

Etikonomi

Jurnal Ekonomi



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Etikonomi

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Etikonomi is published by Faculty of Economics and Business UIN Syarif Hidayatullah Jakarta, Indonesia. Etikonomi journal focused on Economics, Business and Management studies in developing countries. The journal is published twice a year. The journal being accredited in the First Tier (Sinta 1) by Ministry of Education, Culture, Research & Technology No. 158/E/KPT/2021 on December 9, 2021 (Valid from Vol. 20(1), 2021 until Vol. 24(2), 2025) Renewal of the Certificate 051/E/KPT/2017 Since December 4, 2017. Currently this journal is indexed by Emerging Sources of Citation Indeks (ESCI), ASEAN Citations Indeks (ACI), Dimensions, CrossRef, Moraref, etc.

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 <http://journal.uinjkt.ac.id/index.php/etikonomi>

INDEXING AND ABSTRACTING

Etikonomi is being accredited in First Tier (Sinta 1) by Ministry of Education, Culture, Research & Technology No. 158/E/KPT 2021 (Valid from Vol. 20(1), 2021 until Vol. 24(2), 2025) Renewal of Accreditation No. 051/E/KPT/2017 Since December 4, 2017.

Etikonomi has been covered (indexed and abstracted) by following indexing services:

- Emerging Source of Citation Index (ESCI) Web of Science
- ASEAN Citation Index
- Dimensions
- CrossRef
- Ebsco (Open Access Directory)
- Goggle Scholar
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Intellectual Capital and Bank Profitability Nexus: Evidence From Gulf Cooperation Council Countries

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JEL Classification:

E22

G21

O34

L25

Received: 06 May 2024

Revised: 13 May 2025

Accepted: 25 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This article presents novel and fresh empirical evidence on the relationship between intellectual capital and bank profitability and reports the results for the whole sample as well as at country breakdown.

Research Objectives: Using a dataset of 60 banks from GCC countries between 2008 and 2022, the article investigates the association between intellectual capital and bank profitability by implementing M-VAIC.

Research Methods: We developed two models in which profitability ratios are the dependent variables and the M-VAIC components are the independent variables and ran pooled OLS and panel regressions.

Empirical Results: The study's findings showed that while structural capital efficiency has a negative influence on bank profitability, other components have a positive impact on bank profitability. The signs and the significance levels at the country details do not show essential differences.

Implications: The study's results will have significant implications on how bank managers and policymakers invest and manage intellectual capital. The study offered an original contribution to the literature by presenting fresh empirical evidence from GCC countries for a reasonably long period.

Keywords:

intellectual capital; bank profitability; modified value added intellectual capital; financial performance

How to Cite:

Osman, Z., & Yilmaz, I. (2025). Intellectual Capital and Bank Profitability Nexus: Evidence From Gulf Cooperation Council Countries. *Etikonomi*, 24(2), 335 – 352. <https://doi.org/10.15408/etk.v24i2.38708>.

INTRODUCTION

Intellectual capital (IC) is a contemporary notion that is attracting researchers and is growing equally in terms of concept and measurement mechanism, as it is a concept that is continually renewable and evolving in response to its surroundings. Measuring, assessing, and revealing intellectual capital is a significant challenge for many businesses, particularly those in the finance industry, which depend on quantitative metrics. There is strong evidence that intellectual capital will contribute to achieving high value and growth for the organization. In the current knowledge-driven economy, intellectual capital (IC) is considered a valuable element that plays a significant role in creating value, as reflected in high performance (Kalkan et al., 2014). Many authors have believed that IC is a pivotal and significant component for the growth of banks, enhancing their profitability (Nimtrakoon, 2015; Sarea & Alansari, 2016). The IC consists of three items: human capital (HC), structural capital (SC), and capital employed (CE) (Mariya & Shakina, 2014). As opined by Anuonye (2015), HC is related to the competence, skills, and training of employees. In the same vein, the Information system, copyrights, corporate reputation, patents, and quality standards are the components of SC. At the same time, the worth of the assets that contribute to a corporation's ability to generate earnings, known as operating assets, is part of CE Public.

The majority of recent studies implemented the value-added intellectual coefficient (VAIC) model built by Joshi et al. (2013), Yalama (2013), and Asutay and Ubaidillah (2024) to examine the nexus between IC and financial performance of the firms using three components, namely: value-added efficiency of human capital (VAHU), value-added efficiency of structural capital (STVA), and value-added efficiency of capital employed (VACA). However, the literature on the link between VAIC and banks' financial performance still has not concluded on a unique outcome. The majority of previous research that has explored the linkage between the VAIC model and financial performance suggests that IC has a positive impact on the financial performance of firms and the price per share of firms (Chinnasamy et al., 2023). On the other hand, some studies found a weak relationship or negative link between the VAIC and banks' financial performance (Dženopoljac et al., 2016). Many previous studies have been conducted to explore the impact of VAIC on financial performance over the last two decades worldwide (Nawaz & Haniffa, 2017; Khan et al., 2015; Rehman et al., 2012). Despite these studies, there are limited investigations that explore the relationship between WAIC and profitability, especially in the GCC, as far as the researchers' knowledge extends (Buallay, 2019; Alqahtani & Mayes, 2018; Al-Musali & Ku Ismail, 2016; Zafar & Yasin, 2025). These studies have yielded mixed results; furthermore, the majority of them were conducted in a single country of the GCC. The present study aims to report on the gap in the literature by comparing its results with previous research in the GCC and worldwide to determine if there are significant differences compared to other studies.

Kurfi et al. (2017) define IC as a resource of knowledge that is acquired and utilized by the firm. Hence, the challenges of the firm depend on detecting, illustrating, and measuring this knowledge. IC can be defined as the difference between a company's

book value and its market value. Observing the missing value of the financial statements by identifying the gap between the market value and book value of enterprises has drawn the attention of much research. Many authors reported that (HC), (SC), and (CE) are the main components of IC (Cabrito et al., 2018; Martín de Castro et al., 2011). To gauge an organization's intellectual capital performance and compare different companies. The connection between the VAIC model and firm performance has been examined by several studies, which have reported a strong link between IC and firm performance and stock returns (Nimtrakoon, 2015; Ozkan et al., 2017; Shair et al., 2021). In financial and accounting studies, HC can be considered as the intangible assets that have been the pivot of debate over the last two decades. Research in the field has found that such imperceptible assets have presented pressing issues for governments, regulatory authorities, and organizations alike (Zimmerman, 2015). In addition, HC is linked to the employees' tacit or explicit knowledge and their ability to provide helpful knowledge to the firm. Many researchers, such as Castro et al. (2011), believe that human capital (HC) encompasses skills, mental abilities, behaviors, learning, experiences, and abilities that enable individuals to perform at a high level. As mentioned by Becker, HC is the investment of organizations in the field of training and development to enhance the knowledge, experience, and expertise of workers, which leads to maximizing the organization's productivity and outputs.

On the other hand, Shair et al. (2021) defined structural capital (SC) as the support infrastructure that facilitates HC's thriving. In addition, SC is defined as the unequivocal knowledge that an organization possesses (Beltramino et al., 2020). To support the company's productivity, it is necessary to have hardware and software, databases, a structured organization, patents, trademarks, and all the necessary organizational capacity, which is considered SC, referring to the support required for the company's productivity.

Capital employed efficiency (CE) denotes the company's ability to implement procedures that enhance employee efforts to increase their intellectual performance, which is reflected in financial performance. Choudhury (2010) defines capital employed as "the capital utilized is regarded as the strongest predictor of execution". In addition, the CEE has a greater influence on the profitability of participation banks than other parts of VAIC. Similarly, Nimtrakoon (2015) asserts that CEE has a positive impact on performance. Following previous studies, the modified value-added intellectual capital (MVAIC) adopted by this study emphasizes the three components of IC, namely, HC, SC, and CE (Ozkan et al., 2017). Numerous studies in the field have investigated the relationship between IC and firm performance. The results were mixed; some studies have indicated a positive correlation between IC and financial performance, while other studies did not document a significant impact of IC on the financial performance of firms.

Using competitive advantage as a mediator, Awwad and Qtaishat (2023) examined the relationship between IC and the financial performance of Jordanian commercial banks. The authors reported a positive association between IC and both competitive advantage and the financial performance of commercial banks. In the same vein, during the COVID-19 pandemic. Similarly, the impact of IC on financial performance in the

telecommunications industry has been investigated by Lili et al. (2023). Their study documented a positive impact of return on assets (ROA) and return on equity (ROE), but it does not affect earnings per share. Their research revealed that return on equity (ROE) and return on assets (ROA) have a positive and significant influence, whereas earnings per share remain unaffected.

In addition, Ousama et al. (2020) examine the nexus between intellectual capital (IC) and profitability in Islamic banks operating in GCC countries. The results showed a favorable correlation between Profitability and Islamic banks. In their recent study, using the Skandia Navigator Model (SNM), Chinnasamy et al. (2023) evaluated the relationship between intellectual capital (IC) and profitability in India and GCC banks. The results revealed a substantial impact of IC (human capital and customer focus) on profitability in selected banks in India and the GCC. By selecting four companies operating in the distribution of drinking water, Gogan et al. (2016) examine the impact of IC on the firm's performance. The findings reported that the IC has a positive impact on organizational performance.

In technology firms across five ASEAN countries, Nimtrakoon (2015) has reported a positive impact of intellectual capital on firm performance. A recent study conducted by Shairi et al. (2021) presents a positive association between MVAIC and ROA, but a mixed relationship between the efficiency of MVAIC components and ROA. Faruq (2023) examines the relationship between IC and the performance of listed banks in Bangladesh from 2015 to 2021, employing both static and dynamic methods. The study reported that MVAIC has a significant and positive impact on bank performance, regardless of the method adopted. Additionally, corporate governance reports the same result using both methods.

Ozkan et al. (2017) conducted a study to analyze the effect of IC on the financial performance of 44 banks operating in Turkey between 2005 and 2014. The study reveals that the banks' financial performance has been influenced positively by both HC and CE. More interestingly, in the service sector of an emerging country like Vietnam, Nguyen (2023) examines the impact of IC on firm financial performance. The results showed that HC and CE have a strong positive impact on profitability, while ST's impact was inconsistent. In contrast, some authors have reported no significant impact or a negative relationship between IC and financial performance. In their study, Dženopoljac et al. (2016) attempted to investigate the impact of IC on firm financial performance in the technology sector of Serbia. The findings reveal that IC has no remarkable effect on the firm's financial performance in this sector.

This study aims to explore the connectivity between the M-VAIC model and examine the separate effects of (HCE), (SCE), (CEE), and (RCE) on bank performance during 2008-2022 across all banks (conventional and Islamic banks) in the GCC. The study makes a significant contribution to the existing body of literature in several aspects. Firstly, it presents fresh and novel evidence from GCC countries about the relationship between intellectual capital and financial performance. GCC countries exhibit distinct dynamics compared to other regions of the world, possessing strong

currencies and macroeconomic indicators, yet they differ from developed countries in several key aspects.

The study enhances the understanding of the intellectual capital concept in the banking sector, where capital is a crucial factor for survival and solvency. It emphasizes that intellectual capital is also important for the sector, alongside financial capital. Secondly, unlike the majority of previous studies, it employs the M-VAIC model, which is superior to and newer than the traditional VAIC model. Thirdly, the study reports the results for the whole sample as well as at the country breakdown. Moreover, this study may pave the way for scholars to conduct further research on the relationship between IC and profitability.

METHODS

The sample used in this study encompasses banks from six GCC countries for the period 2008-2022. The initial sample consisted of 66 banks, but some were excluded due to missing data. Some of the observations were also removed because of missing or outlier values. Therefore, the dataset is an unbalanced panel comprising 60 banks and 837 observations. The data was collected from the LSEG Workspace (previously Refinitiv) database.

Following Dženopoljac et al. (2016) and Pulic (2004), M-VAIC is adopted to assess the association between the IC and the financial performance of these banks. The return on equity (ROE) and return on assets (ROA) ratios are used as proxies to measure the financial performance of banks, which are widely adopted in many studies (Arif, 2012; Ozkan et al., 2017; Ul Rehman et al., 2024). They have been used in other studies, as pointed out by Joshi et al. (2013) and Yalama (2013), who clarified that ROA and ROE are the primary measures of banks' financial performance. The ROA is computed by dividing the net profit or loss of the year by total assets, while ROE is computed by dividing net profit or loss by total owner equity. Table 2 presents the variables used in the models, the corresponding measurements, and the prior studies referenced.

Table 1. Sample Details

Country	Banks	Observations
Bahrain	8	115
Kuwait	11	160
Oman	7	88
Qatar	7	88
Saudi Arabia	10	150
United Arab Emirates	17	236
Total	60	837

According to previous literature, a link has been established between IC and a firm's financial performance, and the nature of this relationship has been predominantly

viewed as positive by authors. However, some studies confirmed the negative relationship between IC and a firm's financial performance. We argue that IC has value and a significant impact on the profitability of listed Banks in the GCC. In this study, the independent variables used are the components of the M-VAIC model. As developed and reported by Pulic (2000), M-VAIC is calculated as follows:

$$\text{M-VAIC} = \text{HCE} + \text{SCE} + \text{CEE} + \text{RCE}$$

There are two dependent variables, return on assets (ROA) and return on equity (ROE). Therefore, the models can be stated as below:

- (1) $ROA_{i,t} = \beta_0 + \beta_1 HCE_{i,t} + \beta_2 SCE_{i,t} + \beta_3 CEE_{i,t} + \beta_4 RCE_{i,t} + \beta_5 LEV_{i,t} + \beta_6 SIZE_{i,t} + \beta_7 GDPGR_{i,t} + \varepsilon_{i,t}$
- (2) $ROE_{i,t} = \beta_0 + \beta_1 HCE_{i,t} + \beta_2 SCE_{i,t} + \beta_3 CEE_{i,t} + \beta_4 RCE_{i,t} + \beta_5 LEV_{i,t} + \beta_6 SIZE_{i,t} + \beta_7 GDPGR_{i,t} + \varepsilon_{i,t}$

Table 2. Variable Details

Variables	Calculation	Reference Studies
Human capital efficiency (HCE)	HCEi=VA/HC HC refers to the total costs invested in the employees.	(Castro et al., 2011)
Structural capital efficiency (SCE)	SC/VA SC refers to the difference between VA and HC	(Shair et al., 2021)
Capital employed efficiency (CE)	VA/CE CE refers to total equity plus long-term liabilities.	(Dženopoljac et al., 2016)
Relational capital efficiency	VA/RC RC refers to marketing and selling expenses	(Cabrilo et al., 2018)
VA	VA =OP+Ec+D+A Where VAI represents the total value added created. OP denotes the operating profit. EC refers to the employment cost, D refers to the depreciation of A refers to the amortization.	(Ozkan, et al., 2017; Cabrilo et al., 2018)
MVAIC	HCE+SCE+CEE+RCE	(Pulic, 2000; Ahlawat et al. 2024)
Return on Assets (ROA)	Net profit /Total assets	(Arif, 2012; Ozkan, et al., 2017).
Return on Equity (ROE)	Net profit/Total equity	(Joshi et al., 2013; Yalama, 2013)
Firm Size (SIZE)	Natural log of Total Assets	(Alipour, 2012)
Leverage (LEV)	Total Liabilities / Total Assets	(Khan et al., 2015)
GDPDR	GDP Growth Rate	(Al Musali et al., 2016)

Pooled ordinary least squares (OLS) regressions and panel regressions with fixed and random effects models have been run for each model as the estimation method. To compare between fixed and random effects models, we have used the Hausman specification test.

RESULTS AND DISCUSSION

This section of the study presents descriptive statistics, a correlation matrix, and the results of OLS and panel regressions, and discusses the presented results. Table 3 presents the mean, standard deviation, minimum, and maximum values for all variables.

Table 3. Descriptive Statistics

Variable	Observation	Mean	Std. Dev.	Min	Max
HCE	837	3.577	1.782	-7.61	15
SCE	837	.691	.383	-2.75	4.73
CEE	837	.129	.087	-.78	.53
RCE	837	6.385	5.687	-55.15	61
MVAIC	837	10.782	6.493	-49.48	70.03
ROA	837	.012	.013	-.105	.059
ROE	837	.078	.193	-3	.81
LEV	837	.856	.079	.01	1
LNTA	837	23.446	1.179	19.4	26.5
GDPGR	837	2.722	4.053	-8.86	19.59

The composite measure of intellectual capital is the M-VAIC score, which has a mean value of 10.782 and a standard deviation of 6.493. Among the components of M-VAIC, the most significant value in terms of mean comes from relational capital efficiency, followed by human capital efficiency. This result supports the idea that the intellectual capital potential of banks primarily arises from investments in human resources and relationships with stakeholders.

The mean ROA is 1.2% and the mean ROE is 7.8%, which are at reasonable levels. ROE is expected to be greater than ROA, especially for the banking sector, because ROE is calculated as net profit divided by total equity. At the same time, ROA uses total assets in the denominator. Since banks operate with high financial leverage and relatively lower equity, ROE results in higher percentages. The mean leverage is 85.6 %, which is a very reasonable level for the banking industry. The GDP growth rate has a mean value of 2.7% for the countries in the sample, ranging from -8.86% to 19.59%, implying significant macroeconomic differences among the countries. Table 4 presents the pairwise correlations among the variables. The coefficients and p-values, given in parentheses, confirm that there are no high correlations among them.

Table 4. Pairwise Correlations

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1) HCE	1.000									
(2) SCE	0.161 (0.000)	1.000								
(3) CEE	0.334 (0.000)	-0.030 (0.392)	1.000							
(4) RCE	0.288 (0.000)	0.013 (0.708)	0.275 (0.000)	1.000						
(5) MVAIC	0.541 (0.000)	0.114 (0.001)	0.344 (0.000)	0.959 (0.000)	1.000					
(6) ROA	0.616 (0.000)	0.042 (0.222)	0.524 (0.000)	0.372 (0.000)	0.504 (0.000)	1.000				
(7) ROE	0.456 (0.000)	-0.074 (0.032)	0.555 (0.000)	0.301 (0.000)	0.392 (0.000)	0.698 (0.000)	1.000			
(8) LEV	-0.106 (0.002)	0.016 (0.653)	0.049 (0.158)	-0.051 (0.141)	-0.072 (0.037)	-0.119 (0.001)	-0.068 (0.051)	1.000		
(9) LNTA	0.257 (0.000)	0.060 (0.081)	-0.058 (0.092)	-0.042 (0.225)	0.036 (0.293)	0.235 (0.000)	0.189 (0.000)	0.325 (0.000)	1.000	
(10) GDPGR	0.161 (0.000)	0.047 (0.174)	0.094 (0.007)	0.100 (0.004)	0.136 (0.000)	0.204 (0.000)	0.078 (0.023)	-0.100 (0.004)	-0.049 (0.155)	1.000

This section reports the results of regressions run based on the models. There are two models in which ROA or ROE is the dependent variable, and we have run three regressions for each model: pooled ordinary least squares (OLS), panel fixed effects, and panel random effects. Therefore, the total number of regressions is six, and each of them is reported in Table 5.

Table 5 shows the pooled OLS regression results for the model in which ROA is the dependent variable. The model has an R-squared value of 56.5%, which implies that the independent variables explain 56.5% of the variability in ROA. The model has an overall significance with an F-test value of 154. Human capital efficiency, capital employed efficiency, and relational capital efficiency have a positive effect on profitability, while Structural capital efficiency has no significant relationship with ROA. The positive relationship suggests that intellectual capital plays a crucial role in driving financial success, demonstrating that banks that effectively leverage their intellectual assets are more likely to achieve better financial performance. Control variables also

revealed significant coefficients; leverage has a negative effect on the intellectual capital-profitability relationship, while bank size and GDP growth rate have a positive and significant effect.

Table 5. Pooled OLS – ROA is the dependent variable

ROA	Coef.	St.Err.	t-value	p-value	[95% Conf. Interval]	
HCE	.003	0	13.09	0	.002	.003
SCE	-.001	.001	-0.97	.334	-.002	.001
CEE	.054	.004	14.59	0	.046	.061
RCE	0	0	6.45	0	0	0
LEV	-.025	.004	-6.17	0	-.032	-.017
LNTA	.002	0	8.66	0	.002	.003
GDPGR	0	0	3.92	0	0	0
Constant	-.042	.006	-6.86	0	-.053	-.03
Mean dependent var		0.012	SD dependent var		0.013	
R-squared		0.565	Number of obs		837	
F-test		154.059	Prob > F		0.000	
Akaike crit. (AIC)		-5640.598	Bayesian crit. (BIC)		-5602.760	

Table 6. Pooled OLS – ROE is the dependent variable

ROE	Coef.	St.Err.	t-value	p-value	[95% Conf Interval]	
HCE	.023	.003	6.98	0	.017	.03
SCE	-.054	.013	-4.09	0	-.08	-.028
CEE	1.037	.063	16.34	0	.913	1.162
RCE	.004	.001	4.16	0	.002	.006
LEV	-.318	.069	-4.60	0	-.454	-.182
LNTA	.035	.005	7.25	0	.025	.044
GDPGR	0	.001	-0.36	.722	-.003	.002
Constant	-.67	.105	-6.38	0	-.876	-.464
Mean dependent var		0.078	SD dependent var		0.193	
R-squared		0.450	Number of obs		837	
F-test		96.758	Prob > F		0.000	
Akaike crit. (AIC)		-867.430	Bayesian crit. (BIC)		-829.591	

Table 6 shows the pooled OLS regression results for the model in which ROE is the dependent variable. The model has an R-squared value of 45%, which implies that the independent variables explain 45% of the variability in ROE, which is lower than

the R-squared value for the ROA model. The model has an overall significance with an F-test value of 96.7. All components produced significant results; however, Human capital efficiency, capital employed efficiency, and Relational capital efficiency have a positive effect on profitability, while Structural capital efficiency has a negative and significant relationship with ROE. In terms of control variables, the results are parallel to those in the ROA model. Similar to the case of ROA, the positive relationship implies that intellectual capital is one of the most important key drivers of value creation and profitability for the banks. Banks that foster a knowledge-based organizational culture, as evidenced by human capital efficiency, are more likely to experience sustained success and financial returns.

Table 7. Panel Regression – Fixed Effects (ROA)

ROA	Coef.	St.Err.	t-value	p-value	[95% Conf Interval]	
HCE	.002	0	9.10	0	.002	.003
SCE	-.001	.001	-2.11	.036	-.003	0
CEE	.074	.005	15.31	0	.064	.083
RCE	0	0	5.17	0	0	0
LEV	-.012	.005	-2.54	.011	-.021	-.003
LNTA	.001	.001	2.00	.046	0	.003
GDPGR	0	0	3.97	0	0	0
Constant	-.032	.015	-2.07	.039	-.062	-.002
Mean dependent var		0.012	SD dependent var			0.013
R-squared		0.567	Number of obs			837
F-test		144.003	Prob > F			0.000
Akaike crit. (AIC)		-5998.443	Bayesian crit. (BIC)			-5960.604

Table 7 presents the results of the panel regressions with a fixed-effects model in which ROA is the dependent variable. The results of the fixed-effects model reveal that HCE, CEE, and RCE all have a positively significant effect on ROA at a 1% significance level, but SCE has a negatively significant effect on ROA at a 5% level. Leverage has a negatively significant effect, while firm size has a positively significant effect on ROA. The macroeconomic control variable, GDP growth rate, has a significantly positive effect.

Table 8 presents the results of the random effects model, which are parallel to those of the fixed effects model. SCE has a significantly negative effect on ROA at a 10% level. To choose between fixed and random effects, we performed the Hausman specification test. The chi-square test value was found to be 22.036 with a p-value of 0.003, which is less than 5%. This result confirms that the fixed effects model outperforms the random effects model.

