 period found that FDI is not always positive, especially when external shocks such as a pandemic occur, which caused the decline in FDI in 2020 to have a negative impact on economic recovery. Fluctuations in Indonesia's FDI from 2016 to 2022 are negatively correlated with growth when domestic factors such as bureaucracy hinder the positive impact of FDI (Amalia & Prasetyo, 2025).

Research on the effect of inflation volatility on economic growth reveals that studies by (Kuncoro et al., 2024) indicates that inflation volatility in Indonesia's inflation targeting system has a strong negative impact on output volatility of 1.4-1.7% per basis point, as price uncertainty hinders private investment. (Subkhan & Hutajulu, 2023) confirms the dominant negative impact, where inflation fluctuations suppress foreign direct investment (FDI) and productive credit, although at low levels (<4%) they can have a positive impact through liquidity channels.

Most previous studies on financial deepening, FDI, and inflation volatility in Indonesia tend to analyze these variables separately or in pairs, without capturing the simultaneous dynamic interactions among all three variables. More critically, existing studies yield conflicting results attributable to differences in time periods, analytical units, and indicators used. For instance, Astutik & Nugroho (2024) found a negative effect of financial deepening at the national level during a period of excess liquidity, while Harisuddin & Hartono (2019) found a positive relationship at the provincial level over 2001–2016 a period of more stable credit growth. This divergence underscores the need for an integrated, time-sensitive analysis using the ARDL approach, which is capable of capturing both short-run and long-run dynamics to reconcile these contradictions in the context of Indonesia's economic recovery from 2009 to 2024.

Maqashid Syariah encompasses five fundamental objectives: the protection of religion (*hifz al-din*), life (*hifz al-nafs*), intellect (*hifz al-'aql*), lineage (*hifz al-nasl*), and wealth (*hifz al-mal*). In the context of economic development, these objectives collectively underscore the importance of a just, stable, and productive financial system. Financial deepening ideally supports *hifz al-mal* by expanding access to productive financing for all segments of society; however, when credit is misallocated or fails to reach productive sectors, it may contradict this objective by generating financial instability rather than shared prosperity. Similarly, FDI ideally contributes to *hifz al-nafs* through job creation and to *hifz al-'aql* through technology transfer, but extractive or poorly governed FDI may not fulfil these

objectives. Meanwhile, inflation volatility directly threatens *hifz al-mal* by eroding household purchasing power and discouraging productive investment. Therefore, evaluating the actual impact of these variables on economic growth is not only a macroeconomic concern but also a normative imperative aligned with the Maqashid Syariah goal of ensuring *maslahah* (public welfare) especially in Indonesia as the world's largest Muslim-majority country. This suggests that when financial deepening and FDI do not generate inclusive and productive outcomes, or when inflation volatility disrupts stability, these conditions may reflect a misalignment with the objectives of maqashid sharia.

This study offers novelty through a comprehensive ARDL approach to examine the effects of financial deepening (DCPS & M2), FDI, and inflation volatility on Indonesia's economic growth from 2009 to 2024, a period that has not been widely analyzed in an integrated manner following the global crisis and pandemic. This study robustly captures both short-term and long-term effects, including error correction mechanisms. Furthermore, its novelty lies in measuring inflation volatility using a rolling standard deviation window (3 years), which is more sensitive to food price and rupiah shocks than the simple average in previous literature, thus providing more useful policy insights for Bank Indonesia and OJK.

These conditions indicate that the relationship between financial deepening, FDI, and economic growth is complex and context dependent. In Indonesia, structural challenges such as inefficient credit allocation, dependence on foreign capital, and macroeconomic instability may lead to

outcomes that differ from conventional theoretical expectations, both in the short and long term. Therefore, the study entitled "The Effect of Financial Deepening, FDI, and Inflation Volatility on Economic Growth in Indonesia: ARDL Approach" is present to fill the research gap in the Indonesian economic literature by integrating simultaneous analysis of these three key variables in the critical period of 2009-2024.

B. Research Questions

1. What is the impact of financial deepening on Indonesia's economic growth in the short run and long run?
2. How does Foreign Direct Investment (FDI) influence Indonesia's economic growth over the short- and long-term?
3. How does Inflation Volatility influence Indonesia's economic growth over the short and long term?

C. Research Objectives

1. To analyze the impact of financial deepening, measured by Domestic Credit to the Private Sector (DCPS) and Broad Money (M2) as a percentage of GDP, on Indonesia's economic growth in the short run and long run using the ARDL approach.
2. To assess the effect of Foreign Direct Investment (FDI net inflows as a percentage of GDP) on Indonesia's economic growth in the short run and long run using the ARDL approach.