Table 9 presents the results of the panel regressions using the fixed effects model, with ROE as the dependent variable. The results of the fixed effects model reveal that HCE, CEE, and RCE all have a significantly positive effect on ROE at a 1% significance level, whereas SCE has a significantly negative effect on ROE at a 1% level. Leverage has a negatively significant effect, while firm size has a positively significant effect on ROA. The macroeconomic control variable, GDP growth rate, has no significant effect. Compared to ROA, the coefficients under the ROE model are higher.

Table 8. Panel Regression – Random Effects (ROA)

ROA	Coef.	St.Err.	t-value	p-value	[95% Conf Interval]	
HCE	.003	0	10.73	0	.002	.003
SCE	-.001	.001	-1.83	.067	-.003	0
CEE	.068	.004	15.70	0	.059	.076
RCE	0	0	5.75	0	0	0
LEV	-.016	.004	-3.92	0	-.024	-.008
LNTA	.002	0	4.46	0	.001	.003
GDPGR	0	0	4.23	0	0	0
Constant	-.043	.01	-4.31	0	-.063	-.023
Mean dependent var		0.012	SD dependent var			0.013
Overall r-squared		0.555	Number of obs			837
Chi-square		1064.716	Prob > chi2			0.000
R-squared within		0.565	R-squared between			0.548

Table 9. Panel Regression – Fixed Effects (ROE)

ROE	Coef.	St.Err.	t-value	p-value	[95% Conf Interval]	
HCE	.016	.005	3.35	.001	.007	.026
SCE	-.044	.013	-3.55	0	-.069	-.02
CEE	1.588	.089	17.94	0	1.415	1.762
RCE	.002	.001	2.64	.008	.001	.004
LEV	-.427	.085	-5.01	0	-.595	-.26
LNTA	.083	.014	6.11	0	.056	.109
GDPGR	0	.001	0.18	.86	-.002	.002
Constant	-1.742	.283	-6.16	0	-2.297	-1.187
Mean dependent var		0.078	SD dependent var			0.193
R-squared		0.497	Number of obs			837
F-test		108.891	Prob > F			0.000
Akaike crit. (AIC)		-1124.659	Bayesian crit. (BIC)			-1086.820

Table 10 reports the results of the random effects model, which are parallel to those of the fixed effects model. SCE has a significantly negative effect on ROE at a 10 % level. Similarly, the GDP growth rate does not have a significant effect on ROE. As can be seen in these empirical results, the findings of the panel regressions are very similar to and confirm those of pooled OLS regressions. In both models, human capital efficiency, capital employed efficiency, and relational capital efficiency have a positive impact on profitability. Compared to the more tangible, asset-intensive sector, intellectual capital for banks is principally centered on human capital, including the expertise of financial analysts, product and service design teams, relationship managers, and leadership. The positive regression results highlight the value of a skilled and knowledgeable workforce that contributes to customer relations and satisfaction, as well as processes of decision-making, risk management, and innovation. All of these factors can enhance financial performance by refining operational efficiency, ensuring compliance, and informing strategic decision-making. Our results and findings are consistent with those of prior studies (Alipour, 2012; Khan et al., 2015; Faruq et al., 2023).

Table 10. Panel Regression – Random Effects (ROE)

ROE	Coef.	St.Err.	t-value	p-value	[95% Conf Interval]	
HCE	.022	.004	5.57	0	.015	.03
SCE	-.046	.013	-3.68	0	-.071	-.022
CEE	1.285	.074	17.38	0	1.14	1.429
RCE	.003	.001	3.52	0	.001	.005
LEV	-.34	.074	-4.61	0	-.484	-.195
LNTA	.044	.007	6.24	0	.03	.057
GDPGR	0	.001	-0.30	.762	-.003	.002
Constant	-.885	.148	-5.97	0	-1.176	-.595
Mean dependent var		0.078	SD dependent var			0.193
Overall r-squared		0.446	Number of obs			837
Chi-square		726.691	Prob > chi2			0.000
R-squared within		0.490	R-squared between			0.443

The positive result for RCE implies that banks that focus on building and maintaining strong customer relationships, a good brand reputation, and offering individualized services are more likely to realize better financial results. The underlying reason for this situation stems from the importance of customer retention and satisfaction in the banking sector, given its highly competitive nature worldwide, including in the GCC region. As an additional analysis and a robustness check, we ran the panel regression using the “by country” command in Stata; in other words, we ran the models by country details. The results of this additional analysis are reported

in Tables 11A and 11B, in which the ratios of ROA and ROE are the dependent variables, respectively.

Table 11A Panel Regression per Country – Random Effects (ROA)

ROA	Bahrain	Kuwait	Oman	Qatar	KSA	UAE
HCE	0.08 (0.001)***	0.09 (0.000)***	0.07 (0.002)***	0.05 (0.001)***	0.05 (0.002)***	0.07 (0.000)***
SCE	0.02 (0.002)**	0.001 (0.001)**	0.086 (0.024)***	-0.043 (0.012)*	0.079 (0.024)**	-0.001 (0.001)*
CEE	0.07 (0.016)***	0.081 (0.006)***	-0.012 (0.015)***	0.032 (0.012)***	0.016 (0.022)***	0.081 (0.006)***
RCE	0.02 (0.002)***	0.002 (0.002)***	0.002 (0.002)***	0.002 (0.002)***	0.002 (0.002)***	0.002 (0.002)***
LEV	-0.12 (0.028)**	0.011 (0.007)*	0.068 (0.011)**	-0.071 (0.017)**	-0.003 (0.008)*	-0.024 (0.007)*
LNTA	-0.002 (0.004)***	0.003 (0.001)***	-0.002 (0.001)***	-0.006 (0.002)***	-0.004 (0.002)***	0.002 (0.001)***
GDPGR	0.001 (0.005)*	0.004 (0.008)*	0.011 (0.003)*	0.006 (0.004)*	0.005 (0.007)*	0.002 (0.002)**
Constant	0.128 (0.074)***	-0.081 (0.021)***	-0.063 (0.024)***	0.171 (0.032)***	0.051 (0.042)***	-0.043 (0.021)***

*** p<.01, ** p<.05, * p<.1, Standard errors are reported in the parentheses.

Table 11B. Panel Regression per Country – Random Effects (ROE)

ROE	Bahrain	Kuwait	Oman	Qatar	KSA	UAE
HCE	0.021 (0.002)***	0.019 (0.002)***	0.017 (0.003)***	0.014 (0.004)***	0.015 (0.007)***	0.023 (0.002)**
SCE	0.03 (0.004)**	0.04 (0.004)**	0.091 (0.023)*	-0.048 (0.013)**	0.083 (0.025)**	-0.003 (0.001)*
CEE	0.069 (0.017)***	0.079 (0.007)***	-0.014 (0.011)*	0.028 (0.011)***	0.019 (0.021)***	0.088 (0.006)***
RCE	0.003 (0.005)***	0.003 (0.007)***	0.005 (0.005)***	0.004 (0.008)***	0.003 (0.004)***	0.003 (0.002)***
LEV	-0.117 (0.022)***	0.021 (0.008)***	0.066 (0.017)***	-0.074 (0.019)***	-0.004 (0.007)***	-0.023 (0.007)***
LNTA	-0.001 (0.006)***	0.004 (0.005)***	-0.003 (0.003)***	-0.007 (0.001)***	-0.006 (0.004)***	0.007 (0.001)***
GDPGR	0.001 (0.008)*	0.005 (0.009)*	0.014 (0.004)*	0.007 (0.006)*	0.007 (0.005)*	0.004 (0.002)*
Constant	0.111 (0.068)***	-0.083 (0.022)***	-0.064 (0.025)***	0.166 (0.029)***	0.054 (0.049)***	-0.044 (0.021)***

*** p<.01, ** p<.05, * p<.1, Standard errors are reported in the parentheses.

The results revealed that per-country analyses produced similar but stronger coefficients, suggesting that the impact of intellectual capital on profitability is more clearly observable in country-specific analyses. Human capital efficiency (HCE) is found to be highly and positively significant at a 1% significance level in all countries, for both ROA and ROE, with the only exception of ROE being at a % 5% level in the UAE. The coefficients for the ROE case are higher than those in the ROA case. These results suggest that banks' investment in human capital contributes positively to their profitability, with a more pronounced effect on the return on equity. Structural capital efficiency (SCE) produced mixed results in country details. In pooled OLS and panel regressions for the entire sample, it is found to have a negative impact on profitability.

However, per-country results show different signs: Qatar and the UAE have negative coefficients, while others have positive coefficients. This condition can be attributed to the

differences in the policies and regulations of the countries regarding banks' asset structures, depreciation, and amortization rules. Capital employed efficiency (CEE) has a positive impact on both profitability ratios in all countries, except for Oman. Relational capital efficiency (RCE) has a positive impact on both profitability ratios across all countries, emphasizing the importance of strong relationships with all stakeholders. Control variables yielded mixed results in country details, which can be attributed to the structural and macroeconomic differences among the countries. The regression results of the per-country analyses are also consistent with those of previous studies (Nimtrakoon, 2015; Ozkan et al., 2017; Buallay, 2019; Chinnasamy et al., 2023).

CONCLUSION

In this study, we aimed to investigate the impact of intellectual capital on the profitability of banks by using a dataset of banks from GCC countries. The results of all models are similar to one another, differing only in the significance level of certain variables. The analysis reveals that human capital efficiency, structural capital efficiency, and capital employed efficiency have a positive and significant effect on the profitability ratios. In contrast, structural capital efficiency has a negative and significant effect. The results suggest that investing in human resources, such as providing training and career development opportunities, has a positive impact on the bank's profitability. The investment in relational capital, such as marketing and advertising expenditures, as well as other expenditures to improve relationships with suppliers and customers, also positively affects the bank's profitability. Structural capital is found to have a negative effect on profitability in all models. This finding implies that the banks should invest more in human resources. The findings will have important implications for bank managers and policymakers in designing their policies for intellectual capital and developing its components. Bank managers should not regard the costs of employees as regular expenses; instead, they should consider those costs as an investment that will improve profitability. They should consider all aspects and components of intellectual capital. The positive relationships suggest that banks that foster innovation, adopt customer-oriented strategies, and employ knowledgeable human capital are likely to have a better position for sustainable growth. Investing in intellectual capital, such as workforce training, adopting sophisticated financial technologies, and enhancing brand loyalty, can establish long-term competitive advantages in a continually evolving industry.

The results contribute to a comprehensive understanding of the strategic role and value of intellectual capital, offering valuable insights for both academics and practitioners and highlighting the potential for enhanced financial performance in a knowledge-based economy. The results suggest that banks that effectively manage and invest in the components of intellectual capital and resources are likely to enjoy a better position to enhance profitability, drive innovation, and sustain long-term growth. The study has some limitations, although it covers a relatively long period. Future studies may employ a larger dataset, including more banks and a more extended period. They may cover a

larger sample of countries, and they can compare developed and developing countries. Future studies may include some more financial performance metrics to explore the impact of intellectual capital. The regulations of countries regarding the identification and recognition of intellectual capital components could also be considered an impactful dimension in the analysis of the relationship.

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Risk, Liquidity, and Performance: Evidence from the Commercial Banks in Bangladesh

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JEL Classification:

C33

G21

G32

C58

Received: 27 June 2024

Revised: 20 April 2025

Accepted: 09 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study examines the interplay between bank risk, liquidity, and profitability in Bangladesh's banking sector. Using a fresh approach, it shows their combined impact on stability and growth in emerging markets. It provides practical insights for banks to effectively manage these factors and achieve long-term resilience.

Research Objectives: The study aims to investigate the interconnected influence of non-performing loan ratios and liquidity levels on profitability, and to analyze the effects of total asset growth, loan growth, and cost-to-income ratios on these dynamics.

Research Methods: The study used a panel dataset of 31 listed commercial banks from 2012 to 2022. Ordinary Least Squares (OLS) regression was primarily employed, followed by Prais–Winsten regression with corrected standard errors (PCSEs) for correlated panels to validate the findings.

Empirical Results: The research indicates that liquidity (LIQ) has a positive impact on profitability, with the net interest margin (NIM) being significantly influenced by non-performing loans. The control variable, SIZE, also showed statistical significance in performance.

Implications: This study highlights the significance of asset quality, liquidity management, loan composition, and operational efficiency in determining bank profitability, providing valuable insights for bank managers and policymakers in emerging economies seeking to enhance their financial performance.

Keywords:

liquidity; net interest margin; non-performing loan; return on asset; panels corrected standard errors

How to Cite:

Bhowmik. P. K., & Islam, A. (2025). Risk, Liquidity, and Performance: Evidence from the Commercial Banks in Bangladesh. *Etikonomi*, 24(2), 353 – 366. <https://doi.org/10.15408/etk.v24i2.39787>.

INTRODUCTION

In finance and economics, bank liquidity and risk are the most fundamental elements of any financial institution's stability and smooth functioning. Their impact is immense concerning the healthiness and robustness of banks. At the same time, the collapse of either of these factors can lead to significant and urgent spillover effects in the financial system and economy. Khan et al. (2017) state that both concepts are vital for a banking institution's functioning, sound view, and growth. Managing liquidity risk is one of the most challenging tasks in financial intermediation (Cai & Thakor, 2008). Reducing liquidity risk is crucial in day-to-day operations, as banks provide liquidity to the economic system, maintain a suitable liquidity position, and manage it effectively (Datar, 2002). According to the Basel Committee, liquidity refers to a bank's ability to fund its operations and meet all its short-term obligations without incurring significant losses or disruptions. It means maintaining sufficient cash or quickly marketable assets on hand to ensure that the bank has enough funds to meet its immediate liabilities, such as withdrawals by depositors or payment obligations (Anghelache & Bodo, 2018). Liquidity is crucial for maintaining public confidence in the banking system, as it ensures that depositors' withdrawal rights are honored and that banks continue to operate smoothly, even in times of crisis or uncertainty (Gatev et al., 2009).

The factors that determine a bank's liquidity include the structure of its assets and liabilities, the availability of funding sources, regulatory requirements, market conditions, and the bank's general risk appetite (Khoury, 2015). Another critical technique for managing liquidity is diversifying funding sources and creating credit lines with other banks or financial organizations (Landskroner & Paroush, 2008). Bank risk captures all the hazards and uncertainties that concern banks' financial stability and profitability. The risks could be external, arising from changes in markets or regulations, or internal, resulting from flawed management decisions, poor operational practices, or inadequate risk management systems (Anghelache & Bodo, 2018). The primary common forms of bank risk are credit risk, which arises from possible borrower default; market risk, caused by changes in interest rates, currency rates, or asset prices; liquidity risk, previously explained; operational risk, linked to internal systems, processes, or human error; and compliance risk, which includes legal and regulatory requirements (Naili & Lahrichi, 2022).

Principles in managing bank risk include risk assessment through robust frameworks, prudential lending practices, diversity in asset portfolios, adequate capital reserves, and adherence to best practices and regulatory guidelines (Davydov et al., 2021). Maintaining the stability and integrity of the financial system secures, most notably, the defence of the interests of shareholders, depositors, and other stakeholders. It largely relies on effective risk management (Chen et al., 2021). Bank liquidity and risk are fundamental concepts in banking and finance that have distinct impacts on the stability, efficiency, and robustness of financial institutions. Therefore, if these concepts are understood and applied, a bank is well-positioned to confront challenges, capitalize on opportunities, and contribute to the economy's growth and development.

One of the most extensively researched areas in finance and economics is the relationship between bank liquidity, risk management, and profitability, as well as its impact on financial stability. The literature reviewed so far indicates that theoretical and empirical research on the subject has identified a recurring theme: trade-offs between profitability and liquidity have further implications in light of current trends and regulatory frameworks. Traditional banking theory posits a trade-off between profitability and liquidity, commonly referred to as the liquidity-risk trade-off. The theory suggests that while banks with more liquid assets may be better positioned in the face of shocks, they do so at the expense of reduced profitability due to lower yields on such investments. Then again, banks holding riskier assets have the potential for higher returns, but also face the real risk of liquidity problems. In this regard, Chokroborty and Hasan (2024) utilized data from 18 banks over five years (2013-2017) to investigate the interrelationship between the profitability and liquidity management of the banks under consideration, specifically those listed in the public and private sectors of the Dhaka Stock Exchange (DSE) in Bangladesh. This applies to the profitability measurements of indicators such as the return on equity and returns on assets, as well as several liquidity management indicators, including current, cash, credit, and investment deposit ratios. This condition suggests that effective liquidity management does not always compromise profitability; the results indicated that the efficiency in managing liquidity was higher in private sector banks than in public sector banks listed on the Dhaka Stock Exchange (DSE).

Focusing on Bangladeshi commercial banks from 2005 to 2018, Ahmed (2021) conducted panel data regression analysis to investigate how external and bank-specific variables specifically affect the liquidity risk of these banks. The study reported correlations with only a few minor indicators; yet, the conclusion was drawn that banks should evaluate and mitigate the risks associated with potential future liquidity crises. In a study by Tasnova (2022) using statistical techniques on data from 2014 to 2019 regarding examining the variables affecting liquidity in 29 listed commercial banks in Bangladesh, the research showed a positive relation of bank liquidity with profitability, capital adequacy, non-performing loans, and interest rate spread while it also showed hostile ties with the economic cycle and the monetary policy interest rate. Liquidity was notably impacted by capital adequacy and the economic cycle. Naoaj (2023) analyzed the factors influencing liquidity risk within the banking sector, using panel data from 28 banks. The study revealed that leverage consistently had a positive impact on liquidity risk, while bank size and the regulatory environment had a negative impact. The effects of the capital adequacy ratio (CAR) and return on assets (ROA) varied based on each bank's specific characteristics.

Khalid et al. (2019) examined the relationship between financial performance and liquidity of Bangladeshi commercial banks using panel data from 2010 to 2017 for 31 banks listed on the Dhaka Stock Exchange. The study highlighted a severe liquidity crisis in Bangladesh's commercial banks, resulting in higher default rates and liquidity issues; however, it concluded that liquidity had no significant impact on key financial performance measures, such as return on equity (ROE) and return on assets (ROA). In

Nigeria, Taiwo and Mike (2021) investigated the effects of Non-Performing Loans (NPLs) on the liquidity of Nigerian Deposit Money Banks (DMBs), using panel regression analysis on data from 15 DMBs between 2009 and 2019. The study concluded that liquidity was negatively impacted by non-performing loans (NPLs) but positively influenced by capital adequacy ratio (CAR), bank size, and inflation. Ejoh et al. (2014) evaluated the impact of credit risk and liquidity risk management on the profitability of deposit money banks in Nigeria, specifically First Bank of Nigeria Plc. Using a descriptive research design and Pearson product-moment correlation, the study found significant relationships between credit management, liquidity, and profitability, recommending the implementation of adequate internal controls to effectively monitor risk management. Bace (2016) explored the liquid assets to deposit ratio (LADR) as a crucial metric for deposit-taking institutions, reflecting liquidity backed by stable retail deposits rather than volatile wholesale debt funding. The study found that while high liquidity levels can reduce profitability due to lower net interest margins, non-performing loans had the most substantial negative impact on return on average assets. Sahyouni and Wang (2019) examined Middle Eastern and North African banks (2011–2016) using panel data, finding that conventional banks generate more total liquidity than Islamic banks, though the latter create more liquidity per asset. They also identify a negative relationship between liquidity creation and performance (as measured by ROAE), with no significant difference between Islamic and conventional banks.

Abbas et al. (2019) examined the impact of bank capital, liquidity, and credit risk on profitability in commercial banks across developed Asian economies and the USA from 2011 to 2017. The results indicated that liquidity had a positive impact on profitability in Asian banks but a negative impact on large US banks. Additionally, liquidity had a more substantial influence on profitability than capital across all bank sizes. Salim and Bilal (2016) investigated the liquidity position and its impact on the financial performance of Omani banks, examining four local commercial banks over five years (2010–2014) using multiple regression analysis. The study found significant relationships between various liquidity ratios and performance indicators, such as return on assets (ROA), return on equity (ROE), and return on average assets (ROAA); however, no significant relationship was found with the net interest margin (NIM). Tanwar (2024) employed Seemingly Unrelated Regression (SUR) to analyze Indian commercial banks (2004–2021), revealing an inverse liquidity-risk-credit-risk relationship, their combined adverse effect on profitability (ROA and ROE), and the positive role of institutional factors (e.g., law and order), while highlighting capital allocation inefficiencies as a key constraint.

Empirical evidence for a trade-off between liquidity and risk in US banks was presented by Berger and Bouwman (2009), who demonstrated that higher liquidity levels are associated with lower risk levels. Demirguc-Kunt and Huizinga (2010) studied a global sample of banks and found that higher liquidity buffers are linked to lower probabilities of financial distress. In contrast, the bank's broad liquidity holdings may significantly increase its risk, as they can instigate increased risk-taking behavior among bank management. This idea is supported by research findings from Acharya and Naqvi

(2012), who proposed a model suggesting that banks with abundant liquidity will lend more recklessly to earn higher profits, thereby increasing systemic risk. The 2008 global financial crisis led to stringent regulatory reforms, including the adoption of Basel III liquidity rules—specifically, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). Studies by Jimenez et al. (2014) and Lalon et al. (2023) have demonstrated the importance of regulatory frameworks in shaping the relationship between bank risk and liquidity.

This research examines the intricate relationships between bank risk, liquidity, and financial performance in Bangladesh's commercial banking sector. Understanding these dynamics is crucial for policymakers and financial institutions in an environment where financial stability is essential for economic growth. Commercial banks play a central role in the financial system, and their ability to manage liquidity while mitigating risks has a direct impact on their performance and the overall stability of the economy. Bangladesh's banking sector has faced numerous challenges, including high levels of non-performing loans (NPLs), capital adequacy issues, and liquidity shortages, which can erode its financial resilience. By examining the interactions between these factors, this research aims to provide valuable insights that can inform strategies to enhance bank stability, optimize liquidity management, and improve performance. This is particularly crucial for promoting long-term financial stability and fostering sustainable economic growth in Bangladesh.

Despite the growing body of literature on global bank performance and risk management, limited studies have integrated the relationship between bank risk, liquidity, and performance specifically within the context of Bangladesh's commercial banking sector. The novelty of this research lies in its holistic approach to understanding these interactions, which considers the unique challenges that emerging market banks face. Additionally, this study fills the gap in understanding how these factors collectively impact financial stability and performance in a developing economy like Bangladesh, where the banking sector is under significant stress due to issues such as non-performing loans (NPLs) and liquidity deficits. The findings offer new insights into how banks in Bangladesh can strike a balance between risk and liquidity management, thereby enhancing their financial resilience and contributing to the country's overall economic stability.

METHODS

This study utilizes balanced panel data for thirty-three (33) commercial banks in Bangladesh. To explain the link between profitability ($NIM_{i,t}$), bank non-performing loan ratio ($NPLR_{i,t}$), and liquidity ($LIQ_{i,t}$) from 2012 to 2022, an econometric model has been developed. We have considered 33 commercial banks out of 58 commercial banks in Bangladesh (see Table 1), which was methodologically justified and grounded in two critical criteria such as data availability and asset size. Hence, this matter made their inclusion impractical for robust analysis. This research aims to provide a more accurate and representative overview of the commercial banking sector, particularly the

larger banks that hold a substantial portion of the industry's assets. Larger banks tend to have more established operations, and their performance and risk management practices provide critical insights into the overall health and trends within the industry. This approach ensures that the study is both data-driven and reflective of the key players in the sector, enhancing the reliability and generalizability of the findings.

Table 1. Number of Banks

Bank Status	Number of Banks	Percentage (%)
Selected Banks (State-Owned)	6	10
Selected Banks (Private)	27	47
Excluded Banks	25	43
Total	58	100

The panel data estimations enable the control of both observable and unobservable heterogeneity at the bank and temporal levels. This study employs a regression model to investigate the determinants of bank profitability, with a focus on key financial and operational factors. This study employs several variables to explain profitability, bank risk, and liquidity. The dependent variable, Net Interest Margin (NIM), is used as a measure of bank profitability. NIM represents the difference between interest income and expenses relative to total interest-earning assets. To account for distributional concerns, the study has used the natural logarithm of NIM, which normalizes the distribution and reduces the influence of outliers (Chowdhury & Siddiqua, 2016).

The key independent variables include the Non-Performing Loan Ratio (NPLR), Liquidity (LIQ), Loan Growth (LG), Asset Growth (GTA), and Bank Efficiency, measured by the Cost-to-Income Ratio (CIR). The Non-Performing Loan Ratio (NPLR) measures the proportion of loans at risk of default (Islam & Nishiyama, 2019). The Liquidity Ratio (LIQ) is measured by the natural logarithm of total liquid assets, reflecting the bank's ability to meet short-term obligations without incurring significant losses. Loan Growth (LG) captures the expansion of a bank's lending activities, while Asset Growth (GTA) reflects the bank's overall expansion in size. The Cost-to-Income Ratio (CIR) measures operational efficiency (Hess & Francis, 2004). The empirical model specification for this study is as follows:

$$\text{Profitability}_{ij} = \beta_0 + \beta_1 \text{Bank Riks}_{ij} + \beta_2 \text{Liquidity}_{ij} + \beta_3 \text{Loan Growth}_{ij} + \beta_4 \text{Asset Growth}_{ij} + \beta_5 \text{Bank Efficiency}_{ij} + e_{ij}$$

Each explanatory variable represents a critical aspect of banking operations that can influence profitability. Bank risk, as measured by the non-performing loan ratio (NPLR), is expected to negatively impact the net interest margin (NIM) due to its association with asset quality deterioration and higher provisioning costs. Liquidity (LQ) plays a crucial role in determining financial stability; however, its impact on profitability is ambiguous, as excessive liquidity may signal inefficiencies. Loan growth (LG) and asset growth (GTA) are

included to capture the impact of credit expansion and financial development, respectively, with their effects contingent on risk management practices. Finally, bank efficiency (CIR) is expected to exhibit a negative relationship with profitability, as a higher cost-to-income ratio indicates weaker cost control.

RESULT AND DISCUSSION

The result and discussion section includes a summary of the statistics, correlation matrix, and regression results, including linear and PCSE regression. After that, some diagnostic tests were performed to check multicollinearity, Heteroskedasticity, and Cross-Sectional Independence in the study. Thirty-three major commercial banks have been considered for this analysis. Table 2 comprehensively summarizes each variable across 335 observations, presenting its respective mean, standard deviation, and range, which offer insights into the distribution and variability of the data. The NIM (Net Interest Margin) values and those of the other variables illustrate the variability and distribution within the dataset, providing essential insights into its characteristics.

Table 2. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
NIM	335	23.365	.754	19.779	24.485
NPLR	335	.103	.143	0	.806
LIQ	335	24.021	.785	21.843	26.499
LG	335	.111	.121	-.593	.838
GTA	335	.108	.074	-.132	.579
CIR	335	1.035	9.206	-6.285	167.851

Source: Author's Calculation Results from Stata (2024).

The descriptive statistics reveal that the net interest margin (NIM) has a mean value of 23.365, indicating a relatively stable profitability measure across the banks. The non-performing loan ratio (NPLR) shows a mean of 0.103, suggesting that, on average, 10.3% of loans are non-performing, which is a significant concern for asset quality. Liquidity (LIQ) has a mean of 24.021, reflecting the banks' ability to meet short-term obligations. Loan growth (LG) and total asset growth (GTA) show positive mean values, indicating expansion in lending and asset bases, respectively. However, the cost-to-income ratio (CIR) exhibits a wide range, with some banks showing inefficiencies in cost management.

The correlation study reveals significant relationships among several financial aspects, as shown in Table 3. The strong positive relationship between the natural logarithm of net income margin (NIM) and liquidity (LIQ) underscores the importance of efficient liquidity management in enhancing profitability, aligning with the findings of Munteanu (2012), who highlights the impact of liquidity on profitability in Romanian banks. Furthermore, the negative correlations between the non-performing loan ratio (NPLR), loan growth (LG), and asset growth (GTA) are consistent with studies such as those by

Ozili (2019), which suggest that proper loan expansion and asset management can help mitigate non-performing loans. These findings offer valuable guidance for enhancing the financial performance of Bangladeshi banks.

Table 3. Matrix of Correlations

Variables	(NIM)	(NPLR)	(LIQ)	(LG)	(GTA)	(CIR)
NIM	1.000					
NPLR	-0.243***	1.000				
LIQ	0.744***	0.002	1.000			
LG	-0.086	-0.238***	-0.050	1.000		
GTA	-0.119**	-0.193***	-0.110**	0.461***	1.000	
CIR	-0.052	0.023	-0.043	-0.038	-0.062	1.000

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Source: Author's Calculation Results from Stata (2024).

The diagnostic tests conducted for the regression analysis provide essential insights into the potential issues of multicollinearity, heteroskedasticity, and cross-sectional dependence in the model. The VIF tests multicollinearity among the independent variables. Table 4 of VIF shows that all the VIFs of Loan Growth, Total Asset Growth, Non-Performing Loan Ratio, Natural Logarithm of Liquidity, and Cost-to-Income Ratio are relatively low; the highest is associated with Loan Growth, at 1.309. Since the VIF values are below the usual cutoff of 10, it may be concluded that multicollinearity does not pose a significant problem to this model. This can be inferred from the mean VIF value of 1.14, indicating that the explanatory variables are not highly correlated. White's test revealed significant heteroskedasticity ($\chi^2 = 211.2$, $p < 0.01$), indicating that the variance of the error terms varies across observations.

Table 4. Variance Inflation Factor (VIF)

	VIF	1/VIF
LG	1.309	.764
GTA	1.299	.77
NPLR	1.071	.934
LIQ	1.015	.985
CIR	1.007	.993
Mean VIF	1.14	

Source: Author's Calculation Results from Stata (2024).

This result implies evidence of heteroskedasticity in the model, meaning that the variance of the error terms is not constant across observations. The decomposition of the IM-test shows significant heteroskedasticity, skewness, and kurtosis components, further confirming the presence of heteroskedasticity. Pesaran's test confirmed the presence of cross-sectional dependence, suggesting that the residuals across banks are correlated. The

average absolute value of the off-diagonal elements is 0.560, which measures the strength of cross-sectional dependence. Consequently, the PCSE regression model was applied in the analysis. Resolving these diagnostic issues enhances the reliability and validity of the regression analysis. It provides results that may now portray more accurate information regarding factors that affect the NIM of the banking sector in Bangladesh.

The regression analysis used Ordinary Least Squares (OLS) and Prais-Winsten regression with correlated panels corrected standard errors (PCSEs) to account for potential heteroskedasticity and cross-sectional dependence (see Table 5). In this model, the R-squared value is 0.6280, meaning that the included predictors can explain 62.8% of the variation in NIM. The Prais-Winsten regression model (PCSE), which accounts for correlated panels and corrects standard errors, provides detailed insights into how various financial factors impact the NIM of Bangladesh's public and private sector banks. The R-squared value is 0.783, this result means that the included predictors can explain 78.3% of the variation in NIM.

Table 5. Regression Analysis

Variables	OLS			PCSE		
NIM	Coef.	p-value	Sig	Coef.	p-value	Sig
NPLR	(-1.4560)	0.000	***	(-0.8500)	0.0040	***
LIQ	0.7040	0.000	***	0.5040	0.0000	***
LG	(0.5750)	0.0170	**	(0.1820)	0.1620	
GTA	(0.5110)	0.1940		(0.8600)	0.0110	**
CIR	(0.0020)	0.5490		(0.0010)	0.7170	
Constant	6.7160	0.000	***	11.4610	0.0000	***
R-squared	0.6280			0.783		

*** $p < .01$, ** $p < .05$, * $p < .1$

Source: Author's Calculation Results from Stata (2024).

Some of the significant findings from the OLS regression study indicate that non-performing loans (NPLR) have a negative impact on profitability (NIM), with a coefficient of -1.456, suggesting that rising defaults are detrimental to banks' profitability. This finding is consistent with the literature, as noted by Chokroborty and Hasan (2024) and Ejoh et al. (2014), who argue that rising NPL ratios negatively impact the financial performance of banks due to higher provisioning costs and a reduced ability to generate income from loans. Furthermore, Islam and Nishiyama (2019) conducted a comprehensive study on the causes and impacts of NPL in Asian countries, concluding that rising NPL ratios harm bank profitability by increasing the cost of credit management and reducing overall efficiency. The findings underscore the importance of effective credit risk management in maintaining bank profitability. The financial health of banks in Bangladesh is influenced by persistently high NPLRs, which is why banks must implement robust credit management strategies (Akter & Roy, 2017). The PCSE model also shows a negative relationship with a coefficient of -0.85. The reduced coefficient indicates that, after applying panel data

corrections for autocorrelation and heteroskedasticity, the negative impact of NPLR on NIM remains slightly less pronounced but remains significant. This result further supports the negative association between NPLR and profitability, emphasizing the importance of managing credit risk to maintain healthy profit margins.

Liquidity (LIQ) has a positive effect on NIM in both the OLS and PCSE models, reinforcing the conventional view that adequate liquidity is crucial for banks' profitability. The OLS model highlights the critical role of liquidity management in enhancing profitability. The PCSE model further confirms this positive relationship, with a slightly lower coefficient of 0.5040, yet it remains highly significant. The strong positive liquidity-NIM relationship aligns with Lalon et al. (2023) and Ahamed (2021), who link liquidity tools (e.g., loan-to-deposit ratio) to profitability, but caution against the risks of mismanagement. In a global context, Berger and Bouwman (2009) found similar results, arguing that liquidity creation within banks leads to greater stability and improved performance. Ahamed (2021) emphasized contextual factors such as asset size and the macroeconomy in Bangladesh, while both stress the need for regulatory prudence to balance short-term gains with long-term stability. Despite liquidity's profitability boost, unmanaged risks or economic volatility could jeopardize sustainability, warranting cautious interpretation.

In the OLS model, loan growth (LG) has a moderate relationship with net interest margin (NIM). However, in the PCSE model, the impact of LG becomes weaker and statistically insignificant. This result indicates that expanding loan portfolios does not inherently lead to improvements in the net interest margin. This finding aligns with Foos et al. (2010), who argue that loan growth alone may not reflect pricing efficiency or risk-adjusted returns. However, Fahlenbrach et al. (2016) caution that aggressive LG, while statistically neutral here, could still signal latent risks (e.g., underperformance, collapse), particularly if growth outpaces risk management frameworks. This result underscores the need for context-specific regulation (Curry et al., 2008), as factors such as social capital mediate LG outcomes (Jin et al., 2019). Higher trust and community cohesion may mitigate default risks and enhance macroeconomic stability, thereby tempering systemic vulnerabilities. Therefore, while LG's direct impact on NIM appears muted, its indirect consequences—shaped by institutional quality and external conditions—demand proactive oversight to balance growth ambitions with financial resilience.

In the OLS model, the variable for Gross Total Assets (GTA) indicates an insignificant relationship between GTA and NIM. On the other hand, the variable GTA shows a negative relationship with NIM in the PCSE model. This result suggests that the negative impact of larger bank size on profitability becomes more pronounced. This finding indicates that rapid asset growth may be associated with inefficiencies that hinder profitability. Larger banks, although benefiting from economies of scale, may face challenges in managing their growing asset bases effectively, which could result in reduced net interest margins. This result aligns with the findings of Maudos and Guevara (2004), who argue that while expanding assets is often viewed as a sign of bank growth, it may lead to diminishing returns if not managed properly. As asset bases grow, operational costs also increase, and managing a larger portfolio can lead to inefficiencies. Furthermore, this

result aligns with Oanh and Nga (2024), who noted that larger banks may experience lower profitability if asset growth outpaces operational improvements.

Finally, the study finds that the Cost-to-Income Ratio (CIR) does not significantly affect profitability in the PCSE model. This result contrasts with some studies that have found a negative relationship between CIR and profitability, suggesting that operational inefficiency can reduce a bank's profitability. This result contrasts with studies like Hussain (2014) and Antwi (2019), which found a negative relationship between CIR and profitability. While Du Toit and Cuba (2017) observed the impact of economic downturns on CIR and profitability in South Africa, the lack of significance of CIR on NIM in Bangladesh may indicate that factors like liquidity management or macroeconomic conditions play a more crucial role in determining NIM, rather than cost efficiency alone. The findings suggest that while operational efficiency is essential, it may not have as direct an impact on profitability as factors like liquidity and credit risk management.

However, the mixed results for loan growth, asset growth, and cost-to-income ratio suggest that these factors should be managed carefully to ensure that growth does not come at the expense of profitability. The findings highlight the importance of robust risk management practices, efficient liquidity management, and prudent asset expansion strategies for ensuring sustainable profitability in the banking sector.

CONCLUSION

The study investigated the influence of bank liquidity and risk on profitability within a commercial bank. The results suggest that effective liquidity management and a decrease in credit risk are crucial factors in enhancing bank profitability. Non-performing loans indeed exerted a detrimental impact on profitability, underscoring the need for banks to adopt stringent credit risk management practices that could protect them from potential loan defaults. This condition highlights the importance of a robust risk management framework in protecting net interest margins and ensuring stability in bank earnings. Moreover, the positive relationship between liquidity and profitability reveals that effective liquidity management is crucial in underpinning bank performance. In other words, if banks maintain optimal liquidity, they will regularly meet their short-term financial liabilities, securing profitability. On the other hand, however, expanding total assets can negatively impact profitability, suggesting that while expansion is necessary, it should be supported by improved asset management practices to prevent a dilution of returns.

The findings thus advocate that policymakers should incentivize stronger credit risk management practices by encouraging banks to invest in advanced credit assessment tools and early warning systems. Regulatory measures, such as offering tax incentives or regulatory relief to banks that adopt predictive technologies, could significantly enhance credit risk detection and management. Furthermore, regulators should introduce mandatory liquidity coverage ratios (LCR) to ensure that banks maintain a minimum level of high-quality liquid assets (HQLA). The Bangladesh Bank could also encourage the development of more diversified funding sources by promoting syndicated loans

and capital market instruments. Again, policymakers must recognize the challenges posed by the size of banks. As larger banks may face diminished profitability due to increased operational complexity, it is essential to strengthen regulatory oversight for these institutions. Introducing more stringent capital adequacy ratios and requiring frequent stress tests for larger banks can mitigate the risks associated with their size. This regulatory framework will ensure that larger banks contribute to the economy without creating systemic risks. Optimizing asset management practices through investment in technology and enhancing operational efficiencies will be equally crucial for managing larger asset bases without compromising profitability. These measures will cumulatively strengthen the financial resilience and profitability of Bangladeshi banks, thereby contributing to the stability and growth of the banking sector. By focusing on these areas, policymakers and bank managers can achieve sustainable financial performance and promote broader economic stability in the region.

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Bitcoin, Economic Freedom, and Underground Economies: A Tax Evasion Nexus

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JEL Classification:

H26

E42

O17

E26

C33

Received: 11 November 2024

Revised: 01 May 2025

Accepted: 12 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: Our research uniquely integrates the dimension of economic freedom to assess its moderating effect on tax evasion in G-7 countries. This study also provides the latest tax evasion estimates in G-7 countries using the currency demand approach to measure the effectiveness of policies employed by the regulators to reduce large numbers of tax evasion.

Research Objectives: This study estimates tax evasion in G-7 countries and measures the impact of cryptocurrencies on tax evasion at different levels of economic freedom.

Research Methods: This study employs the Currency Demand Approach to estimate tax evasion and then utilizes asymmetric/symmetric panel techniques (ARDL/NARDL) to confirm the impact of cryptocurrencies and all indicators of economic freedom on tax evasion.

Empirical Results: Our investigation unveils that cryptocurrencies significantly impact tax evasion. This study also finds economic freedom indicators' asymmetric/symmetric impact and confirms the moderating impact. Economic freedom indicators significantly increase/decrease the impact of cryptocurrencies on tax evasion.

Implications: Cryptocurrencies may be given due importance while drafting tax-related policies, and policymakers must maintain the optimum levels of economic freedom where cryptocurrencies do not support tax evasion.

Keywords:

tax evasion; cryptocurrencies; economic freedom; panel models; currency demand approach

How to Cite:

Bhutto, N. A., Nawaz, A. D., & Khan, S. (2025). Bitcoin, Economic Freedom, and Underground Economies: A Tax Evasion Nexus. *Etikonomi*, 24(2), 367 – 384. <https://doi.org/10.15408/etk.v24i2.42345>.

INTRODUCTION

Tax evasion is a persistent global issue and a leading cause of the budget deficit globally, which has reached \$104.5 billion annually in Europe and \$90 billion in the USA. In a recent report by Bloomberg, the IRS chief states that tax evasion has increased drastically to \$1 trillion a year due to new techniques adopted by tax evaders. The above-mentioned big numbers for developed economies are serious concerns for development and smooth economic growth. Governments have to depend on borrowing due to a lack of funds for living standards, resulting in huge interest payments (Altaf et al., 2019). Such borrowing amplifies the negative impact of tax evasion on the economy. Austin et al. (2019) concluded that individuals evade taxes due to high tax rates and switch to a state quickly rather than lose their state due to taxes. Firms also evade taxes to tackle financial constraints to meet financial requirements (Alm et al., 2019). The tax burden of the firms, low trust in the Government, the judicial system, firm size, and highly cash-intensive sectors are associated with firms' tax evasion (Abdixhiku et al., 2017). Tax evasion has always been challenging for economies due to innovative methods of tax evaders (Alleyne & Harris, 2017).

Recently, cryptocurrencies have appeared as a standard for developing innovative solutions. Cryptocurrencies reduce bureaucracy, increase security, and promote global inclusion in an emerging cryptographic money system (Bhullar et al., 2025; Grym et al., 2024). Financial regulators are afraid of their negative role but want to maintain the positive aspect of the most secure and global system of payments. This controversial role of cryptocurrencies motivated the author to empirically analyze cryptocurrencies' role to help policymakers determine if cryptocurrencies are a potential source of tax evasion.

There is a need for empirical studies in the literature to measure the impact of cryptocurrencies on macroeconomic factors, such as tax evasion. Considering the threat level and innovative tax evasion techniques, it is important to know the contributing factors towards tax evasion so that related measures can be taken. Besides cryptocurrencies, economic freedom is also a significant determinant of tax evasion (Acheke, 2015; Alabede, 2018; Islam et al., 2020; Matusiak, 2018; Nurunnabi, 2018; Picur et al., 2021; Picur & Riahi-Belkaoui, 2006; Riahi-Belkaoui, 2004; Rysava & Zidkova, 2021; Tekin et al., 2018). However, the literature has mixed findings that require further analysis. Linear models have been employed in the literature, so an in-depth analysis of long-run/short-run and nonlinear ways is yet to be explored. Based on the problems faced by the economies, this study examines the nonlinear association between economic freedom, cryptocurrencies, and tax evasion. Uniquely, this study also measures the association of cryptocurrencies and tax evasion at different levels of economic freedom, which the Economic Freedom theory suggests. The existence of one independent variable may change the impact of another independent variable on the dependent variable. In such cases, an interaction term is used. The researchers also explored the impact of interaction terms besides social, corporate, and macroeconomic determinants of tax evasion. Ahrens and Bothner (2020) measured the effect of the international tax-related information-sharing agreement on

tax evasion, used multiple interaction term dummies, and found a significant impact of interaction terms on tax evasion.

This study uses various interaction terms of independent variables as supported by the literature (Ariyanto et al., 2020; Chouaibi et al., 2024; Oktaviani & Yulinar, 2018). Economic freedom is measured using multiple indicators: Government Integrity, Government Spending, Business Freedom, Labor Freedom, Monetary Freedom, Trade Freedom, Investment Freedom, and Financial Freedom. Tax evasion is closely related to economic conditions and policies, and measuring the relationship between economic performance and tax evasion is necessary. Government Integrity is found to be significantly associated with tax evasion (Drogalas et al., 2018; Lushi, 2016; Mihóková et al., 2019). Monetary freedom is also associated with tax evasion (Islam et al., 2020; Mihóková et al., 2019; Nurunnabi, 2018). Similarly, another significant factor in reducing tax evasion is Financial Freedom (Habibullah et al., 2017). A recent effort to explore the relationship between tax evasion and economic freedom indicators in the SAARC region was made by Islam et al. (2020). The study's results concluded that economic freedom negatively impacts tax evasion.

To precisely measure the changing magnitude of tax evasion and to explore new determinants of tax evasion, this study contributes to the literature by providing the latest estimates of tax evasion in the G-7 countries. Moreover, this study fills the gap in empirical studies to measure the impact of cryptocurrencies on tax evasion. This is also among the very first studies, as per the best of the author's knowledge, in G-7 countries, which cover more than 58% of the total world wealth. Lastly, this study measures the moderating impact of economic freedom on the relationship between tax evasion and cryptocurrencies, a relationship that is not well-documented in the literature.

The study of Austin et al. (2019) was conducted in the context of the USA and tax evasion at the individual level. The author found that the behavior of individuals for tax evasion is related to their expectations and direction of change. Individuals evade more tax when the tax rate increases and vice versa, but this is temporary. Miller (2019) also concluded that American corporations and business entities evade taxes of \$100 billion.

In the context of Canada, Makni et al. (2019) conducted a study based on the determinants of tax haven use by Canadian firms. The authors selected 255 firms for 2014-2015 and used the probit regression. They concluded that thin capitalization, tax fees to auditing firms, and multinationalism are important determinants of tax haven usage. Khlif and Amara (2019) studied 35 countries, including Canada, to determine the relationship between tax evasion and political connections. The authors found that political connections have a positive association with tax evasion.

A study by Kemme et al. (2020) explored tax evasion in countries with low tax morale. The authors used data from 21 OECD countries. The authors concluded that countries with low tax morale engage in tax evasion. Further, this evasion is done via round-tripping through tax havens. An extensive study was conducted by Gurdal

et al. (2020) in the context of G-7 countries to determine the causal relationship between tax revenue, government expenditure, and economic growth.

Concluding this discussion, not all factors of economic freedom are given the justified importance as important determinants of tax evasion in the literature. In most studies, as mentioned earlier, only a single indicator of economic freedom is used. However, other important factors like monetary, trade, labor, and investment should be included in the literature. Literature has also mixed findings about the role of economic freedom and tax evasion based on econometric methodology, the research context, and the directionality of impact. Besides linear association, it is also important to measure the asymmetric impact that may reverse the direction of impact between tax evasion and economic freedom.

METHODS

This study employed annual data from 2001 to 2020 to estimate the tax evasion index, as all the macroeconomic variables used for estimation are found annually from World Governance Indicators provided by the World Bank. Tax evasion estimates are calculated from 2001 onward. However, an association of cryptocurrencies and tax evasion is measured during 2013-2020, as Bitcoin market capitalization is available from 2013 onward only. The tax evasion estimates are obtained by employing the ARDL model and Currency Demand Approach (CDA). This study employs dynamic and asymmetric models (ARDL / NARDL) based on the complexity of the topic. Stata is used for analysis purposes. The details of the variables and sources of the data are provided in Table 1.