3. To analyze the impact of Inflation Volatility, measured using a 3-year rolling standard deviation of the inflation rate, on Indonesia's economic growth in the short run and long run using the ARDL approach.
4. To examine the existence of a long run cointegration relationship among financial deepening (DCPS and M2), FDI, Inflation Volatility, and Indonesia's GDP using the ARDL Bounds Test.
5. To measure the speed of short-run adjustment toward long-run equilibrium through the Error Correction Term (ECT) in the ARDL model.

D. Research Benefits

1. Theoretical benefits
 - a) This study contributes to empirical literature by providing evidence on the simultaneous effects of financial deepening (DCPS & M2), FDI net inflows, and inflation volatility on Indonesia's economic growth during 2009-2024, a period covering two major global shocks the 2008 financial crisis and the COVID-19 pandemic.
 - b) This research offers a methodological contribution by applying the ARDL bounds testing approach with a 3-year rolling standard deviation measure of inflation volatility, which is more sensitive to short-term price shocks than conventional average inflation measures used in prior literature.
2. Practical Benefits

- a) For policymakers such as Bank Indonesia, OJK, BKPM, and Bappenas, the findings provide specific evidence on the conditions under which financial deepening and FDI net inflows may not optimally contribute to economic growth, offering inputs for improving credit allocation efficiency and strengthening the quality of foreign investment absorption in Indonesia.
- b) For businesses and economic actors, this study highlights the importance of short-run inflation stability in reducing investment uncertainty and supporting more inclusive and sustainable economic development.
- c) For researchers and Islamic economists, the findings serve as a reference for further research integrating Maqashid Syariah perspectives into macroeconomic analysis, particularly in exploring how financial deepening and FDI can be better aligned with the principles of *maslahah* and *'adalah* in an Islamic economic framework.

E. Structure of the Study

Chapter I: Introduction

This chapter outlines the study's background, research questions, objectives, benefits, and discussion structure. It highlights the importance of analyzing how financial deepening, FDI, and inflation volatility impact Indonesia's economic growth from 2009 to 2024, while

justifying the ARDL approach for capturing short- and long-term dynamics amid post-pandemic recovery.

Chapter II: Literature Review

This chapter reviews theories relevant to the research variables, including Solow growth model and Mc Kinnon theory. It also examines previous empirical studies on the relationships between these variables, develops a conceptual framework, and formulates research hypotheses based on theoretical and empirical evidence from Indonesia-specific literature.

Chapter III: Research Methodology

This chapter outlines the research approach, data types from World Bank, population and sample (time series 2009-2024), operational definitions of variables, and data collection and analysis methods. It explains the use of ARDL bounds testing and diagnostic tests to examine short- and long-term effects of financial deepening, FDI, and Inflation Volatility on Indonesia's economic growth.

Chapter IV: Results and Discussion

This chapter presents the analysis results, including descriptive statistics, stationarity tests (ADF), ARDL estimation, cointegration (bounds F-test), and robustness diagnostics. The discussion interprets findings relative to research objectives and hypotheses, linking results to Solow model, previous Indonesian studies, and implications of

financial deepening/FDI amid inflation volatility for middle-income trap challenges

Chapter V: Closing

This chapter summarizes key conclusions from ARDL findings, discusses policy implications for BI (inflation targeting), OJK/BKPM (FDI absorption), and Bappenas (RPJMN 2025-2029), provides actionable recommendations, addresses study limitations, and suggests directions for future research, like shariah finance integration or provincial panel analysis.



CHAPTER V

CONCLUSION

A. Conclusion

This study analyzes the impact of financial deepening, FDI, and Inflation Volatility on economic growth over the period from 2009 to 2024 using ARDL methods. This research focuses on Financial Deepening using 2 indicators, Domestic credit per private sector and broad money, Foreign Direct investment (FDI), and inflation volatility.

First, financial deepening shows different effects in the short run and the long run. In the short term, domestic credit to the private sector has a negative and significant impact on economic growth. The probability value stands at 0.0000, which falls below the 0.05 significance threshold. Long-term analysis indicates that domestic credit to the private sector exerts a significant negative influence on economic growth, confirmed by a probability value under 0.05%.