Table 1. Data and Variables

Variable Name	Description	Symbol	Source
Tax evasion	Annual Tax Evasion Index	Tax evasion	The author's calculation using the CDA approach
Money Supply	Natural logarithm of real monetary aggregate M1	M1	World Bank
Currency in circulation	Natural logarithm of real currency holdings measured as nominal currency in circulation normalized by a GDP deflator.	C	World Bank
Tax to GDP	Tax to GDP ratio	Tax	World Bank
Real GDP	Natural logarithm of real GDP	Yt	World Bank
Deposit Interest Rate	The interest rate paid to deposit account holders	R	World Bank
Inflation Rate	Natural logarithm of the inflation rate		World Bank
Bitcoin Market Capitalization	Market Capitalization	bitC	CoinMarketCap
Enforcement Strength	Enforcement strength of public administration	ENF	World Bank
Income	Per Capita Income	INCOME	World Bank

This study adopts Tanzi's (1980) approach to estimate tax evasion in G-7 countries. The currency demand approach is extensively used in literature (Amoh & Adafula, 2019; Athanasios et al., 2020; Dell'Anno & Davidescu, 2019). This approach is an extended version of the Cagan (1958) approach, which was the first to estimate tax evasion in the context of the USA using monetary variables. Cagan (1958) assumed that the share of currency in the money supply in the base year is representative of the economic agent's behavior. The unexplained or residual of this ratio will gauge the size of the shadow economy. This estimation is based on unexplained normal economic factors that cause the shadow economy to grow. Eq (1) is the model of the currency demand approach:

$$C = f(Y^d, R, \pi, Tax, Urbanization, ENF) \quad (1)$$

Since disposable income is defined as net of direct taxes, equation (1) can be rewritten as

$$C = f(Y - T, R, \pi, Tax, Urbanization, ENF) \quad (2)$$

Where C is the currency demand for the whole economy (Including official and unofficial demand), R is the interest and π inflation rates. As disposable income rises, then the demand for currency also increases. As the opportunity cost of holding money which is interest rate R and the inflation rate increases, the demand for currency reduces. Enforcement results in lower currency demand, and Urbanization results in higher currency demand. The main assumption in this approach is that the underground economy is more cash-intensive, so as the tax rate increases, the demand for currency increases. The same assumption is confirmed in literature (Amoh and Adafula, 2019; Athanasios et al., 2020; Dell'Anno and Davidescu, 2019).

Transforming the general Eq (2), Eq(3) will be as follows to estimate tax evasion.

$$\ln \frac{C_{it}}{M_{it}} = b_0 + b_1 \ln(1 + tax_{i,t}) + b_2 Enf_{i,t} + b_3 \ln Y_{i,t} + b_4 \ln(1.1 + \pi_{i,t}) + b_5 R_{i,t} + b_6 \ln(Urb_{i,t}) + e_{i,t} \quad (3)$$

By using the data of G-7 countries from 2001 to 2020 in Eq (3), the coefficients are obtained and put into Eq. (3):

$$\ln \frac{C_{i,t}}{M_{i,t}} = b_0 + -0.000781 * \ln(1 + tax_{i,t}) - 0.007839 * Enf_{i,t} + +3.14E - 07 * \ln Y_{i,t} + 2.15E - 05 \ln(1.1 + \pi_{i,t}) + 3.79E - 04 * R_{i,t} - 0.014512 * \ln(Urbanization_{i,t}) + e_{i,t} \quad (4)$$

Eq. (4) is used to get predicted values for overall currency demand. We get the value of currency demand each year. The same procedure is repeated with zero tax revenue and the highest enforcement value, i.e., 2.5. This predicted currency value is again obtained for each year, but this is an illegal currency. The difference between the above two steps estimates illegal currency in the economy. Further, the velocity of money in circulation is calculated by dividing nominal GDP by the value of legal money. Finally, this calculated velocity of the money is multiplied by the extra currency to get the shadow economy.

The primary research model of this study is as follows:

$$Tax\ Evasion_{i,t} = \alpha_0 + \beta_1 bitC_{i,t} + \sum_{i=1}^n \gamma_i Control_{i,t} + \varepsilon_{i,t} \quad (5)$$

$$Tax\ Evasion_{i,t} = \alpha_0 + \beta_1 Econ_Freedom_{i,t} + \sum_{i=1}^n \gamma_i Control_{i,t} + \varepsilon_{i,t} \quad (6)$$

$$Tax\ Evasion_{i,t} = \alpha_0 + \beta_1 Econ_Freedom * bitC_{i,t} + \sum_{i=1}^n \gamma_i Control_{i,t} + \varepsilon_{i,t} \quad (7)$$

Eq (5) to Eq (7) will be extended after putting the control variable as follows:

$$Tax\ Evasion_{i,t} = \alpha_0 + \beta_1 bitC_{i,t} + \beta_2 lnGDP_{i,t} + \varepsilon_{i,t} \quad (8)$$

$$Tax\ Evasion_{i,t} = \alpha_0 + \beta_1 Econ_Freedom_{i,t} + \beta_2 lnGDP_{i,t} + \varepsilon_{i,t} \quad (9)$$

$$Tax\ Evasion_{i,t} = \alpha_0 + \beta_1 Econ_Freedom_{i,t} * bitC_{i,t} + \beta_2 lnGDP_{i,t} + \varepsilon_{i,t} \quad (10)$$

Where Tax Evasion is annual tax evasion in G-7 countries, bitC is the yearly market capitalization of Bitcoin. Tax Evasion is annual tax evasion in G7 countries, calculated using the Currency Demand Approach (CDA) developed by Tanzi (1980). More than 2,200 cryptocurrencies are circulating in this digital system (CoinMarketCap, 2021). It is harder to use the market capitalization of all these currencies due to the addition or deletion in the crypto market. So, the market capitalization of Bitcoin, which is 95% of all cryptocurrencies' market capital, is used as a proxy to measure cryptocurrencies.

Applying the panel ARDL model in Eq(8) to Eq(10), the regression equations will be as follow respectively:

$$Tax\ Evasion_{i,t} = \alpha_0 + \sum_{i=1}^{n1} b_i \Delta BitC_{i,t-i} + \sum_{i=0}^{n2} c_i \Delta lnGDP_{i,t-i} + \sum_{i=0}^{n3} d_i \Delta Tax\ Evasion_{i,t-i} + \alpha_1 BitC_{i,t-1} + \alpha_2 lnGDP_{i,t-1} + \alpha_3 Tax\ Evasion_{i,t-1} + e_{i,t} \quad (11)$$

$$Tax\ Evasion_{i,t} = \alpha_0 + \sum_{i=1}^{n1} b_i \Delta BitC_{i,t-i} + \sum_{i=0}^{n2} c_i \Delta lnGDP_{i,t-i} + \sum_{i=0}^{n3} d_i \Delta Tax\ Evasion_{i,t-i} + \alpha_1 BitC_{i,t-1} + \alpha_2 lnGDP_{i,t-1} + \alpha_3 Tax\ Evasion_{i,t-1} + e_{i,t} \quad (12)$$

$$Tax\ Evasion_{i,t} = \alpha_0 + \sum_{i=1}^{n1} b_i \Delta BitC * Econ_Freedom_{i,t-i} + \sum_{i=0}^{n2} c_i \Delta lnGDP_{i,t-i} + \sum_{i=0}^{n3} d_i \Delta Tax\ Evasion_{i,t-i} + \alpha_1 Econ_Freedom * BitC_{i,t-1} + \alpha_2 lnGDP_{i,t-1} + \alpha_3 Tax\ Evasion_{i,t-1} + e_{i,t} \quad (13)$$

Variables shown with the differenced symbol will determine short-run movements, while with α_s show the long-run relationship.

After applying the non-linear ARDL model, which the author applies in the case of non-linear relationship, the NARDL model will be as follows:

$$Tax\ Evasion_{i,t} = \alpha_0 + \alpha_1 BitC^+ + \alpha_2 BitC^- + \sum_{i=1}^n \gamma_i Control_{i,t} + \varepsilon_t$$

$(\alpha_0, \alpha_1, \alpha_2)$ are vectors of long-run coefficients to be estimated, **and** $BitC^+$ and $BitC^-$ are the partial sums of positive and negative changes in the market capitalization of Bitcoin.

$$BitC^+ = \sum_{i=1}^t \Delta BitC^+ = \sum_{i=1}^t \max(\Delta BitC_i, 0)$$

$$BitC^- = \sum_{i=1}^t \Delta BitC^- = \sum_{i=1}^t \min(\Delta BitC_i, 0)$$

$$Tax\ Evasion_{i,t} = a_0 + \sum_{i=1}^{n1} b_i \Delta POS_{BitC_{i,t-i}} + \sum_{i=1}^{n2} c_i \Delta NEG_{BitC_{i,t-i}} + \sum_{i=0}^{n3} d_i \Delta \ln GDP_{t-i} + \sum_{i=0}^{n4} f_i \Delta Tax\ Evasion_{t-i} + \alpha_1 POS_{BitC_{t-1}} + \alpha_2 NEG_{BitC_{t-1}} + \alpha_4 Tax\ Evasion_{t-1} + e_t \quad (14)$$

Using the interaction of Economic Freedom indicators and bitC as an independent variable and applying NARDL, the following equation will be obtained:

$$Tax\ Evasion_{i,t} = a_0 + \sum_{i=1}^{n1} b_i \Delta POS_{Eco\ Freedom * bitC_{i,t-i}} + \sum_{i=1}^{n2} c_i \Delta NEG_{Econ\ Freedom * bitC_{i,t-i}} + \sum_{i=0}^{n3} f_i \Delta Tax\ Evasion_{t-i} + \alpha_1 POS_{Econ\ Freedom * bitC_{t-1}} + \alpha_2 NEG_{Econ\ Freedom * bitC_{t-1}} + \alpha_3 Tax_Evasion_{t-1} + e_{i,t} \quad (15)$$

Variables shown with the differenced symbol will be determining short-run movements, while those with α_s shows the long-run relationship.

RESULTS AND DISCUSSION

This section presents the results of all methods adopted in this study. Table 2 presents the time series of the estimated tax evasion in the G-7 countries. Canada has the highest average annual tax evasion among the G-7 countries, with a score value of 13.43%, while Italy has the lowest yearly tax evasion, at 9.16%. Germany is 2nd among G-7 countries, having a value of 12.37%. Similarly, France is in third position with an average tax evasion of 11.25% of the GDP, and the USA is in fourth. The UK has an average tax evasion of 10.78% from 2001 to 2020, while this value is 9.66% for Japan. These estimates are also compared with the tax evasion estimates calculated by Medina and Schneider (2019). Medina and Schneider (2019) used Multiple Indicators-Multiple Causes (MIMIC) approaches from 2002 to 2017. Our average values are closer to these estimates. However, all the G-7 countries have a decreasing trend of tax evasion from 2001 to 2020, which shows the effectiveness of the policies.

Table 3 provides the summary statistics of the variables under study. Economic freedom indicators are provided by the Heritage Foundation, which measures annual Economic Freedom at the country level. The range score for most variables is 1-100, except for Bureaucracy; 100 indicates the highest score level in that category. No outlier was found in the dataset.

Table 4 presents the results of different unit root tests. Literature supports the existence of trends in time series and panel datasets, so it is necessary to check and remove unit roots before regression. Multiple unit root panel tests are applied for robustness. The author employed ARDL and NARDL bound testing approaches, which require data to be stationary at the level or at the first difference. All the variables are found to be stationary at a level as well as at the first difference.

Table 2. Historical Estimates of Tax Evasion in G-7 Countries using the Currency Demand Approach (CDA) as a percentage of GDP Period is 2001-2020.

Year	Canada	France	Germany	Italy	Japan	USA	UK
2001	15.56	12.73	13.27	10.35	9.89	12.73	12.13
2002	15.10	12.22	13.36	10.23	9.35	12.38	11.73
2003	15.09	12.51	12.73	10.18	9.85	12.03	11.49
2004	15.31	12.49	12.85	9.88	9.95	12.29	11.24
2005	15.51	12.17	12.69	9.59	9.94	12.05	11.05
2006	15.29	12.17	13.01	9.43	10.14	11.99	11.12
2007	15.06	11.83	13.11	9.17	9.94	11.80	11.11
2008	14.54	11.60	12.50	9.10	9.83	11.24	10.77
2009	12.55	11.04	11.78	8.91	9.47	10.63	10.09
2010	12.85	11.03	12.09	8.96	9.59	10.70	10.33
2011	13.08	10.97	12.17	8.86	9.45	10.57	10.37
2012	12.87	10.78	11.91	8.76	9.42	10.67	10.32
2013	12.84	10.71	11.87	8.76	9.42	10.69	10.39
2014	12.99	10.57	12.27	8.61	9.52	10.75	10.57
2015	12.13	10.63	12.15	8.70	9.64	10.81	10.69
2016	11.82	10.52	12.15	8.76	9.74	10.79	10.58
2017	12.08	10.37	12.20	8.77	9.64	10.95	10.61
2018	11.74	10.46	12.12	8.75	9.56	11.01	10.57
2019	11.59	10.52	11.94	8.88	9.52	10.66	10.52
2020	10.52	9.68	11.17	8.62	9.42	9.81	9.89
Average	13.43	11.25	12.37	9.16	9.66	11.23	10.78

Table 3. Summary Statistics

Variables	Mean	Median	Maximum	Minimum	Std. Dev.	Obs.
Bureaucracy	99.814	100.680	105.700	92.405	3.107	140
Business Freedom	83.635	85.000	96.900	69.800	7.919	140
Economic Freedom	71.546	73.050	81.200	58.000	6.718	140
Financial Freedom	67.786	70.000	90.000	30.000	13.680	140
Government Integrity	73.239	76.000	92.000	38.500	12.713	140
Government Spending	39.610	42.500	71.200	2.000	16.641	140
Investment Freedom	73.429	72.500	90.000	50.000	12.539	140
Labor Freedom	69.205	73.300	98.500	39.900	17.510	112
Monetary Freedom	82.529	82.850	94.300	71.700	4.772	140
Trade Freedom	83.914	83.000	88.400	77.800	3.262	140
In Real GDP	27.817	26.856	32.646	25.929	2.067	140
Schneider Estimates	11.942	11.100	23.700	5.700	4.036	119
Tax Burden	61.686	61.800	80.000	33.900	9.925	140
Bitcoin Mar Cap.	24.37	24.19	27.00	22.19	1.71	56

Table 4. Unit Root Tests

Variables	HT	Breitung	IPS	Hadri
Tax Evasion	0.9321	1.6238	0.3590	25.9192***
Δ Tax Evasion	-0.0181***	-3.4968***	-5.9162 ***	-1.2348
Tax Burden	0.4358***	0.1339	-10.9524***	9.7796 ***
Δ Tax Burden	-	-0.6594	-	2.6967***
Economic Freedom	0.7622**	-0.7040	-1.0575	14.0375***
Δ Economic Freedom	-0.0649***	-2.4776***	-8.3470***	-0.2107
Government Integrity	0.6377***	-1.2396	-1.7674**	9.3045***
Δ Government Integrity	-	-5.1255***	-6.9412***	0.3402
Government Spending	0.7541**	-1.0772	-0.8298	12.8236***
Δ Government Spending	-0.0283***	-3.0787***	-7.6450***	0.0559
Business Freedom	0.7562**	-0.9481	-0.4674	8.4301***
Δ Business Freedom	0.0022***	-2.2595**	-7.8995***	0.1169
Labor Freedom	0.7797	-0.3965	0.4729	13.7535***
Δ Labor Freedom	-0.0962***	-4.5960***	-7.1411***	-0.7090
Monetary Freedom	0.7474**	-0.5531	-0.2756	14.9157***
Δ Monetary Freedom	-0.0737***	-6.0967***	-7.3297***	-1.5346
Trade Freedom	0.7635**	-0.0087	-2.1349 **	19.2541***
Δ Trade Freedom	-0.0124***	-4.3717***	-7.3231***	1.8925**
Investment Freedom	0.8105	-0.4242	0.1420	20.2705***
Δ Investment Freedom	-0.0591***	-7.7588***	-7.0631***	-1.0617
ln GDP	0.9033	0.7681	0.3731	25.2753***
Δ ln GDP	0.0387***	-4.2209***	-5.9170***	-1.1211
Marginal Personal Income Tax	0.8936	-0.5443	-0.1108	21.4643***
Δ Marginal Personal Income Tax	0.1017	-3.3730***	-5.7551***	-0.6471
Marginal PIT and SSC	0.8007	-1.5158*	1.0066	17.2944***
Δ Marginal PIT and SSC	-0.0527***	-4.5800***	-6.5360***	-1.3372
Corporate Income tax	0.8699	0.4041	0.1614	21.8242***
Δ Corporate Income tax	-0.2547***	-6.4881	-8.4118***	-0.5121
Bureaucracy	0.8279	0.2498	-0.5307	20.5234***
Δ Bureaucracy	0.0214***	-2.7720***	-8.7520***	0.5862
Bitcoin	0.8214	0.2218	2.6253	7.5779***
Δ Bitcoin	-0.3193***	-	-3.8315***	-1.3716

Table 5 presents the results of linear ARDL models, and in most cases, a short-run association of economic freedom variables is against the empirical literature. Moreover, in the long run association, Financial Freedom, Trade Freedom, Business Freedom, Monetary Freedom, and Economic Freedom have a positive sign on tax evasion, which is supported by the literature (Acheke, 2015; Alabede, 2018; Islam et al., 2020; Riahi-Belkaoui, 2004; Tekin et al., 2018). These unexpected signs motivated the authors to explore these relationships non-linearly for clarity.

Table 6 presents the results of non-linear autoregressive distributed lag models (NARDL), where tax evasion is the dependent variable, and economic freedom indicators are independent variables. Tax Burden is found to have an insignificant non-linear association with tax evasion. Although long-run cointegration is insignificant, the coefficients of positive and negative changes differ significantly, and the Wald test rejects the null hypothesis of equivalence. Positive changes in the tax burden impact tax evasion negatively, and negative changes support tax evasion. Similarly, in the short run, the relationship is also non-linear and insignificant. Economic Freedom is positively associated with tax evasion in the linear model, and this study also explores the non-linear relationship. The authors find that Economic Freedom has a non-linear relationship in the long run, as the null hypothesis of the Wald test is rejected. Tax evasion increases as Economic Freedom improves, but this surge is more pronounced when Economic Freedom is decreased. As the cointegration is insignificant, the hypothesis that states that Economic Freedom has an asymmetric impact on tax evasion is rejected. So, the policymakers have to be careful while changing the economic policies.

Government Integrity has a negative and non-linear relationship with tax evasion. As Government Integrity improves, it reduces tax evasion. The long-run cointegration does not exist, but the coefficients are significantly different for positive and negative changes. This is true for both long- and short-term associations of tax evasion and Government Integrity. The role of Government Integrity in the short run for the linear model is contrary to the literature, but it is confirmed in the non-linear model. So, the hypothesis that Government Integrity has an asymmetric impact on tax evasion is rejected. Government Integrity is studied in a non-linear way and has expected signs of impact on tax evasion in both the short and long run.

The role of Government Spending as a predictor of tax evasion is linear and positively significant. The coefficient of Government Spending with tax evasion is negative, so as the government spends more, citizens' confidence improves, and they tend to keep on paying taxes. The same is true for the short-run relationship between tax evasion and Government Spending. The same results are supported by the studies of Achek (2015).

Table 5. Panel ARDL

Independent Variables	ARDL (4,4,4)		ARDL (4,4,4)		ARDL (4,4,4)		ARDL (4,4,4)		ARDL (1,1,1,1)	
	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run
Tax Evasion	-0.17***	-0.61**	-0.542**	-0.33	-0.42*	-0.178				
lnGDP	-0.83*	3.32***	-0.54***	3.86***	-1.01***	3.70***	0.29***	3.12	-0.92***	3.88***
Tax burden		0.46***	-0.05(L1)**						-6.720***	3.20***
Economic Freedom			-0.06***	0.10(L3)***						
Government Integrity			-0.08***	0.031*						
Government Spending			-0.02***	0.02**						
Business Freedom			0.55**	-0.02(L1)***						
Coint Eq	-0.095***	-0.111	-0.357**	-0.178	-0.395**	-0.019				

Table 5. Panel ARDL (continued)

Independent Variables	ARDL (4,4,4)		ARDL (4,4,4)		ARDL (4,4,4)		ARDL (3,3,3)	
	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run
Tax Evasion	-0.466**	-0.070	-0.785*	0.142				
lnGDP	-0.417***	3.626***	2.629***	-0.599***	-0.190***	4.323***	0.840***	3.947***
Monitory Freedom	0.119***	-0.042*						
Trade Freedom		0.383**	0.082(L3)**					
Investment Freedom			0.225***	0.002				
Financial Freedom			0.052	-0.024**				
Labor Freedom			0.009***	-0.013				
Coint Eq	-0.512**	-0.132***	-0.026	-0.189**	-0.124			

Table 6. Panel NARDL

Independent Variables	NARDL (4,4,4)		NARDL (3,3,3,3)		NARDL (1,2,2,2)		NARDL (2,3,3,3)		NARDL (2,1,1,1)		NARDL (2,2,2,2)	
	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run	Long Run	Short Run
Tax Evasion				-0.643**				-0.245		-0.126*		-0.308**
lnGDP+	13.26	4.087*										
lnGDP-	-32.08	4.800***	3.984***	2.957***	6.958***	3.162***	1.561***	2.575***	-0.704	3.329***	0.576***	3.373***
Tax burden+			-0.109***	-0.014								
Tax burden-			0.018*	0.032								
Economic Freedom+					0.067	-0.007						
Economic Freedom-					1.766***	-0.077						
Government Integrity+							-0.013***	-0.018*				
Government Integrity-							-0.006**	-0.001				
Government Spending+									-0.168***	0.024***		
Government Spending-							0.015			0.003		
Business Freedom+											-0.038***	0.002
Business Freedom-											-0.004	-0.035
Coint Eq	-0.029*		-0.081		-0.036		-0.367		-0.148		-0.197**	
Wald Test												
Pos=Neg	0.764		239.138***		6.111**		5833.794***		0.598		8.216***	

Table 6. Panel NARDL (continued)

Independent Variables	NARDL (3,3,3)			NARDL (3,3,3,3)			NARDL (2,2,2,2)		
	Long Run	Short Run		Long Run	Short Run		Long Run	Short Run	
Tax Evasion		-0.255			-0.268*			-0.239	
lnGDP	3.03***	3.253		1.379***	2.921***		-0.996***	3.449***	
Monitory Freedom+	-0.15***	-0.01							
Monitory Freedom-	-0.0	0.02							
Trade Freedom+				0.330***	-0.077*				
Trade Freedom-				0.962***	-0.056				
Investment Freedom+									
Investment Freedom-									
Financial Freedom+									
Financial Freedom-									
Labor Freedom+							0.011**	0.021	
Labor Freedom-							0.039***	-0.014	
Coint Eq	-0.217*			-0.145			-0.218**		
Wald Test Pos=Neg	99.418***			97.693***			It cannot be run due to fewer observations	14.863***	

*, **, *** indicates significance at 0.1, 0.05, and 0.01 level

Table 7. Random Effect Panel OLS Results

Independent Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9	Model 10	Model 11
1nGDP	.221	-.006	-.155	.148	.025	.262	.134	.399	.349	.183	.101
1nBitcoin	.308	.568*	.393	-.065	.369	-.083	-2.30***	.71	-.101	.481**	1.276
Tax Burden	.172										
Bitcoin*Tax Burden	-.007										
Economic Freedom		.293*									
Bitcoin*EF		-.01**									
Government Integrity			.204**								
Bitcoin*GI			-.007*								
Government Spending				.06							
Bitcoin*GS				-.002							
Business Freedom					.162						
Bitcoin*BF					-.005						
Labor Freedom						.022					
Bitcoin*LF						0					
Monetary Freedom							-.623***				
Bitcoin*MF							.027***				
Trade Freedom								.355			
Bitcoin*TF								-.009			
Investment Freedom									.01		
Bitcoin*IF									0		
Financial Freedom										.218**	
Bitcoin*FF										-.009**	
Bureaucracy											.14
Bitcoin*Bureaucracy											-.014*
No. of Obs.	56	56	56	56	56	56	56	56	56	56	56
r-squared	0.004	0.426	0.622	0.004	0.263	0.015	0.044	0.004	0.035	0.001	0.003
Chi-square	24.02***	26.08***	16.12***	7.09	12.26**	7.85*	80.72***	78.41***	11.44**	53.94***	16.43***

*, **, *** indicate significance at 0.1, 0.05, and 0.01 levels.

In the NARDL (2,2,2,2), it is concluded that Business Freedom is negatively associated with tax evasion, and this association is non-linear. The positive changes in Business Freedom reduce tax evasion more than the negative ones. Improving Business Freedom results in more tax evasion than reducing Business Freedom. The regulatory bodies need to focus more on enhancing Business Freedom, as it brings more benefits, including reduced tax evasion. The marginal benefits of improving Business Freedom are greater than those of reducing it.

The short-run impact of Business Freedom on tax evasion in a non-linear model is not statistically significant. Based on the findings of this study, the hypothesis, which states that there is an asymmetric impact of Business Freedom on tax evasion, is accepted. This is the very first study measuring the non-linear association of Business Freedom

with tax evasion and confirms the non-linear association. As no study measures such a non-linear association, there is no prior empirical support.

Monetary Freedom has a non-linear and significant relationship with tax evasion. The positive changes in Monetary Freedom reduce tax evasion more than the negative changes. More closely, when Monetary Freedom is reduced, it does not negatively impact tax evasion. The role of Monetary Freedom in the linear and non-linear models is significant in reducing tax evasion, which is also supported by the literature (Islam et al., 2020; Nurunnabi, 2018). The hypothesis, which states that there is an asymmetric impact of Monetary Freedom on tax evasion, is not rejected. Due to a gap in the literature, there is no prior evidence of a non-linear association.

Table 7 presents the results of multiple models where economic freedom indicators are used individually along with Bitcoin market capitalization. The existence of multicollinearity among the economic freedom indicators motivated the author to use these variables individually. As Bitcoin's existence is persistent, the overall impact of Financial Freedom is positive for the economy. Bureaucracy is found to be insignificantly associated with tax evasion, but the presence of Bitcoin reduces tax evasion. Overall, Monetary Freedom and Financial Freedom are positively impacting tax evasion. There is a gap in the literature where such interaction terms are studied in association with tax evasion, so the author does not find support for or oppose the findings of this study. However, the findings provide future direction to study this phenomenon in the context of developing countries to improve the robustness and generalizability of the results.

CONCLUSION

The objective of this study was to obtain updated estimates of tax evasion in G-7 countries for the period 2001-2020 by using the Currency Demand Approach. Measuring the impact of cryptocurrencies on tax evasion, at different levels of economic freedom indicators, was also one of the objectives of this study. The latest tax evasion estimates are presented in the study. The impact of cryptocurrencies on tax evasion is found to be positive, which is due to the utilization of the returns from cryptocurrencies in the economy. An asymmetric association of economic freedom indicators is also measured, in addition to the symmetric association. The study's results indicated an asymmetric association between cryptocurrencies and tax evasion. Most economic freedom indicators exhibited a linear relationship with tax evasion, except for Labor Freedom and Investment Freedom, which showed an asymmetric association with tax evasion. The study also incorporated interaction terms between cryptocurrencies and economic indicators, revealing that economic freedom moderates the association between cryptocurrencies and tax evasion. The results further demonstrated that economic freedom indicators are significant predictors of tax evasion, with Economic Freedom, Government Integrity, Monetary Freedom, and Financial Freedom moderating the association between tax evasion and cryptocurrencies.

Policymakers should adopt a multi-faceted approach to regulation, considering the various factors that influence tax evasion and the role of cryptocurrencies. This approach

should aim to create a balanced regulatory environment where Bitcoin contributes to economic transparency and fiscal responsibility. Specifically, policymakers should enhance bureaucratic efficiency beyond 95.5 points to leverage Bitcoin's role in reducing tax evasion. Financial freedom should be increased beyond 60 points, investment freedom should be maintained beyond 72 points, and business freedom should be maintained beyond 81 points to maximize Bitcoin's tax compliance benefits. Trade freedom should be maintained optimally at around 85 points, while monetary freedom should be regulated to avoid excessive tax evasion beyond 83 points. Labor freedom should be increased beyond 42 but maintained at less than 82 points to prevent an insignificant impact. Government spending beyond 20 points and government integrity beyond 72 should be promoted to reinforce Bitcoin's role in reducing tax evasion. Economic freedom should be strengthened beyond 69, and the tax burden should be optimized above 57.9 to ensure Bitcoin's positive influence on tax compliance.

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Drivers of Cryptocurrency Adoption in Iran: Evidence from the Baluchistan Region

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JEL Classification:

G1
G4
G10
G41

Received: 22 November 2024

Revised: 26 May 2025

Accepted: 16 June 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study explores the key factors influencing the acceptance of cryptocurrencies in Iran, focusing on the under-researched Baluchistan region. In contrast to previous studies focusing on developed or technologically advanced economies, this research explores a socioeconomically disadvantaged region experiencing economic instability and restricted access to formal financial services.

Research Objectives: The main goal of the study is to identify and analyze the key factors influencing cryptocurrency acceptance in this region.

Research Methods: Using data from 200 active cryptocurrency users, we employed exploratory factor analysis followed by multiple regression analysis to identify and test predictive factors.

Empirical Results: The findings reveal six primary drivers: financial constraints, national economic volatility, personality traits, social influences, managerial factors, and trust. Among these, income-related motivations and macroeconomic instability emerged as the strongest predictors of adoption.

Implications: The study contributes to the literature by contextualizing cryptocurrency behavior within a developing country's marginalized setting and provides insights for policymakers to enhance financial inclusion. It also highlights the need for regulatory clarity and user education to support safe and effective participation in digital finance.

Keywords:

acceptance; cryptocurrency; economic instability; social influence

How to Cite:

Karimzadeh, M., Yousefi, F., Goldarzehi, R., & Delgram, A. (2025). Drivers of Cryptocurrency Adoption in Iran: Evidence from the Baluchistan Region. *Etikonomi*, 24(2), 385 – 406. <https://doi.org/10.15408/etk.v24i2.42529>.

INTRODUCTION

The proliferation of financial technologies has transformed the structure and dynamics of global economic systems. Among these, digital currencies—particularly cryptocurrencies—have emerged as a significant innovation (Carrick, 2016). Cryptocurrencies utilize cryptographic methods to enable secure transactions and control the issuance of new units, operating as decentralized alternatives to traditional fiat currencies (Gil-Cordero et al., 2020). This decentralization, underpinned by blockchain technology, introduces transparency and immutability to transaction records, fostering greater user trust and reducing reliance on centralized intermediaries (Shehzad et al., 2018). The increasing appeal of cryptocurrencies is driven by both technological advancements and the growing public interest in alternative financial instruments that transcend conventional banking limitations.

Several features differentiate cryptocurrencies from traditional financial systems, such as peer-to-peer transfers, near-instant settlements, reduced transaction costs, and a high degree of user anonymity (Phillips et al., 2019; Burr et al., 2018). Unlike fiat currencies regulated by central banks, cryptocurrencies operate through decentralized networks without a central authority, making them particularly appealing during times of financial instability or distrust in policy. (Kumar & Anandrao, 2019). Furthermore, studies have shown that cryptocurrency adoption can positively affect individual welfare by improving savings mechanisms and consumption smoothing (Murakami & Viswanath-Natraj, 2025).

The launch of Bitcoin in 2009, amid the global financial crisis, marked a watershed moment in digital finance. It demonstrated the feasibility of decentralized monetary systems and laid the groundwork for a new class of digital assets (Calderon, 2018; Kumar & Anandrao, 2019). Since then, the digital currency ecosystem has expanded with the emergence of other tokens such as Ethereum, Ripple, and Litecoin. The market capitalization of cryptocurrencies surged from under \$500 million in 2012 to over \$782 billion in early 2021, indicating a compound annual growth rate exceeding 150%. Bitcoin experienced an unprecedented increase in value, rising from \$7,000 to over \$60,000 in 2021, reflecting its dual role as both a speculative asset and a potential store of value (Sun et al., 2021).

As of 2024, the global cryptocurrency market has continued to grow at a notable pace. Revenues are expected to reach \$51.5 billion, with a projected compound annual growth rate (CAGR) of 8.62% that could push revenues to \$71.7 billion by 2028. User adoption is also accelerating, with penetration anticipated to rise from 10.76% in 2024 to 12.39% in 2028, resulting in an estimated global user base of over 992 million. These statistics underscore the increasing integration of cryptocurrencies into mainstream economic activities.

Nevertheless, adoption remains uneven and faces persistent challenges. Technical vulnerabilities such as hacking, malware, and private key mismanagement continue to undermine trust in digital currencies (Apostolaki, 2017; Krombholz et al., 2016; Folkenstein & Lennon, 2016; Madanchian et al., 2025; Luo et al., 2025). Although

blockchain itself offers protection against tampering, security risks associated with exchanges and user endpoints remain substantial (Nadeem et al., 2021). In addition, regulatory ambiguity, legal uncertainties, market volatility, and the irreversible nature of transactions hinder broader acceptance (Kumar & Anandrao, 2018). The misuse of blockchain for illicit purposes has also fueled skepticism regarding its legitimacy and long-term viability (Conti, 2018). Financial illiteracy and low risk tolerance among specific user segments further exacerbate vulnerability to market shocks (Hayashi & Routh, 2025).

The increasing effect of cryptocurrencies on global financial ecosystems has inspired extensive research into the factors influencing their adoption. Previous studies have applied behavioral, psychological, and technological models to explain individual and collective decisions. Xia (2022) found that social influence, perceived value, and traceability are significant in Malaysia, with customer satisfaction acting as a mediator. Shahzad et al. (2024) emphasized the roles of awareness, trust, and ease of use in facilitating acceptance, reaffirming the Technology Acceptance Model (TAM) as a suitable framework. Liu (2025) highlighted peer influence and social networks as essential, particularly in volatile markets. Similarly, Jalan (2023) identified interpersonal trust as a key structural factor driving the use of cryptocurrencies.

Despite this growing body of literature, existing studies have primarily focused on developed or technologically advanced economies. As Alzahrani (2019) noted, adoption in developing contexts is often shaped by practical concerns, such as transaction speed, privacy, and perceived investment potential, rather than technological novelty or institutional support. However, most research overlooks how these dynamics operate in economically marginalized or financially excluded populations, where informal economies, social networks, and religious attitudes may significantly influence behavior.

This study addresses that research gap by focusing on Iran's Baluchistan region—a context characterized by economic underdevelopment, limited access to formal financial services, and regulatory ambiguity. Iran's overall engagement with cryptocurrencies has increased dramatically in recent years. As of 2023, approximately 22% of Iranians own cryptocurrencies, while 29% report having used or invested in them. Legal ambiguities persist, with the 2018 directive from the Board of Ministers permitting cryptocurrency mining under license but offering no clear regulatory framework for use in transactions. While cryptocurrencies are not formally prohibited, the lack of clarity in the Monetary and Banking Law has created uncertainty about their legal standing. Nonetheless, Iran's projected cryptocurrency revenue for 2024 is \$123.4 million, with user numbers expected to exceed \$17.32 million by 2028.

This evolving landscape positions Iran as a critical context for studying cryptocurrency adoption, especially in underserved regions like Baluchistan. The province, despite being the largest in Iran by land area, faces persistent socioeconomic challenges, including infrastructural neglect, low formal financial penetration, and high unemployment. Its economic detachment from national systems, combined with increasing digital access and a youthful demographic, creates a unique environment for decentralized finance.

Understanding how behavioral, economic, and social factors intersect in this context is essential for informing inclusive financial strategies and addressing regional disparities in digital access.

Although cryptocurrency adoption has been examined extensively in global literature, few studies have explored how specific socio-cultural and economic conditions affect adoption in economically marginalized regions. Furthermore, models like TAM and UTAUT often overlook context-specific factors such as income instability, informal peer influence, and religious attitudes that may shape user decisions in such settings. This study contributes to the literature by examining these dimensions in Baluchistan using a two-stage quantitative method: exploratory factor analysis (EFA) followed by regression analysis. The research questions guiding this study are: a) What factors most significantly influence cryptocurrency acceptance in Baluchistan? b) How do income, economic instability, social norms, personality traits, management factors, and trust shape this acceptance?

The novelty of this research lies in its focus on an economically and geographically marginalized region within a politically uncertain environment. In contrast to earlier studies focused on developed economies, this research provides insights from a population that has often been neglected in academic and policy discussions. By capturing the unique drivers and barriers to cryptocurrency adoption in Baluchistan, the study offers valuable insights for theory development and digital financial inclusion strategies in similar high-risk and underserved contexts.

METHODS

This study adopted a quantitative research approach to investigate the key factors influencing cryptocurrency acceptance in Iran's Baluchistan region. The research design was structured in two stages. First, an exploratory factor analysis (EFA) was conducted to identify the underlying dimensions associated with cryptocurrency adoption. A structured questionnaire comprising 20 items was developed based on a comprehensive literature review and consultations with domain experts in cryptocurrency and behavioral finance. Responses were collected using a 5-point Likert scale from 200 participants actively engaged in cryptocurrency trading in Baluchistan. In the second stage, multiple linear regression analysis was performed to assess the predictive power of the six factors identified through EFA.

Exploratory factor analysis was selected due to its suitability for uncovering latent factors without relying on pre-existing theoretical frameworks, aligning with the study's exploratory nature. Unlike conventional deductive approaches that test established models, a deductive-inductive method was employed to identify novel factors influencing cryptocurrency acceptance. Variables were initially selected through an extensive review of domestic and international literature on technology adoption and cryptocurrency use. These variables were then refined through iterative consultations with experts, who evaluated their relevance and clarity. The finalized variables, summarized in Table 1, formed the basis for a 20-item questionnaire designed to capture the behavioral, economic, and social dimensions of cryptocurrency adoption.

The target population consisted of individuals actively participating in cryptocurrency trading in Baluchistan, Iran, including those who are involved in buying, selling, or holding digital currencies. A simple random sampling method was employed to ensure representativeness within this population. Participants were recruited through online cryptocurrency trading platforms, local digital finance communities, and social media groups focused on cryptocurrency in Baluchistan. To enhance accessibility, the questionnaire was distributed in both digital and paper-based formats, accommodating the region's varying levels of technological infrastructure. A total of 200 respondents completed the survey, satisfying the recommended sample size for EFA, which requires 5–10 observations per variable ($20 \text{ variables} \times 10 = 200$). This sample size ensures statistical robustness while accounting for the region's logistical constraints, such as limited internet access and geographic dispersion.

Table. 1 Main Variables of the Study

Row	Questions
1	There is no need for high capital to enter this market
2	Earning income
3	Low financial ability of people to enter other markets (constructions, gold, dollar, ...)
4	Low return of production activities in the country
5	Fluctuations and the absence of economic stability in the country
6	Inflation expectations and try to maintain the value of our assets
7	The failure of the Iranian stock market
8	High fluctuations in the value of the national currency and the need for income in dollars
9	The significant influence of social networks
10	I entered this market due to the profit made by friends and relatives
11	I entered this market due to the suggestion of my friends
12	I entered this market because of my risk-taking spirit
13	I entered this market due to the impossibility of tracking my capital and keeping my assets hidden
14	Entering this market does not require a degree from a university or special courses
15	I entered this market due to the existence of a legal gap in the country to ban the buying and selling of cryptocurrencies
16	Not paying tax
17	I entered this market due to the absence of Sharia prohibition in buying and selling cryptocurrencies
18	My confidence in the bright future of this market
19	I have enough and reliable information about this market
20	Optimism about the acceptance of these types of assets in the near future by people and governments

The 20-item questionnaire was analyzed using SPSS software to perform EFA, which identified the underlying factors explaining the correlation patterns among the observed variables. Principal component analysis with varimax rotation was applied to extract the most significant factors. Then, the resulting factors were used in a multiple linear regression analysis to evaluate their predictive impact on cryptocurrency acceptance.

The combination of EFA and regression analysis enabled a comprehensive exploration of the behavioral, economic, and social drivers of cryptocurrency adoption in Baluchistan's unique context.

Factor analysis is used to uncover the underlying variables of a phenomenon or to summarize a set of data. The primary data utilized is the correlation matrix constructed from the analyzed variables. Unlike other statistical methods, factor analysis does not predefine dependent variables. It functions based on two main types: exploratory and confirmatory factor analysis. By creating a correlation matrix, factor analysis reveals clusters of variables. Variables within each cluster show strong correlations with one another but minimal correlations with variables in other clusters. Variables lacking correlation with any others are typically removed, as a reasonable level of correlation among analyzed variables is expected. Exploratory factor analysis, specifically using the factor validity index, assesses the construct validity of the questionnaire. It determines whether the questionnaire measures the intended indicators (Khani et al., 2020).

In this research, the questionnaire's internal consistency, or reliability, is measured using Cronbach's alpha. As internal consistency increases, the alpha coefficient also rises. This indicates that the questions or items are highly relevant to the target construct (the variable related to the research hypotheses). A value exceeding 0.7 is generally regarded as indicative of good reliability. This research's alpha coefficient of 0.846 demonstrates excellent internal consistency, signifying that the 20 questions effectively measure a latent variable.

After conducting the exploratory factor analysis (EFA) that identified key latent factors influencing cryptocurrency acceptance, multiple linear regression analysis was used to evaluate the magnitude and significance of these factors' influence on the dependent variable: Cryptocurrency Acceptance. Regression analysis directly quantifies the predictive strength of independent variables, making it especially valuable for hypothesis testing and model validation in behavioral studies.

We employed multiple linear regression to investigate how key factors, derived from exploratory factor analysis (EFA), predict cryptocurrency acceptance (CA). The model is expressed as:

$$CA = \beta_0 + \beta_1 FIN + \beta_2 ECN + \beta_3 SOC + \beta_4 PER + \beta_5 MAN + \beta_6 TRU + \varepsilon$$

Where:

CA = Cryptocurrency Acceptance (dependent variable)

FIN = Income and Financial Factors

ECN = National Economic Fluctuations

SOC = Social Influence

PER = Personality

MAN = Managerial Factors

TRU = Trust

ε = Error term

As indicated in the EFA, each factor score was calculated by averaging the Likert-scale responses of items linked to that factor. This approach ensures that the scores accurately represent the underlying constructs. The regression analysis was conducted using SPSS. Regression provides a simple method to evaluate each factor's direct contribution to cryptocurrency acceptance, aligning with our goal of identifying key drivers.

It is crucial to verify that the model's underlying statistical assumptions are met. Table 2 displays the diagnostic tests conducted to evaluate the regression model's suitability and reliability used in this study. First, the Shapiro-Wilk test was conducted to evaluate the normality of residuals. A p-value of 0.15 indicates that the residuals do not significantly deviate from a normal distribution. This supports the assumption of normality, which is essential for valid hypothesis testing and confidence interval estimation.

Table. 2 Statistical Assumption Checks for Regression Model Validity

Assumption	Test/Method	Result	Interpretation
Normality of Residuals	Shapiro-Wilk test	p = 0.15	Residuals are normally distributed, supporting model validity.
Linearity	Scatterplot of predicted vs. residuals	No curvilinear patterns observed	The linear relationship between predictors and outcome is confirmed.
Constant Variance	Breusch-Pagan test	p = 0.09	Homoscedasticity is present, indicating consistent residual variance.
No Autocorrelation	Durbin-Watson statistic	1.92 (close to 2)	Residuals are independent, with no significant autocorrelation.
No Multicollinearity	Variance Inflation Factors (VIFs)	All VIFs < 2 (see Table 10)	No excessive correlation among predictors, ensuring model stability.

Source: results of the research

We analyzed a scatterplot of predicted values against the residuals to verify linearity. The lack of clear curvilinear patterns indicates that the relationship between the independent and dependent variables is indeed linear, fulfilling the criterion for multiple linear regression. We employed the Breusch-Pagan test to assess the homogeneity of variance (homoscedasticity). The p-value obtained was 0.09, which exceeds the conventional significance threshold of 0.05. This suggests that the variance of residuals remains relatively constant across different levels of the independent variables. Therefore, this finding supports the assumption of constant error variance.

The Durbin-Watson statistic was employed to identify autocorrelation in the residuals. The resulting value of 1.89 is nearly at the ideal level of 2, indicating that the residuals are uncorrelated and meet the independence assumption. Finally, we calculated the Variance Inflation Factors (VIFs) to evaluate multicollinearity among all predictor variables. All VIF values fell below 2, suggesting a minimal correlation between the independent variables. This result indicates that multicollinearity is not an issue, allowing for stable and interpretable regression coefficients. In conclusion, all diagnostic tests

validate that the assumptions needed for reliable multiple regression analysis are satisfied, which enhances confidence in the model's results and their applicability.

RESULTS AND DISCUSSION

Table 3 summarizes the demographic characteristics of the study participants. The results indicate that the largest age group among respondents completing the questionnaire was between 30 and 40 years old. Additionally, 90% of respondents identified as male, and most held a master's degree. Table 3 further reveals that most participants have less than one year of experience in the cryptocurrency market, while 34.8% possess experience between one and three years.

Prior to performing factor analysis, evaluating the data's suitability is essential. This involves assessing whether the sample size and the interrelationships among the variables are sufficient for factor analysis. The Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy is designed specifically for exploratory factor analysis and signals data sufficiency. Its values range from 0 to 1: below 0.5 indicates unsuitability for factor analysis, values between 0.5 and 0.69 suggest caution, and scores above 0.7 show that current correlations in the data are appropriate for analysis.

Table. 3 The demographic characteristics of the study

Demographic Variable		Percentage
Age	Less than 20	1.5
	20-25	30.3
	30-40	47
	More than 40	21.2
Gender	Male	90
	Female	10
Education	Diploma	10.6
	College	10.6
	Bachelor	34.8
	Master degree	37.9
	PhD	6.1
Experience	Less than 1 year	56.1
	1-3	34.8
	3-5	7.6
	More than 5	1.5

Source: results of the research

Data suitability is further confirmed by Bartlett's test, where a significance level below 5% suggests rejecting the identity assumption in the correlation matrix, indicating

that factor analysis is suitable for uncovering the underlying structure (factor model). Our study's KMO index, nearing 0.7, affirms the model's robustness and suggests that the data concerning factors influencing "acceptance of cryptocurrencies in Baluchistan" is appropriate for factor analysis. Furthermore, the significant result of Bartlett's test ($\text{Sig} < 0.01$) further supports the rejection of the identity assumption, validating the use of factor analysis for structure identification.

Table. 4 Bartlett's Test and Numerical Value of KMO

Kaiser-Meyer-Olkin Measure of Sampling Adequacy	0.697
Bartlett's Test of Sphericity Approx. Chi-Square	358.367
df	190
Sig.	0.000

Source: results of the research

The regression model accounts for 53.6% of the variance in cryptocurrency acceptance ($R^2 = 0.536$), which is regarded as a considerable effect size in the behavioral and social sciences (Cohen, 1988). The F-statistic of 35.42 is significant at the 0.001 level, demonstrating that the overall regression model is a good fit. Summary of the regression model predicting cryptocurrency acceptance (N=200): The R^2 of 0.536 shows that 53.6% of the variance is explained, aligning closely with findings from Rahayu (2022) regarding cryptocurrency adoption in Indonesia ($R^2 = 0.50$). The Adjusted R^2 of 0.521, similar to R^2 , indicates that the six predictors provide meaningful contributions without unnecessary complexity. The ANOVA results affirm the statistical significance of the model.

Table. 5 Model Summary and ANOVA

Model	R	R^2	Adjusted R^2	Std. Error	F	Sig.
Regression	0.732	0.536	0.521	0.482	35.42	<0.001

Source: results of the research

Table 6 presents the eigenvalues and variance associated with the identified factors. The "Factors/Components" column displays the initial number of factors determined in the first stage of factor analysis. Since 20 variables were included in the study, 20 initial factors were generated. The "Initial Eigenvalues" column shows the initial eigenvalues for each factor, represented as the total explained variance. This variance is further expressed as a percentage of the total variance along with a cumulative percentage.

An eigenvalue for each factor represents the proportion of the total variance of the variables explained by that specific factor. It can be calculated by summing the squares of the factor loadings for all variables within that factor. Therefore, eigenvalues indicate the exploratory importance of the factors concerning the variables. A low eigenvalue

signifies that the factor plays a minor role in explaining the variance of the variables. The “Eigenvalues of Extraction Factors without Rotation” column presents the explained variance of factors with eigenvalues exceeding 1. Finally, the “Eigenvalues of Rotated Extracted Factors” column displays the values for extracted factors after rotation.