This shows that credit expansion in Indonesia during the period studied was not allocated efficiently to productive sectors. In the short term, the negative impact shows that increased credit was directed more toward consumption than productive investment, thus failing to generate immediate economic growth. In the long term, these negative results indicate structural problems in the financial system, such as inappropriate credit allocation, high non-performing loan (NPL) rates, or excessive dependence on debt without a corresponding increase in productivity. The results of this study show that financial deepening alone is not sufficient to stimulate economic

growth; the quality and productivity of credit allocation must be considered to determine its impact on the economy.

For Broad Money in the short term, broad money has a negative and significant impact on economic growth. With a probability value of 0.0000 and 0.0001, which is less than the 0.05 significant level. In the long run also show that broad money has a negative and significant impact on economic growth. With a probability value of 0.0000, which is less than the 0.05 significant level. These results indicate that abundant money supply during the observed period did not effectively increase real sector productivity. In the short term, excessive money supply caused inflationary pressure rather than stimulating output. In the long term, this negative relationship shows that increased liquidity alone is not sufficient to drive sustainable economic growth without efficient financial intermediation and productive investment. Overall, the results suggests that the expansion of financial resources in Indonesia during the observed period did not effectively support productive economic activities.

Second, Foreign Direct Investment (FDI) shows different effects in the short run and the long run. In the short term, Foreign Direct Investment (FDI) has a negative and significant impact on economic growth. With a probability value of 0.0000, which is less than the 0.05 significant level. In the long run also show that Foreign Direct Investment (FDI) has a negative and significant impact on economic growth. With a probability value of 0.0002, which is less than the 0.05 significant level. These results indicate that foreign capital flows during the period observed have not been

optimally directed into the domestic productive structure. This shows that foreign direct investment (FDI) flows alone are not sufficient to drive sustainable economic growth without strong domestic absorption capacity.

Third, Inflation volatility shows different effects in the short run and the long run. In the short term, Inflation volatility has a negative and significant impact on economic growth. With a probability value of 0.0002, which is less than the 0.05 significant level. In the long run also show that Inflation volatility) doesn't have a significant impact on economic growth. With a probability value of 0.0520, which is higher than the 0.05 significant level. These results indicate that macroeconomic instability directly disrupts economic activity in the short term. However, in the long term, inflation volatility does not significantly affect economic growth, suggesting that the economy may adjust to price fluctuations over time through policy responses.

Based on the results of this study, it can be concluded that financial deepening, Foreign Direct Investment (FDI), and inflation volatility play an important role in Indonesia's economic growth during the 2009–2024 period. The results show that financial deepening, measured by domestic credit to the private sector and broad money supply (M2), has a statistically significant negative impact on economic growth in both the short and long term. Similarly, FDI shows a negative and significant impact in both the short and long term. On the other hand, inflation volatility was found to have a negative and significant impact on economic growth in the short term, indicating that macroeconomic instability directly disrupts economic

performance. However, in the long term, these impacts become statistically insignificant, suggesting that the economy may gradually adjust to inflation fluctuations through policy responses and structural adaptations. Overall, this study highlights that sustainable economic growth is not only driven by financial deepening or capital inflows, but rather by efficiency, stability, and quality.

B. Suggestion

1. For Academic

Future researchers may wish to include additional variables to measure institutional quality, governance, and human capital development. Given that this study found mixed or negative relationships for some variables, further investigation using alternative proxies for financial development or different econometric approaches could provide deeper insights. Additionally, comparative studies across policies or regions could help identify structural differences that influence the effectiveness of financial deepening and foreign capital inflows.

2. For Practitioners

Given the finding that financial deepening does not always contribute positively to growth, financial institutions should prioritize the quality of credit disbursement rather than merely expanding the volume of loans. Greater emphasis needs to be placed on financing productive and value-added sectors that directly contribute to economic growth. Strengthening risk management systems and improving credit

assessment mechanisms are crucial to minimizing financial inefficiencies and instability.

3. For Policy Maker

Given that this study indicates that the impact of financial deepening, FDI, and inflation volatility is not always optimal, policymakers should focus on improving the efficiency of financial intermediation and ensuring that financial sector expansion supports real sector productivity. The regulatory framework should encourage productive lending while maintaining financial stability.

For foreign investment, policies should aim to attract high-quality foreign direct investment (FDI) that promotes innovation, job creation, and industrial upgrading, rather than merely increasing the volume of capital inflows. In addition, maintaining macroeconomic stability, particularly by controlling inflation volatility, remains a top priority, as instability can hinder investment and economic growth. Coordinated fiscal and monetary policies are needed to reduce short-term economic uncertainty and support sustainable long-term growth

STATE ISLAMIC UNIVERSITY
SUNAN KALIJAGA
YOGYAKARTA

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