Kaiser’s criterion was initially used to determine the number of factors to retain. This criterion states that only factors with an eigenvalue of 1 or higher are potential sources of variation within the data. In Table 5, six factors influencing cryptocurrency acceptance (factors 1 to 6) have eigenvalues greater than 1, indicating their capacity to explain variances and justifying their inclusion in the subsequent analysis. These six factors together account for 62.378% of the total variance of the variables.

Table. 6 Percentage of variance and specific values of factors affecting the acceptance of cryptocurrencies in the Baluchistan region

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	4.165	20.825	20.825	4.165	20.825	20.825	2.542	12.711	12.711
2	2.657	13.284	34.109	2.657	13.284	34.109	2.378	11.889	24.600
3	1.795	8.974	43.083	1.795	8.974	43.083	2.296	11.482	36.082
4	1.377	6.886	49.969	1.377	6.886	49.969	1.875	9.375	45.457
5	1.296	6.478	56.447	1.296	6.478	56.447	1.752	8.761	54.218
6	1.186	5.931	62.378	1.186	5.931	62.378	1.632	8.159	62.378
7	.981	4.903	67.281						
8	.919	4.597	71.878						
9	.816	4.078	75.956						
10	.754	3.768	79.724						
11	.665	3.326	83.051						
12	.602	3.012	86.063						
13	.510	2.548	88.611						
14	.503	2.514	91.125						
15	.442	2.209	93.334						
16	.345	1.723	95.057						
17	.311	1.554	96.611						
18	.283	1.415	98.026						
19	.219	1.096	99.123						
20	.175	.877	100.000						

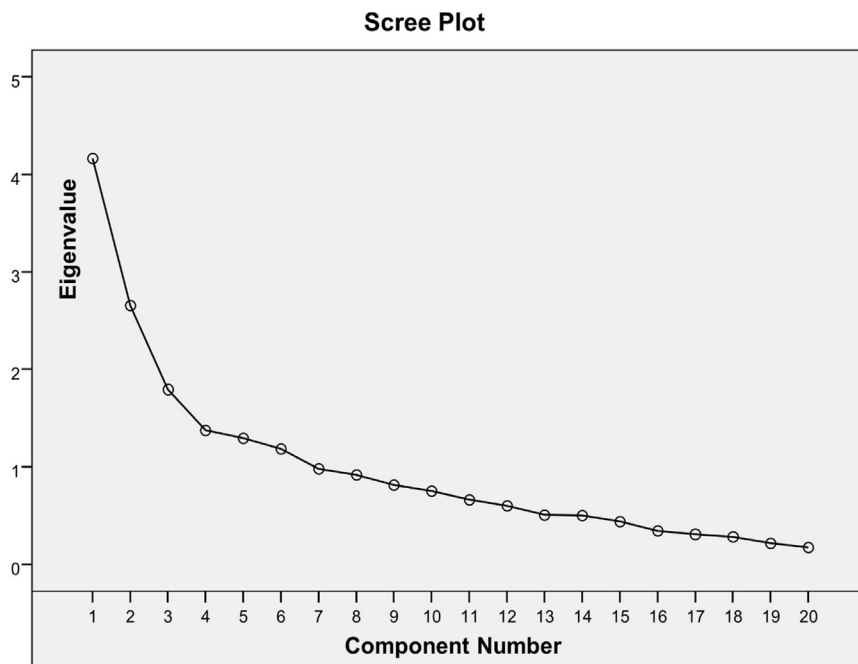
Source: results of the research

The naming of each factor should reflect the shared meaning of the variables with significant factor loadings within that factor. This name essentially serves as a

conceptual umbrella for those variables. Naturally, variables with higher factor loadings hold greater importance in the naming process and exert a more substantial influence on the selected title or label that represents the factor's underlying concept. One recommended approach for factor naming involves isolating variables with high factor loadings (above 0.6) and then naming the factor based on the common characteristics exhibited by these variables. In other words, variables with low factor loadings play a minimal role in factor naming.

A diagram of the mountain slope (rocks or pebbles) determines the number of factors. Examining the scree plot is recommended to further refine the exact number of factors to retain. This visual representation confirms the eigenvalue criterion presented in Table 6. As shown in Diagram 1, six factors have eigenvalues exceeding 1. This indicates that 20 variables can be effectively reduced to 6 factors.

Figure 1. Slope diagram of the Range of Factors



The unrotated matrix, also known as the component matrix, represents the factor analysis components before rotation and displays the correlations between the extracted variables and factors. Since this matrix does not reveal a clear pattern for identifying factors, a rotated matrix is employed to achieve a more distinct layout. Due to the complexities involved in interpreting results with diagonal rotation methods and the relative ease associated with orthogonal rotation methods, most researchers select the latter (Henson & Roberts, 2006). Orthogonal rotation can be accomplished through Varimax, Quartimax, and Equimax. Varimax is the preferred method in many software programs, including SPSS (Zabardast, 2016). Given that orthogonal rotation assumes uncorrelated factors with a correlation coefficient of zero, Pearson's correlation test was

conducted to verify this assumption. The results presented in Table 7 demonstrate that the correlation coefficient for all factors is indeed zero, confirming their uncorrelated nature. This allows for using orthogonal methods like the Varimax rotation to rotate the factors.

Table 7. Factor Correlation Test

		Factor 1	Factor 2	Factor 3	Factor 4	Factor 5	Factor 6
Factor 1	Pearson Correlation	1	0.000	0.000	0.000	0.000	0.000
	Sig. (2-tailed)		1.000	1.000	1.000	1.000	1.000
	N						
Factor 2	Pearson Correlation	0.000	1	0.000	0.000	0.000	0.000
	Sig. (2-tailed)	1.000		1.000	1.000	1.000	1.000
Factor 3	Pearson Correlation	0.000	0.000	1	0.000	0.000	0.000
	Sig. (2-tailed)	1.000	1.000		1.000	1.000	1.000
Factor 4	Pearson Correlation	0.000	0.000	0.000	1	0.000	0.000
	Sig. (2-tailed)	1.000	1.000	1.000		1.000	1.000
Factor 5	Pearson Correlation	0.000	0.000	0.000	0.000	1	0.000
	Sig. (2-tailed)	1.000	1.000	1.000	1.000		1.000
Factor 6	Pearson Correlation	0.000	0.000	0.000	0.000	0.000	1
	Sig. (2-tailed)	1.000	1.000	1.000	1.000	1.000	

Source: results of the research

Table 8 shows the rotated matrix for the effective factors or criteria of cryptocurrency acceptance. This matrix can be interpreted more easily than the previous unrotated matrix. The higher the absolute value of these coefficients, the more critical the relevant factor is in the desired variable's total changes (variance). The results show that 20 variables are summarized in 6 more general factors, and each variable's factor load is shown in the corresponding sub-factor.

The rotated factor matrix requires selecting significant factor loadings. The most common practice involves focusing on variables with factor loadings of 0.4 or higher. While some sources consider a minimum factor loading of 0.3 acceptable, factor loadings can generally be categorized as follows: 0.3 (acceptable level of significance), 0.4 (more acceptable level of significance), and 0.5 (high acceptable level of significance). Our research chose a factor loading of 0.5 as the threshold.

Table. 8 Matrix of Rotated Factors and Their Factor Load

	Component					
	1	2	3	4	5	6
X1	0.502					
X2	0.840					
X3	0.645					
X4	0.750					
X5		0.543				
X6		0.694				
X7		0.784				
X8		0.810				
X9			0.592			
X10			0.542			
X11			0.648			
X12				0.552		
X13				0.516		
X14				0.641		
X15					0.501	
X16					0.511	
X17					0.682	
X18						0.628
X19						0.510
X20						0.522

Source: results of the research

Factor naming emphasizes aligning with the shared meaning of variables that exhibit significant factor loadings within each factor. This essentially provides a conceptual umbrella for the associated variables. Naturally, variables with higher factor loadings carry more weight in the naming process and have a more substantial influence on the chosen label that best represents the underlying concept of the factor. One practical approach involves isolating variables with high factor loadings (above 0.6) and naming the factors based on their common characteristics. In other words, variables with low factor loadings have a minimal role in the naming process.

Table 9 demonstrates consideration for theoretical and experimental texts in this field, along with adherence to naming principles and practices. The extracted factors are designated as follows: income and financial factors, national economic fluctuations, social influence, personality, managerial factors, and trust.

The 20 research items were effectively reduced to six factors through exploratory factor analysis. These six factors were identified as key ranking indicators for the

participating respondents. They were named based on the items included within each factor and the shared concepts derived from those items. The table of eigenvalues shows the variance explained by each factor. According to the total cumulative variance percentage, their combined predictive power totals 62.378%. Therefore, six factors were identified as crucial for developing a ranking model for cryptocurrency acceptance: income and financial factors, national economic fluctuations, social influence, personality, managerial factors, and trust.

Table 9. Classification and Naming of Factors

Factor name	Factor Loading	Indicator
Income and financial factors	0.502	There is no need for high capital to enter this market
	0.840	Earning income
	0.645	Low financial ability of people to enter other markets
	0.750	Low return of production activities in the country
National economic fluctuations	0.543	Fluctuations and absence of economic stability in the country
	0.694	Inflation expectations and trying to maintain the value of our assets
	0.784	The failure of the Iranian stock market
	0.810	High fluctuations in the value of the national currency and the need for income in dollars
Social influence	0.592	The great influence of social networks
	0.542	I entered this market due to the profit made by friends, and relatives
	0.648	I entered this market due to the suggestion of my friends
Personality Traits	0.552	I entered this market because of my risk-taking spirit
	0.516	I entered this market due to the impossibility of tracking my capital and keeping my assets hidden
	0.641	Entering this market does not require a degree from a university or special courses
Managerial and legal factors	0.501	I entered this market due to the existence of a legal gap in the country to ban the buying and selling of cryptocurrencies
	0.511	Not paying tax
	0.682	I entered this market due to the absence of Sharia prohibition in buying and selling cryptocurrencies
Trust	0.628	My Confidence in the bright future of this market
	0.510	I have enough and reliable information about this market
	0.522	Optimism about the acceptance of these types of assets in the near future by people and governments

Source: results of the research

Table 10 presents the regression coefficients, which include unstandardized (B) and standardized (β) coefficients, standard errors, t-statistics, p-values, VIFs, and 95% confidence intervals. This study investigated the determinants of cryptocurrency acceptance in Baluchistan, a region characterized by economic underdevelopment, political uncertainty, and social conservatism. The findings from exploratory factor analysis (EFA) and multiple regression analysis provide a multifaceted understanding of how both individual and contextual factors shape cryptocurrency adoption in this region. The results of the study offer theoretical and practical implications, mainly when situated within the frameworks of technology adoption and behavioral economics.

Table 10. Regression Coefficients

Predictor	B	SE	β	t	p-value	VIF	95% CI for B
Intercept	1.102	0.222	—	4.960	0.001	—	[0.666, 1.538]
Income & Financial	0.376	0.062	0.401	6.060	0.001	1.620	[0.254, 0.498]
National economic fluctuations	0.341	0.065	0.362	5.250	0.001	1.710	[0.213, 0.469]
Social influence	0.234	0.060	0.267	3.900	0.001	1.490	[0.116, 0.352]
Personality traits	0.146	0.053	0.163	2.760	0.006	1.350	[0.042, 0.250]
Managerial and legal factors	0.128	0.052	0.137	2.460	0.014	1.420	[0.026, 0.230]
Trust	0.108	0.050	0.121	2.160	0.032	1.380	[0.010, 0.206]

Source: results of the research

The regression analysis confirmed the statistically significant influence of six latent constructs—income and financial factors, national economic fluctuations, social influence, personality traits, managerial/legal factors, and trust—on the intention to adopt cryptocurrencies. Among these, income, financial motivations, and national economic fluctuations emerged as the most powerful predictors. These results respond to the study's initial research question: "What are the key determinants influencing the adoption of cryptocurrency in Baluchistan?". The findings reflect Baluchistan's macroeconomic environment, characterized by restricted industrial activity, elevated unemployment rates, and pervasive poverty that compel residents to explore alternative sources of income. Under these conditions, the appeal of cryptocurrency, especially its perceived ability to generate swift profits and autonomy from traditional banking, is heightened.

The dominance of income-related motivations reflects the financial desperation faced by many individuals in Baluchistan. The region suffers from chronic underinvestment and a weak manufacturing base, with most residents relying on informal sectors such as cross-border trade or subsistence agriculture. Additionally, prolonged droughts have decimated agricultural productivity, pushing more people toward alternative markets. In this context, cryptocurrencies offer a perceived escape from financial marginalization. Even individuals with limited capital appear willing to participate, viewing digital assets

as tools for financial survival rather than speculative investment. These observations corroborate the earlier findings of Abu-Shanab (2013), emphasizing the central role of income as a determinant of technology adoption in constrained economic settings.

National economic instability also significantly influenced the acceptance of cryptocurrency. Iran's broader economic environment—shaped by international sanctions, currency depreciation, inflation, and fiscal mismanagement—creates a pervasive sense of uncertainty that directly impacts public behavior. The Rial's devaluation, coupled with high inflation and a loss of trust in traditional savings mechanisms, has led to an accelerated interest in alternative assets such as cryptocurrencies, gold, and foreign currencies. The 2019 collapse of the Tehran Stock Exchange, where the index plummeted after reaching a historic high, intensified this trend. Many citizens who suffered losses in that market have redirected their capital toward more autonomous and globally integrated instruments like cryptocurrencies. This result supports theories of risk-aversion and capital preservation as key motivators during economic turbulence. Research indicates that due to the instability of the domestic economy and high inflation, capital is directed toward valuable assets to preserve its value. Consequently, in Iran, a portion of people's capital has flowed into the cryptocurrency market in response to domestic economic challenges.

Social influence also demonstrated a significant effect on adoption. This result aligns with the Theory of Reasoned Action, which posits that subjective norms significantly shape individual behavioral intentions. In a tightly knit and community-oriented society like Baluchistan, individuals are highly influenced by their immediate social circles. Family opinions, peer behaviors, and religious leaders play crucial roles in legitimizing or delegitimizing certain practices. As cryptocurrencies gain traction among influential members of the community, the normalization of this technology spreads quickly. A key characteristic of the Baluchistan region is its traditional way of life. Strong family ties and a close-knit community foster awareness of each other's experiences and events. This social and cultural context facilitates the rapid spread of technological adoption and use. These results are in line with the findings of Verkasalo et al. (2010), and they underscore the need for adoption models to integrate culturally sensitive variables, especially in traditional societies.

Personality traits were another notable predictor, suggesting that intrinsic differences in risk tolerance, openness to innovation, and financial behavior play a non-negligible role in shaping acceptance. Individuals with higher levels of financial self-efficacy and a proclivity for autonomy may be more inclined to experiment with decentralized digital systems. This is especially relevant in regions where formal financial literacy programs are lacking, and people rely heavily on personal judgment and social cues. The findings are consistent with prior studies by Özbek et al. (2014) and Svendsen et al. (2013), which emphasized the role of personality in shaping technology adoption.

Managerial and legal factors further contributed to explaining the variance in adoption behavior. In the absence of clear governmental regulations, individuals often interpret legal ambiguity as a space for opportunity rather than deterrence. The lack of taxation on cryptocurrency transactions, in conjunction with inadequate financial oversight, creates incentives for informal economic activities, including tax evasion and capital mobility. Rahayu (2022) highlights how such loopholes can contribute to the growth of underground economies. In Baluchistan, where institutional trust is already limited, the perception of regulatory gaps serves as a functional enabler of adoption. For many cryptocurrency holders in Iran, tax avoidance is a primary motivator for cryptocurrency trading. Transactions carried out using cryptocurrency as a substitute for cash are not currently subject to tax reporting due to the absence of specific regulations regarding cryptocurrency transactions.

Trust in the cryptocurrency market was also statistically significant, albeit with a smaller effect size. This reflects the dual nature of trust in high-risk environments. On one hand, technological trust facilitates participation by reducing perceived uncertainty; on the other hand, necessity-driven behavior may override cautious evaluation. Setiawan and Widanta (2021), Folkinshteyn and Lennon (2016), Dhagarra et al. (2020), Wang et al. (2015), and Chang et al. (2017) all emphasize the foundational role of trust in shaping digital engagement. In Baluchistan, trust appears to stem more from communal reinforcement and anecdotal success stories than from systematic evaluation of cryptocurrency platforms. This dynamic warrants closer examination, especially as fraudulent schemes remain a risk.

An additional layer of complexity in Baluchistan concerns religious interpretations of cryptocurrency. The region's deeply rooted Islamic traditions introduce ethical and jurisprudential hesitations about whether trading digital currencies is *halal* (permissible) or *haram* (forbidden). While this study did not measure religiosity directly, it observed that some respondents expressed concern about the Shariah-compliance of their financial decisions. Hasan et al. (2023) and Shahab et al. (2022) have debated the Islamic legitimacy of cryptocurrencies, particularly about speculation (*maysir*) and uncertainty (*gharar*). These perspectives merit deeper qualitative exploration in future studies, especially as religious endorsement or condemnation can significantly alter user behavior in Islamic communities.

Multicollinearity diagnostics confirm that the predictors are statistically independent, bolstering the credibility of the regression model. These results reveal a complex but coherent picture of cryptocurrency adoption in Baluchistan, one that integrates structural economic hardship, sociocultural norms, personal agency, regulatory ambiguity, and emerging trust in decentralized finance. By contextualizing these findings within Baluchistan's unique socio-economic and political landscape, this study not only contributes to the literature on digital finance but also offers practical insights for policymakers, financial educators, and regulatory bodies seeking to engage with marginalized populations.

These findings directly address and affirm all research questions, while also challenging the universality of mainstream technology adoption models. They highlight the necessity of developing contextually grounded frameworks to understand digital finance in marginalized and transitional settings. These results offer several insights. First, the dominance of income and economic fluctuations as predictors underscores the role of cryptocurrencies as a survival mechanism in Baluchistan, contrasting with their speculative role in developed economies. Second, the significant influence of social and personality factors highlights the interplay of cultural and individual dynamics, extending global adoption models (e.g., TAM) to a marginalized context. Third, the weaker role of trust suggests that necessity-driven adoption may bypass conventional trust-building processes, a finding with implications for policymakers aiming to regulate cryptocurrencies in unstable economies. Compared to prior studies (e.g., Xia, 2022; Shahzad et al., 2024), which emphasize universal factors like ease of use, this analysis reveals the primacy of context-specific drivers—economic hardship, community influence, and regulatory gaps—in shaping adoption in Baluchistan.

CONCLUSIONS

This study explored the key factors influencing cryptocurrency adoption in Iran's Baluchistan region through a two-step quantitative approach: exploratory factor analysis, followed by multiple regression. The findings of the study revealed that economic factors, particularly income constraints and national financial instability, are the strongest predictors of adoption. Social influence, personality traits, institutional gaps, and trust also significantly contribute to shaping individuals' decisions to engage with cryptocurrency. These results confirm that in economically marginalized areas, necessity and perceived financial insecurity play a dominant role in motivating participation in decentralized finance.

Despite its insights, the study's focus on Baluchistan limits its generalizability, and its quantitative approach may miss nuanced user perspectives that qualitative methods could reveal. Future research can compare other Iranian regions or similar developing economies and adopt longitudinal designs to track evolving trends. To leverage cryptocurrencies for financial inclusion, Iranian policymakers should enact clear regulations, license trading platforms, and develop fair tax policies to curb fraud and underground economies. Addressing religious concerns through dialogue with Islamic scholars, enhancing security in exchanges, and offering public education on blockchain technology are also critical to fostering informed adoption. These measures can transform cryptocurrency use in Iran from a necessity-driven response to a strategic tool for economic empowerment, aligning with regional needs and global blockchain advancements seen in countries like Turkey and the United Arab Emirates.

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Market Anomalies and Investor Behavior: The January Effect in ASEAN Countries

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JEL Classification:

E22

F21

G14

Received: 25 September 2024

Revised: 23 April 2025

Accepted: 12 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study provides a fresh contribution to the literature on market anomalies, specifically the January Effect, within ASEAN capital markets.

Research Objectives: The objective of this research is to investigate the presence and extent of the January Effect by analyzing stock returns and abnormal returns of publicly listed companies in ASEAN capital markets.

Research Methods: Data were obtained through purposive sampling, resulting in a final sample of 153 companies. The research hypotheses were tested using paired sample t-tests.

Empirical Results: The findings indicate that the January Effect is evident in certain capital market indices within ASEAN but is not consistently observed across all markets. The presence of higher stock returns and abnormal returns in January does not conclusively confirm the January Effect in every instance.

Implications: Investors are advised to exercise caution and not rely solely on seasonal anomalies, a comprehensive approach that includes broader market fundamentals and macroeconomic indicators is essential for sound decision-making within ASEAN capital markets.

Keywords:

January effect; Stock return; Abnormal return; Capital market; Efficient Market Hypothesis

How to Cite:

Mubaroq, A. C., Setyorini, C. T., Rafinda, A., Ramdhani, P. F., Alhendi, O., & Ikhsanudin, M. A. (2025). Market Anomalies and Investor Behavior: The January Effect in ASEAN Countries. *Etikonomi*, 24(2), 407 – 424. <https://doi.org/10.15408/etk.v24i2.41491>.

INTRODUCTION

Capital markets play a vital role in the economic development of a country. Various metrics and correlations are used to evaluate and test capital market dynamics, such as capital market performance (Acha & Akpan, 2019; Bello et al., 2022), Gross Domestic Product (GDP) (Alam & Hussein, 2019), and sukuk performance (Sari et al., 2018; Tan & Shafi, 2021), among other indicators. The primary goal of measuring economic growth through capital markets often centers on raising investment capital. Short-term capital is typically obtained through money market instruments, while long-term funding is secured through the issuance of shares and bonds. Capital markets offer an alternative source of funding, particularly for high-risk ventures that are underserved by traditional banks (Algaeed, 2021). Entrepreneurs can leverage these markets to access additional capital and expand their business networks (Cumming et al., 2021).

Predicting capital market movements is notoriously difficult (Paramita & Mohanty, 2019), prompting analysts and investors to study market behavior for more accurate forecasting. A key measure of market efficiency is how quickly and accurately prices adjust to new information. In an efficient capital market, security prices fully reflect all relevant information (Marisetty & Madasu, 2021), ensuring fair valuation at any given time. Two important concepts in this field are the Efficient Market Hypothesis (EMH) and Post-Announcement Drift. EMH is a cornerstone of modern financial theory, proposing that stock prices always incorporate available information when markets are informationally efficient (Kim et al., 2019). This assumption underpins many long-term investment strategies used by financial institutions, investors, and regulators (Vochozka et al., 2020).

Post-Announcement Drift, on the other hand, describes the phenomenon where stock prices continue to move in the direction of significant announcements, even after the information becomes public. In a truly efficient market, stock prices would follow a random walk pattern, determined solely by future information. Under these conditions, the opportunity to earn abnormal returns would be negligible (Asnawi et al., 2020). In reality, however, markets often fail to digest information quickly or completely, resulting in irregular price movements and abnormal returns (Anshari et al., 2020). Investors frequently exploit these inefficiencies, as seen in the Indian capital market and historically in the U.S. capital market during the 1900s (Plastun & Plastun, 2018), as well as more recent studies of the NYSE and LSE in 2012 (Tkalcovic & Schimiedecke, 2019) and the Oslo Stock Exchange between 1980 and 2019 (Tørmoen & Vigdel, 2021). These observations challenge the EMH, with market anomalies, such as the January Effect, serving as key counterexamples.

Abnormal returns, which deviate from expected investment outcomes, are frequently linked to such anomalies. One of the most recognized is the January Effect, where stock prices tend to rise in January and, in some instances, decline in December (Guo, 2022). This anomaly evolved from earlier effects, such as the weekend effect, day-of-the-week effect, holiday effect, and thirteenth-day effect, many of which have since lost

relevance. Although the January Effect has been widely researched, questions remain about its consistency, underlying causes, and impact across sectors. Scholars have proposed various explanations. Arendas et al. (2021) outlined several potential causes: (1) tax-loss selling—investors sell underperforming stocks at year-end to offset tax liabilities; (2) window dressing—portfolio managers sell poor-performing stocks to enhance end-of-year reporting; (3) small-stock beta, many firms release financial reports in January, influencing investor sentiment; and (4) a predictive pattern where strong January returns signal continued performance for the remainder of the year.

Emerging markets, particularly in Southeast Asia, show signs that such anomalies may persist due to unique market structures and investor behaviors. While several studies have explored the January Effect in Indonesia, findings vary. For example, Kusuma et al. (2021) observed that stock returns influence the January Effect in LQ-45 companies, a conclusion also supported by Avdalović & Milenković (2017) in Balkan equity markets, and by Maxhuni (2022) and Plastun (2018), who found similar results. However, other studies have refuted these findings, arguing that stock returns do not significantly impact or reflect the January Effect. Dewi & Santosa (2019) studied firms listed on the Indonesia Stock Exchange (IDX), while Ghallabi et al. (2024), Andrianto & Mirza (2016), and Enow (2024) examined various indexes, including the Islamic index, Nikkei 225, JSE, CAC 40, DAX, and NASDAQ. Similarly, Garay Alvarado & Demmler (2019), Kiprono (2018), and Tkalcovic & Schimiedecke (2019) examined the Mexican Stock Market Index and major global exchanges, finding no evidence of the January Effect in those contexts.

Abnormal returns, frequently associated with market anomalies, have also drawn conflicting interpretations. Some research supports their influence on the January Effect. For instance, Rahmadan et al. (2023) analyzed technology firms on the IDX, while Azzahra & Putri (2023) examined LQ-45 index companies, both concluding that abnormal returns impact the January Effect. In contrast, Dewi & Santosa (2019), focusing on IDX30 firms, and Ansori & Wiagustini (2018), studying the JII index, found no significant relationship between abnormal returns and the January Effect.

This research is distinct in its regional scope, analyzing capital markets across Southeast Asia collectively rather than in isolation. This approach provides comparative insights into how the January Effect manifests in different yet economically and culturally connected markets. The regional focus is critical, given Southeast Asia's increasing economic influence and diverse market conditions. These conditions offer a rich context for testing whether anomalies like the January Effect are globally consistent or vary by market structure and investor behavior (Eduah et al., 2024). This analysis contributes to the broader theoretical debate on the EMH and market anomalies, while also delivering practical insights for investors, analysts, and policymakers navigating emerging markets.

The main objective of this study is to examine the existence and consistency of the January Effect across Southeast Asian capital markets by comparing stock returns and abnormal returns in January versus other months. This research contributes in three key ways: first, by filling a gap in regional anomaly research within emerging markets;

second, by expanding the understanding of whether market anomalies are universal or context-specific; and third, by providing empirical evidence that can guide investment strategies and inform regulatory frameworks across Southeast Asia.

METHODS

This study adopts a quantitative comparative approach to analyze differences in stock returns and abnormal returns among companies listed on selected ASEAN capital market indices. The research focuses on six major indices in Southeast Asia: FBMKLCI (Malaysia), LQ45 (Indonesia), PSEi (Philippines), SET50 (Thailand), STI (Singapore), and HNX30 (Vietnam), covering the period from 2020 to 2022. These indices were selected to reflect a blend of developed and emerging markets within the ASEAN region, thereby enabling a meaningful cross-country comparison.

The sampling method used is purposive sampling, with the following inclusion criteria: (1) companies must have been consistently listed in their respective index throughout the 2020–2022 period; (2) they must have complete and accessible stock price data and reporting information for the duration of the study; and (3) they must not have engaged in extraordinary corporate actions—such as mergers, stock splits, acquisitions, or delisting, that could materially distort stock price movements during the observation period. Based on these criteria, a total of 153 companies were selected. After the removal of outliers to ensure data integrity and robustness, the final dataset comprised 432 stock return observations and 444 abnormal return observations.

The study utilizes secondary data obtained from reliable financial sources, including the official websites of stock exchanges—Bursa Malaysia, Indonesia Stock Exchange (IDX), Philippine Stock Exchange (PSE), Stock Exchange of Thailand (SET), Singapore Exchange (SGX), and Hanoi Stock Exchange (HNX)—as well as global financial platforms such as Investing.com and Yahoo Finance. Stock returns are calculated using the daily closing price method, defined as the percentage change in price between two consecutive trading days. Abnormal returns are computed using the Market Model, which estimates expected returns based on a stock's historical relationship with the relevant market index. Abnormal return is defined as the difference between the actual return and the expected return on a given trading day, isolating the portion of the return not explained by general market movements.

The analysis is conducted using SPSS version 26. The primary statistical test employed is the Paired Sample t-Test, used to compare mean stock returns and abnormal returns between January (Group 1) and the rest of the year (February to December, Group 2). Prior to hypothesis testing, the dataset is assessed for normality using the Kolmogorov–Smirnov test and evaluated for other key statistical assumptions, including homogeneity of variances, to ensure the validity of the results. The outcomes of this analysis are interpreted to determine whether statistically significant differences exist between January and non-January periods, thereby testing the presence and extent of the January Effect in the selected ASEAN markets.

RESULT AND DISCUSSION

This study begins with an analysis of descriptive statistics to examine the characteristics of stock return and abnormal return data across six ASEAN stock indices, FBMKLCI (Malaysia), LQ45 (Indonesia), PSEi (Philippines), SET50 (Thailand), STI (Singapore), and HNX30 (Vietnam)—for the period 2020 to 2022. As shown in Table 1, the results reveal significant variability in returns, particularly during January, aligning with the commonly observed “January Effect” anomaly. For instance, the LQ45 index recorded a minimum return of -0.214 in January 2020 and a maximum return of 0.085 in January 2022. Similarly, the PSEi index reported the highest January return at 0.189 in 2022, while the SET50 index posted the lowest January return at -0.254 in 2020.

On average, January returns are either lower or more volatile than returns during the rest of the year. Notably, in January 2020, all indices except HNX showed negative average returns, reflecting a broad market downturn likely driven by the uncertainty surrounding the onset of the COVID-19 pandemic. In contrast, non-January returns generally display more stable and positive average values, suggesting reduced volatility outside the January period. For example, the FBMKLCI index had a mean January return of -0.043 in 2020, compared to a non-January mean return of 0.002. Similar patterns are evident in the LQ45 and PSEi indices.

Table 1. Descriptive Stock Return Statistics

Month	N	2020			2021			2022		
		Min	Max	Mean	Min	Max	Mean	Min	Max	Mean
FBM January	24	-0.158	0.042	-0.043	-0.132	0.017	-0.067	-0.128	0.050	-0.037
FBM Non-january	24	-0.015	0.021	0.002	-0.018	0.035	0.008	-0.013	0.033	0.005
LQ January	25	-0.214	0.023	-0.072	-0.187	0.078	-0.078	-0.095	0.085	0.003
LQ Non-january	25	-0.021	0.053	0.011	-0.044	0.068	0.006	-0.033	0.063	0.010
PSE January	23	-0.203	0.011	-0.088	-0.158	0.059	-0.069	-0.064	0.189	0.047
PSE Non-january	23	-0.024	0.039	0.011	-0.013	0.058	0.013	-0.041	0.010	-0.007
SET January	31	-0.254	0.181	-0.025	-0.112	0.124	0.005	-0.123	0.114	0.007
SET Non-january	31	-0.031	0.032	-0.005	-0.018	0.039	0.010	-0.031	0.040	0.004
STI January	24	-0.152	0.061	-0.033	-0.104	0.115	0.010	-0.111	0.140	0.014
STI Non-january	24	-0.046	0.022	-0.003	-0.035	0.034	0.001	-0.024	0.039	0.005
HNX January	17	-0.172	0.136	-0.034	-0.216	0.460	0.009	-0.286	0.462	-0.090
HNX Non-january	17	0.002	0.159	0.061	0.024	0.303	0.105	-0.113	0.025	-0.045

Source: Data processed

Table 1 presents the descriptive statistics of stock returns for various indices across ASEAN markets during the 2020–2022 period. For the FBMKLCI index, the minimum return was -0.158 in 2020, recorded by PETRONAS Chemicals Group Bhd (5183),

while the maximum return was 0.050 in 2022, recorded by Hong Leong Financial Group (1082). In the LQ45 index, the lowest return was -0.214 in 2020, posted by Perusahaan Gas Negara Tbk (PGAS), and the highest was 0.085 in 2022, achieved by Bank Negara Indonesia (Persero) Tbk (BBNI). For the PSEi index, the minimum return was -0.203 in 2020, attributed to GT Capital Holdings Inc. (GTCAP), and the maximum was 0.189 in 2022, recorded by Aboitiz Power Corporation (AP). The SET50 index showed a minimum return of -0.254 in 2020, from Thai Oil Pcl (TOP), and a maximum return of 0.181, posted by B. Grimm Power Pcl (BGRIM). In the STI index, the lowest return was -0.152 in 2020, observed in Yangzijiang Shipbuilding Holdings (BS6), and the highest was 0.140 in 2022, recorded by Sembcorp Industries (U39). Finally, the HNX30 index recorded the widest return range, with a minimum of -0.286 in 2020 by Tri Viet Asset Management Corporation Joint Stock Company (TVC), and a maximum of 0.462 in 2022 by Licogi 14 JSC (L14).

Table 2 provides descriptive statistics for abnormal returns, offering further insight into return variability across the ASEAN indices. As observed with stock returns, abnormal returns during January tend to show greater volatility. The most extreme abnormal return occurred in the HNX30 index, with a maximum of 0.361 in 2021 and a minimum of -0.423, highlighting the high volatility of the Vietnamese market, likely driven by speculative trading behavior. On average, abnormal returns in January are slightly negative or hover near zero, whereas abnormal returns in non-January months tend to cluster more tightly around zero. This pattern suggests a higher degree of market efficiency during non-seasonal months, in line with expectations from efficient market theory.

Table 2. Descriptive Statistics of Abnormal Returns

Indices	N	2020			2021			2022		
		Min	Max	Mean	Min	Max	Mean	Min	Max	Mean
FBM January	25	-0.105	0.092	0.001	-0.091	0.076	-0.031	-0.091	0.129	0.000
FBM Non-january	25	-0.008	0.010	0.000	-0.007	0.008	0.003	-0.012	0.008	0.000
LQ January	27	-0.160	0.093	-0.008	-0.186	0.284	-0.012	-0.227	0.070	-0.022
LQ Non-january	27	-0.008	0.015	0.001	-0.026	0.017	0.001	-0.006	0.021	0.002
PSE January	23	-0.140	0.103	-0.019	-0.081	0.066	-0.004	-0.099	0.147	0.016
PSE Non-january	23	-0.009	0.013	0.002	-0.006	0.007	0.000	-0.013	0.009	-0.001
SET January	33	-0.171	0.222	0.014	-0.105	0.112	-0.004	-0.120	0.108	0.011
SET Non-january	33	-0.020	0.016	-0.001	-0.010	0.011	0.001	-0.010	0.011	-0.001
STI January	24	-0.136	0.062	-0.013	-0.101	0.117	-0.003	-0.122	0.061	-0.024
STI Non-january	24	-0.006	0.012	0.001	-0.011	0.009	0.000	-0.006	0.011	0.002
HNX January	16	-0.154	0.128	-0.033	-0.423	0.361	-0.017	-0.230	0.085	-0.112
HNX Non-january	16	-0.012	0.014	0.003	-0.033	0.038	0.002	-0.008	0.021	0.010

Source: Data processed

Table 2 reports the minimum, maximum, and average (mean) abnormal returns for each index over the 2020–2022 period. For the FBMKLCI index, the minimum abnormal return was -0.105, recorded by PETRONAS Chemicals Group Bhd (5183) in 2020, while the maximum was 0.129, observed in Press Metal Aluminum Holdings (8869) in 2022. In the LQ45 index, the lowest abnormal return was -0.227 by Aneka Tambang Tbk. (ANTM) in 2022, and the highest was 0.284 by Indah Kiat Pulp & Paper Tbk. (INKP) in 2021.

For the PSEi index, LT Group Inc. (LTG) posted the minimum abnormal return of -0.140 in 2020, while Aboitiz Power Corporation (AP) recorded the maximum of 0.147 in 2022. The SET50 index showed a minimum of -0.171 from Thai Oil Pcl (TOP) and a maximum of 0.222 from B. Grimm Power Pcl (BGRIM), both in 2020. In the STI index, the lowest abnormal return was -0.136 in 2020 by Yangzijiang Shipbuilding Holdings (BS6), and the highest was 0.117 in 2021, recorded by Thai Beverage (Y92). Lastly, for the HNX30 index, the minimum abnormal return was -0.423 in 2021 by C.E.O Group Joint Stock Company (CEO), while the maximum was 0.361, posted by NETLAND Real Estate Joint Stock Company (NRC), also in 2021.

Table 3. Normality Test of Stock Returns

Indecs	N	2020			2021			2022		
		Mean	Std. Dev	Sig	Mean	Std. Dev	Sig	Mean	Std. Dev	Sig
FBM January	24	-0.043	0.043	0.200	-0.067	0.039	0.200	-0.037	0.052	0.200
FBM Non-january	24	0.002	0.009	0.117	0.008	0.014	0.200	0.005	0.009	0.109
LQ January	25	-0.072	0.069	0.200	-0.078	0.069	0.200	0.003	0.048	0.200
LQ Non-january	25	0.011	0.020	0.078	0.006	0.025	0.192	0.010	0.024	0.200
PSE January	23	-0.088	0.061	0.054	-0.069	0.049	0.200	0.047	0.072	0.113
PSE Non-january	23	0.011	0.016	0.200	0.013	0.019	0.200	-0.007	0.013	0.124
SET January	31	-0.025	0.097	0.106	0.005	0.052	0.200	0.007	0.061	0.200
SET Non-january	31	-0.005	0.013	0.200	0.010	0.014	0.200	0.004	0.016	0.200
STI January	24	-0.033	0.053	0.200	0.010	0.061	0.200	0.014	0.064	0.200
STI Non-january	24	-0.003	0.017	0.127	0.001	0.015	0.060	0.005	0.015	0.200
HNX January	17	-0.034	0.084	0.200	0.009	0.162	0.200	-0.090	0.177	0.116
HNX Non-january	17	0.061	0.038	0.145	0.105	0.068	0.134	-0.045	0.041	0.200

Source: Data processed

Before conducting hypothesis testing, the study assessed data normality using the Kolmogorov–Smirnov test (Tables 3 and 4). The results show that both return and abnormal return data are normally distributed across all indices and periods, as indicated by significance values greater than the 0.05 threshold. This result confirms that the data

meet the assumptions required for the application of the Paired Sample t-Test. The detailed results of the normality tests are presented in Table 3.

Table 3 presents the results of the stock return normality test for each index during the 2020–2021 period. The significance values from the Kolmogorov–Smirnov test are all above the 0.05 threshold, indicating that the stock return data for all indices are normally distributed.

Table 4. Abnormal Return Normality Test

Indecs	N	2020			2021			2022		
		Mean	Std. Dev	Sig	Mean	Std. Dev	Sig	Mean	Std. Dev	Sig
FBM January	25	0.001	0.042	0.200	-0.031	0.044	0.198	0.000	0.051	0.200
FBM Non-january	25	0.000	0.004	0.200	0.003	0.004	0.198	0.000	0.005	0.200
LQ January	27	-0.008	0.072	0.190	-0.012	0.113	0.171	-0.022	0.058	0.200
LQ Non-january	27	0.001	0.007	0.190	0.001	0.010	0.171	0.002	0.005	0.200
PSE January	23	-0.019	0.059	0.200	-0.004	0.035	0.149	0.016	0.067	0.200
PSE Non-january	23	0.002	0.005	0.200	0.000	0.003	0.149	-0.001	0.006	0.200
SET January	33	0.014	0.093	0.200	-0.004	0.054	0.200	0.011	0.056	0.200
SET Non-january	33	-0.001	0.008	0.200	0.001	0.005	0.200	-0.001	0.005	0.200
STI January	24	-0.013	0.048	0.120	-0.003	0.060	0.200	-0.024	0.056	0.200
STI Non-january	24	0.001	0.004	0.120	0.000	0.005	0.200	0.002	0.005	0.200
HNX January	16	-0.033	0.084	0.200	-0.017	0.167	0.200	-0.112	0.086	0.200
HNX Non-january	16	0.003	0.008	0.200	0.002	0.015	0.200	0.010	0.008	0.200

Source: Data processed

Table 4 presents the results of the abnormal return normality test. The significance values for both January and non-January periods across all indices exceed the 0.05 threshold, indicating that the abnormal return data are normally distributed. Therefore, the assumption of normality required for the Paired Sample t-Test is satisfied. The analysis used to test the research hypothesis is the Paired Sample t-Test. This statistical method compares two related samples to identify whether there is a significant difference between them. The results of the Paired Sample t-Test for each index during the 2020–2022 period are presented in Table 5.

Table 5 presents the results of the Paired Sample t-Test for stock index returns across various ASEAN countries. For the FBMKLCI index, the significance values for all three consecutive years are below 0.05 (<0.05), indicating a statistically significant difference in stock returns between January and the other months during the 2020–2022 period. In the LQ45 index, the significance values for 2020 and 2021 are also below 0.05, suggesting differences in stock returns between January and non-January months during those years. However, in 2022, the significance value is

0.447 (above 0.05), indicating no significant difference in stock returns for that year. The PSEi index shows significance values below 0.05 for all three years, confirming consistent differences in stock returns between January and other months from 2020 to 2022.

Table 5. Paired T-test Return Test

	t	df	Sig. (2-tailed)	Information
FBM_JANUARY_20 - FBM_NONJANUARY_20	-4.777	23	0.000	Significant
FBM_JANUARY_21 - FBM_NONJANUARY_21	-7.639	23	0.000	Significant
FBM_JANUARY_22 - FBM_NONJANUARY_22	-4.092	23	0.000	Significant
LQ_JANUARY_20 - LQ_NONJANUARY_20	-5.056	24	0.000	Significant
LQ_JANUARY_21 - LQ_NONJANUARY_21	-5.401	24	0.000	Significant
LQ_JANUARY_22 - LQ_NONJANUARY_22	-0.773	24	0.447	Not Significant
PSE_JANUARY_20 - PSE_NONJANUARY_20	-7.188	22	0.000	Significant
PSE_JANUARY_21 - PSE_NONJANUARY_21	-7.374	22	0.000	Significant
PSE_JANUARY_22 - PSE_NONJANUARY_22	3.616	22	0.002	Significant
SET_JANUARY_20 - SET_NONJANUAR_20	-1.098	30	0.281	Not Significant
SET_JANUARY_21 - SET_NONJANUARY_21	-0.523	30	0.605	Not Significant
SET_JANUARY_22 - SET_NONJANUARY_22	0.272	30	0.788	Not Significant
STI_JANUARY_20 - STI_NONJANUARY_20	-2.676	23	0.013	Significant
STI_JANUARY_21 - STI_NONJANUARY_21	0.656	23	0.519	Not Significant
STI_JANUARY_22 - STI_NONJANUARY_22	0.667	23	0.511	Not Significant
HNX_JANUARY_20 - HNX_NONJANUARY_20	-3.836	16	0.001	Significant
HNX_JANUARY_21 - HNX_NONJANUARY_21	-2.004	16	0.062	Not Significant
HNX_JANUARY_22 - HNX_NONJANUARY_22	-1.041	16	0.313	Not Significant

Source: Data processed

Conversely, the SET50 index shows significance values above 0.05 across the 2020–2022 period, indicating no statistically significant difference in returns between January and the rest of the year. For the STI index, the 2020 significance value is 0.013 (below 0.05), suggesting a notable difference in returns. However, in 2021 and 2022, the significance values are above 0.05, indicating no significant return differences in those years.

Table 6 presents the significance values of abnormal returns across stock indices in ASEAN countries. For the FBMKLCI index, the abnormal return significance values in 2020 and 2022 are above 0.05, indicating no significant difference in abnormal returns between January and the other months. However, in 2021, the significance value is 0.002 (below 0.05), suggesting a statistically significant difference in abnormal returns

for that year. In the LQ45 index, the significance values for all three years (2020–2022) are above 0.05, indicating no significant change in abnormal returns between January and non-January months.

The same pattern is observed in the PSEi and SET50 indices, where no significant differences in abnormal returns are found across the three years. For the STI index, the significance values in 2020 and 2021 are above 0.05, showing no notable change in abnormal returns between January and the rest of the year. However, in 2022, the significance value is 0.045 (below 0.05), indicating a significant difference in abnormal returns for that year. Regarding the HNX30 index, the significance values in 2020 and 2021 are above 0.05, suggesting no meaningful difference in abnormal returns between January and non-January periods. In contrast, the 2022 significance value is below 0.05, confirming a statistically significant difference in abnormal returns for that year.

Table 6. Paired t-test Abnormal Return Test

	t	df	Sig. (2-tailed)	Information
FBM_JANUARY_20 - FBM_NONJANUARY_20	0.131	24	0.896	Not Significant
FBM_JANUARY_21 - FBM_NONJANUARY_21	-3.471	24	0.002	Significant
FBM_JANUARY_22 - FBM_NONJANUARY_22	-0.024	24	0.981	Not Significant
LQ_JANUARY_20 - LQ_NONJANUARY_20	-0.547	26	0.589	Not Significant
LQ_JANUARY_21 - LQ_NONJANUARY_21	-0.567	26	0.576	Not Significant
LQ_JANUARY_22 - LQ_NONJANUARY_22	-1.950	26	0.062	Not Significant
PSE_JANUARY_20 - PSE_NONJANUARY_20	-1.576	22	0.129	Not Significant
PSE_JANUARY_21 - PSE_NONJANUARY_21	-0.534	22	0.599	Not Significant
PSE_JANUARY_22 - PSE_NONJANUARY_22	1.147	22	0.264	Not Significant
SET_JANUARY_20 - SET_NONJANUARY_20	0.866	32	0.393	Not Significant
SET_JANUARY_21 - SET_NONJANUARY_21	-0.478	32	0.636	Not Significant
SET_JANUARY_22 - SET_NONJANUARY_22	1.153	32	0.258	Not Significant
STI_JANUARY_20 - STI_NONJANUARY_20	-1.340	23	0.193	Not Significant
STI_JANUARY_21 - STI_NONJANUARY_21	-0.253	23	0.803	Not Significant
STI_JANUARY_22 - STI_NONJANUARY_22	-2.117	23	0.045	Significant
HNX_JANUARY_20 - HNX_NONJANUARY_20	-1.596	15	0.131	Not Significant
HNX_JANUARY_21 - HNX_NONJANUARY_21	-0.415	15	0.684	Not Significant
HNX_JANUARY_22 - HNX_NONJANUARY_22	-5.216	15	0.000	Significant

Source: Data processed, 2023

DISCUSSION

The Paired Sample t-Test results across the six ASEAN stock indices, FBMKLCI (Malaysia), LQ45 (Indonesia), PSEi (Philippines), SET50 (Thailand), STI (Singapore), and HNX30 (Vietnam), reveal statistically significant differences in some instances. However, these differences are neither consistent nor uniformly indicative of the January Effect. This inconsistency suggests that while return or abnormal return anomalies may occur, they do not follow a repeatable seasonal pattern strong enough to support the classical interpretation of the January Effect. Instead, these anomalies appear to be sporadic and episodic, shaped by context-specific factors rather than by a universal seasonal trend.

In financial theory, the January Effect is defined as a persistent and predictable rise in stock prices during January, historically attributed to tax-loss harvesting (Ooi, 2025; Roni, 2022), institutional portfolio rebalancing (López-Martín, 2023), or behavioral biases (Shanaev & Ghimire, 2021). However, the findings of this study challenge the applicability of that model within the ASEAN context. When empirically tested across diverse emerging markets in Southeast Asia, seasonal anomalies lack the consistency and directionality that would confirm the existence of a systematic January Effect.

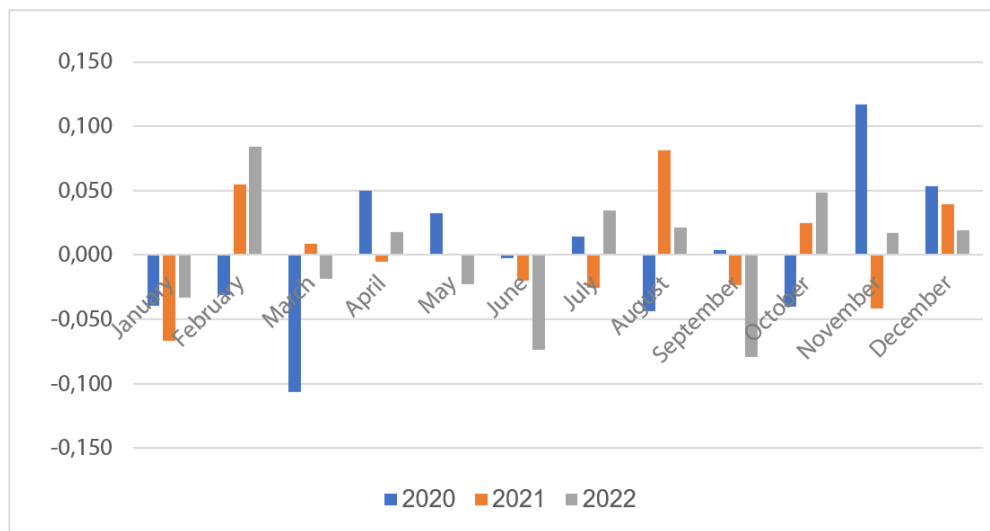
More specifically, the analysis reveals that differences in January returns are more prominent when examined through raw returns rather than abnormal returns. This discrepancy provides a critical insight: when market-adjusted measures are applied—those accounting for expected returns or systematic market risk—the strength of the anomaly diminishes. In financial analysis, abnormal returns serve as more reliable indicators of inefficiency because they isolate returns that exceed market expectations. Thus, the decline in statistical significance when transitioning from raw returns to abnormal returns reinforces the interpretation that observed January gains are more likely a reflection of market volatility or systemic noise, rather than evidence of genuine seasonal inefficiency.

The case of the FBMKLCI index from Bursa Malaysia illustrates this point well. Although the t-test indicated statistically significant differences in returns during the 2020–2021 period, a visual inspection of the return distribution (Figure 1) shows that January returns were not consistently higher than those in subsequent months. This result underscores a key conclusion: statistical significance alone, without a consistent upward January bias, is insufficient to confirm the presence of the January Effect. As such, statistical findings must be interpreted within the broader context of economic significance and directional consistency—both of which are absent in this study.

The distinctive contribution of this research, in contrast to prior studies, lies in its regional and comparative scope, offering a broader and more integrative analysis across multiple ASEAN capital markets rather than focusing on a single national context. Komariah et al. (2022) identified statistically significant differences in monthly returns

but concluded that these did not follow a predictable pattern consistent with the January Effect. Evianti et al. (2024) detected signs of the anomaly in the earlier years of their sample, but noted its disappearance in later periods, illustrating its temporal instability. Similarly, Latifa & Atikah (2024) found no significant differences in returns or abnormal returns, reinforcing the notion that such anomalies are likely episodic and context-dependent rather than systematic or persistent.

Figure 1. Distribution of Returns FBMKLCI



This study also highlights several underlying factors that may explain the lack of consistency in the January Effect across ASEAN markets. One major factor is the impact of the COVID-19 pandemic. In 2020, most ASEAN markets experienced heightened volatility, government interventions, and shifts in investor sentiment (Solihin et al., 2022). The higher incidence of significant return differences during that year supports the view that macroeconomic uncertainty, rather than seasonal behavior, may drive short-term return anomalies. In times of crisis, investor overreaction, liquidity constraints, and a flight-to-safety mentality can disrupt usual trading patterns, creating the illusion of seasonal anomalies that are driven by exogenous shocks (Kasim et al., 2022).

A second factor is the structural composition of the indices used in this study. The focus on large-cap indices may reduce the likelihood of detecting the January Effect. Foundational studies, including Rozeff & Kinney Jr. (1976), argue that the January Effect is predominantly a small-cap phenomenon, influenced by investor neglect, illiquidity premiums, and greater susceptibility to behavioral biases (Szymański & Wojtalik, 2020). Large-cap stocks, by contrast, are closely monitored by analysts, actively traded, and more efficiently priced, which reduces the opportunity for persistent seasonal anomalies. Therefore, the sampling bias toward large-cap indices in this study may structurally limit the detectability of calendar-based effects.

Cultural and behavioral factors also play a role. Investor behavior in ASEAN countries tends to be more conservative, with relatively low participation from retail investors compared to Western markets. Cultural norms surrounding the end of the year, such as religious observances, increased risk aversion during uncertain periods, and generally lower levels of financial literacy, may limit practices like year-end portfolio rebalancing or tax-loss selling, which are key mechanisms often cited as drivers of the January Effect in developed economies (Wissawapaisal, 2023). As noted by Shahid & Sattar (2017), cultural and behavioral contexts influence investor decisions and reduce the likelihood of cyclical trading behavior. In contrast, investors in Western markets often engage in aggressive year-end financial adjustments influenced by tax planning, institutional mandates, and consumption cycles, thereby creating the conditions for predictable January price increases.

From a theoretical perspective, these findings lend support to the Efficient Market Hypothesis (EMH), particularly in its semi-strong form. EMH posits that all publicly available information is quickly and accurately reflected in stock prices, leaving no room for consistent abnormal returns. The absence of robust January anomalies across ASEAN indices suggests that prices generally follow a random walk and that any deviations are likely short-lived or the result of external shocks, rather than persistent inefficiencies (Dewi & Santosa, 2019). According to EMH, if market participants act rationally and information is disseminated symmetrically and absorbed efficiently, calendar anomalies such as the January Effect should not persist (Çakır, 2023).

Furthermore, from a behavioral finance standpoint, the lack of a consistent January Effect may reflect the bounded rationality of investors in less developed markets. In contexts where heuristics and cognitive biases such as overconfidence, loss aversion, and anchoring do not strongly influence calendar-based trading, seasonal anomalies are less likely to manifest (Haataja, 2021). Additionally, ASEAN markets may lack the institutional dynamics, such as mutual fund window dressing or year-end pension fund reallocations, that typically contribute to seasonal patterns in more mature financial systems.

CONCLUSION

This research aimed to examine the presence and consistency of the January Effect in six major ASEAN stock indices—FBMKLCI, LQ45, PSEi, SET50, STI, and HNX over the 2020-2022 period, using a comparative quantitative approach. The results indicate that although some indices exhibited statistically significant differences in January returns, these occurrences were sporadic and lacked consistency across years and markets. When returns were adjusted using the market model to calculate abnormal returns, the significance of these differences vastly diminished. This result suggests that the observed variations were more likely driven by external shocks and general market volatility rather than by a true seasonal anomaly.

Based on these findings, the study concludes that the January Effect is neither persistent nor generalizable in ASEAN capital markets during the observed period. The results support the Efficient Market Hypothesis (EMH), particularly in its semi-strong form, which posits that publicly available information is quickly incorporated into stock prices, limiting the potential for systematic seasonal anomalies. The study offers meaningful implications for investors, regulators, and researchers. For policymakers and market authorities, the findings underscore the importance of promoting broader market participation, particularly from retail and institutional investors, while also enhancing transparency, investor education, and access to information. Such measures could contribute to improved price discovery and greater overall market efficiency.

However, several limitations should be acknowledged. These include the relatively short three-year observation period, the exclusive focus on large-cap index constituents, and the influence of macroeconomic disruptions such as the COVID-19 pandemic, all of which may affect the generalizability of the results. Future research is encouraged to address these limitations by extending the study period, including small-cap or sector-specific indices, and incorporating additional variables such as trading volume or investor sentiment. Applying more advanced econometric methods or integrating behavioral finance frameworks may also yield a more nuanced understanding of how seasonal effects manifest in emerging markets.

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Examining Underpricing in Initial Public Offering: Deepening Insights on Non-Financial Information

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JEL Classification:

G10

G24

G32

D82

Received: 10 June 2024

Revised: 20 April 2025

Accepted: 29 April 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: The nominal value variable from the prospectus in this study is the novelty, as no previous research has been found. Investors indicate the nominal value as a positive signal from the company to reduce existing information asymmetry.

Research Objectives: This study examines the phenomenon of IPO underpricing on the Indonesia Stock Exchange, resulting in suboptimal IPO fund-raising.

Research Methods: Using a quantitative approach with descriptive and causality designs, the study analyzed 251 companies from 2017 to 2023 through multiple linear regression analysis.

Empirical Results: Indonesia has a high IPO underpricing rate of 37.17%. Most IPOs (68.54%) were Shariah-compliant. The reputation of underwriters changed each year, and the free float ratio declined over time. On average, IPOs were oversubscribed by more than 28 times each year. Although COVID-19 affected market sentiment, it did not impact underpricing. The nominal value of IPO stocks varied each year but generally declined. Regression results show Shariah compliance and strong underwriters reduce underpricing, while higher free float, oversubscription, and nominal value increase it.

Implications: The implications of this research theoretically support signaling theory and information asymmetry. Practically, this research can be a reference for further researchers, investors, companies, and the government as regulators.

Keywords:

initial public offering; underpricing; signaling; asymmetric information; public ownership

How to Cite:

Rezky, D. M., Mahri, A. J. W., & Utami, S. A. (2025). Examining Underpricing in Initial Public Offering: Deepening Insights on Non-Financial Information. *Etikonomi*, 24(2), 425 – 440. <https://doi.org/10.15408/etk.v24i2.39355>.

INTRODUCTION

The number of companies that go public or carry out IPOs on the IDX continues to increase annually. By the end of 2023, 79 companies set an all-time high record. As for 2019-2021, the number fluctuated slightly due to disrupted business conditions and the COVID-19 pandemic, resulting in several companies delaying their share listings on the stock exchange. The phenomenon that often occurs during an initial public offering (IPO) is that the company's share price is underpriced when it is listed on the stock exchange and traded in the secondary market (Ahmad-Zaluki & Badru, 2021; Agustina et al., 2021; Putra & Lubis, 2023). Empirical evidence of high first-day returns for IPO companies is known as IPO underpricing (Mazumder & Saha, 2021). Hence, the phenomenon of underpricing in IPO stocks is a universal phenomenon (Hanafi & Hanafi, 2022).

IPO underpricing has long been a subject of intense academic scrutiny and practical debate. The phenomenon of IPO underpricing was historically first documented in the United States by Ibbotson in 1975, who found an average initial return of 11.4% for IPOs between 1960 and 1969. Since then, numerous studies have confirmed the existence of underpricing in various countries. This phenomenon has been observed in various markets, including emerging economies like Indonesia, where unique features such as a high proportion of Shariah-compliant offerings add complexity. The level of underpricing varies significantly across countries, industries, offering methods, and periods, but the presence of a positive and substantial initial return is powerful. Although the roots of underpricing date back to the last decades of the twentieth century, this topic continues to captivate market participants due to the significant transfer of wealth from the company issuing the offer to the investors who acquire shares, as a consequence of firms' IPOs (Teti & Montefusco, 2022). So that some companies generally do not tend to IPO with underpriced shares, as this would result in a transfer of wealth from the companies to the investors. On the other hand, for investors, underpricing is beneficial because they can acquire shares with high valuations at a lower price (Abbas et al., 2022).

Several theories can explain the phenomenon of underpricing, including the signaling theory, the information asymmetry theory, and the winner's curse model. Additionally, many studies have used company performance variables such as EPS, ROA, ROE, DER, etc. (Rodoni et al., 2018; Madyan et al., 2020; Bandi et al., 2020; Sonu, 2022), and also other information variables such as the reputation of underwriters, auditor reputation, macroeconomic data, and others (Sundarasan et al., 2018; Rodoni et al., 2018; Agustina et al., 2021; Albada et al., 2023).

Despite extensive research on IPO underpricing, the role of nominal value from the prospectus in this phenomenon remains underexplored. These conditions may affect investor perception and, therefore, demand and could impact initial pricing and, subsequently, the performance. This condition means that there might be less attention given to the relationship between nominal value and share price, which leads to a gap in understanding how this might impact IPO underpricing. Thus, by researching nominal value, crucial lessons can be learned about IPO pricing strategies and investor behavior.

Indonesia is one of the most attractive countries for research on sharia as it is the largest Muslim country in the world in terms of population. The phenomenon of IPO underpricing remains a critical area of financial research, particularly in emerging markets like Indonesia, where Shariah compliance adds unique dynamics to investor behavior (Hanafi & Hanafi, 2022). Shariah offers a potential contribution to the debate on optimal IPO methods and IPO underpricing issues in general, and it is expected to reduce information asymmetry and agency problems (Hanafi & Hanafi, 2022). In previous research, Bakar & Rosbi (2017), which is in line with Yaakub & Sherif (2019), concluded that sharia status has a positive effect on the level of IPO underpricing, while according to Mayes & Alqahtani (2015) sharia compliance has a negative effect which is supported by research by Mehmood et al. (2021). In addition, research conducted by Boulanouar & Alqahtani (2016), supported by Hanafi & Hanafi (2022) and Albada (2024), indicates that Sharia status has no significant effect on the level of IPO underpricing.

Apart from Sharia status, another factor considered when looking at a company that will IPO is the reputation of the underwriter. Underwriters with a good reputation will try to maintain their image and market share by successfully guaranteeing the company's IPO (Bandi et al., 2020). A better underwriter reputation can signal the quality of the company, reduce information asymmetry, and reduce the level of IPO underpricing (Hanafi & Hanafi, 2022). In previous research, Arora & Singh (2019) document that underwriter reputation is associated with higher levels of underpricing or said to have a positive effect; this research is supported by Abbas et al. (2022) as well as Hanafi & Hanafi (2022) in contrast to the research of Rodoni et al. (2018) which is also supported by Setya et al. (2020) and Hu et al. (2021) which concluded that reputable underwriters have a negative effect on the level of underpricing. Meanwhile, according to Agustina et al. (2021), the underwriter's reputation statistically has no significant effect on the level of underpricing.

The phenomenon of underpricing can also be influenced by external shareholders, both individuals and institutions, after the IPO, known as public ownership or public float (Michel et al., 2014). In Indonesia, the Indonesia Stock Exchange sets a minimum requirement for the number of shares owned by the public or free float shares of at least 50 million shares and at least 7.5% of the total shares listed. In previous research, Madyan et al. (2020) concluded that the post-IPO public ownership ratio has a positive effect on the level of IPO underpricing. This research is supported by Hanafi & Hanafi (2022) and Harjayanti et al. (2025), in contrast to research conducted by Macit et al. (2015), which concludes that asymmetric information proxied by the percentage of shares sold to the public has a negative effect on the level of IPO underpricing. The results of this study are supported by Kavalenka (2018), Acedo-Ramírez et al. (2019), and Panda & Guha Deb (2023). The results of research by Yuliani et al. (2019) concluded that the percentage of shares offered to the public did not affect the level of underpricing. This research is supported by Zuliardi & Witiastuti (2020), who concluded that the percentage of free float/percentage of stock offerings does not affect the IPO underpricing rate.

When a company's shares are officially listed on the Indonesia Stock Exchange, there are usually words conveyed by internal and external company parties that assist in the public offering process. One of them is the disclosure of oversubscription. Oversubscription refers to the ratio of the number of shares requested by investors to the number of shares offered (Tajuddin et al., 2018). Oversubscription can affect the level of underpricing because excess demand can cause an increase in the share price at the time of the IPO. Mehmood et al. (2021) conducted previous research that concluded there is a positive influence between oversubscription and the level of IPO underpricing, which is in line with the research of Albada et al. (2023). Meanwhile, according to the results of research by Mayes & Alqahtani (2015) and Boulanouar & Alqahtani (2016), oversubscription does not influence the level of IPO underpricing.

At the end of 2019, the world was hit by a virus pandemic called Coronavirus. In early March 2020, the Coronavirus entered Indonesia, which resulted in various activities being hampered due to the COVID-19 fear sentiment. COVID-19 has introduced a new variable pandemic-induced sentiment that has had profound effects on every field. Due to its impact on all fields, the topic of the coronavirus pandemic has become increasingly attractive to researchers around the world (Fedorova et al., 2023). One of those affected is the financial sector, in this study in particular is IPO activity, which can be seen in the data on the number of IPOs in 2019-2020 which has decreased and when the new normal 2020-2021 begins to be applied, it grows again but not so much and when the sentiment of Covid-19 fear begins to subside, IPOs in 2022-2023 begin to grow rapidly. COVID-19 sentiment, characterized by heightened uncertainty and volatility, can provoke episodes of widespread sales of risky assets (Zaremba et al., 2020). Integrating this variable into the analytical framework not only reflects the contemporary market milieu but also challenges conventional theories by testing them under crisis conditions. Therefore, the COVID-19 fear sentiment can also affect the behavior of investors who will buy IPO shares. Baig & Chen (2022) found that COVID-19 has a positive effect on the level of IPO underpricing. This research is supported by İlbasım (2023) as well as Zhang & Neupane (2024), which shows that Covid-19 sentiment has a significant positive relationship with the level of underpricing. In contrast to the research results of Mazumder & Saha (2021), which concluded that Covid-19 proxied by the fear index has a negative effect on initial return. This research is in line with Indrawati & Kohardinata (2022) and Meliana & Nainggolan (2023).

In conclusion, the objective of this study is to re-examine IPO underpricing through the lens of Shariah compliance, underwriter reputation, free float ratio (percentage of shares offered), oversubscription, and COVID-19 sentiment in Indonesia. In this market, Islamic finance and pandemic recovery intersect. By resolving contradictions in prior literature (e.g., Shariah as a signal vs. a driver of overreaction) and introducing nominal value as a novel factor, we provide actionable insights for issuers, regulators, and investors navigating Indonesia's evolving IPO landscape.

METHODS

In this study, we used purposive sampling techniques based on specific criteria. These criteria are: 1) stocks of companies that IPO on the Indonesia Stock Exchange in 2017-2023; 2) stocks that experienced the underpricing phenomenon on the first day of the IPO; and 3) stocks that experienced oversubscription at the time of IPO. With these criteria, the number of samples in this study amounted to 251 shares of companies that IPO on the Indonesia Stock Exchange (IDX) between 2017 and 2023. The dependent variable in this study is underpricing IPO, and the Independent variables are Shariah Compliance, Underwriter Reputation, Free Float Ratio, Oversubscription, Covid-19 Sentiment, and Nominal Value.

Table 1. Variables Operationalization

Variable	Indicator	Source of Data
Dependent Variable:		
Underpricing	The first day closing price of the IPO minus the offer price divided by the offer price.	Yahoo Finance and related company prospectus documents
Independent Variables:		
Shariah Compliance	Dummy variable, 1 if the company's shares are categorized as shariah compliance, 0 if not compliant.	Financial Services Authority (OJK) website and the Indonesia Stock Exchange (IDX) website.
Underwriter Reputation	Dummy variable, 1 if reputation underwriter is included in Top 10 most active IDX members in total trading value, 0 if not included.	IDX Yearly Statistics
Free Float Ratio	Number of shares offered divided by the total number of shares expressed in percentage.	Related company prospectus document
Oversubscription	Number of shares demanded by investors divided by number of shares offered.	Digital media such as economic, business, and financial news websites.
Covid-19 Sentiment	Dummy variable, 1 if the company's shares IPO in 2020-2021, 0 if the IPO is other than 2020-2021.	The time span of the covid-19 virus entering Indonesia.
Nominal Value	The nominal value contained in the prospectus of the company.	Related company prospectus document

Therefore, the research model for the study is:

$$UND = \alpha - \beta_1 SHARIAH - \beta_2 RU10 + \beta_3 FLOAT + \beta_4 OVS + \beta_5 COVID + \beta_6 NOMINAL + \varepsilon$$

Where:

UND : Underpricing

SHARIAH : Shariah Compliance

RU10 : Underwriter Reputation (Top 10)

FLOAT : Free Float Ratio

OVS : Oversubscription
COVID : Covid-19 Sentiment
NOMINAL : Nominal Value

In the context, an explanation will be sought between the independent variable as the cause and the dependent variable as the effect in a phenomenon. This study will explain the influence of the variables Shariah compliance, underwriter reputation, free float ratio, oversubscription, COVID-19 sentiment, and nominal value on the IPO underpricing level. Data analysis in scientific research aims to present empirical findings in the form of descriptive statistical data and inferential statistical analysis to draw conclusions on the research results. To answer research questions, data analysis techniques in this study will use descriptive analysis and multiple regression analysis. Before conducting research hypothesis testing, it is necessary to test several classical assumptions. The classical assumption test is conducted so that the model in the study meets the BLUE assumption (Best, Linear, Unbiased, Estimator). These assumptions include linearity tests, multicollinearity tests, heteroscedasticity tests, and autocorrelation tests.

Regression analysis is one of the parametric inferential statistical techniques. The time dimension in this study is cross-sectional, namely, data that includes all shares of companies conducting initial public offerings or IPOs in the period 2017-2023. This analysis is conducted to determine the influence of variables in the research model, specifically the relationship between independent variables and dependent variables, using both partial (t-test) and simultaneous (F-test) analyses.

RESULTS AND DISCUSSION

The phenomenon of IPO underpricing in Indonesia remains significantly high, averaging 37.17%, which is comparable to other emerging markets. This study investigates how Shariah compliance, underwriter reputation, free float ratio, oversubscription, Covid-19 sentiment, and nominal value influence underpricing in IPOs. The findings suggest that Shariah compliance and underwriter reputation negatively impact underpricing, while free float ratio, oversubscription, and nominal value positively influence it. However, Covid-19 sentiment does not significantly affect underpricing. These findings contribute to the ongoing discourse on IPO pricing and market behavior by aligning with and challenging previous research. Overall, these findings underscore the importance of both firm-specific characteristics and prospectus information in shaping IPO underpricing. They provide a nuanced understanding that can help issuers, underwriters, and regulators better navigate the IPO process in Indonesia.

The number of IPO shares per sector can vary each year. However, the number of IPO stocks per sector does not guarantee the success of the IPO or the company's future success. This is because many factors can affect the success of an IPO or a company in the future. Each company certainly has different risks and challenges, including competition in its respective industry, global economic conditions, government policies, and internal

factors of the company itself. Companies need to continue to evaluate internal conditions and pay attention to external conditions in making strategic decisions, such as conducting an IPO. Sector rotation is one of the external factors that reflects the movement of money invested in shares from one industry to another as an effort by investors and traders to anticipate the next stage of the economic cycle. Therefore, the number of IPO companies per sector each year will differ depending on overall conditions.

Table 2. Number of IPO Companies 2017-2023

Sector	Sample	%
Energy	18	7.17
Basic Materials	24	9.56
Industrials	17	6.77
Consumer Non-Cyclicals	41	16.33
Consumer Cyclicals	45	17.93
Healthcare	8	3.19
Finance	12	4.78
Property & Real Estate	27	10.76
Technology	24	9.56
Infrastructures	19	7.57
Transportation & Logistic	16	6.37
Total	251	

Table 3. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
UND	251	.0045	.7000	.369596	.2200996
SHARIAH	251	0	1	.67	.470
RU10	251	0	1	.22	.417
FLOAT	251	.0106	.5200	.225430	.0877043
OVS	251	1.00	500.00	52.6561	85.66323
COVID	251	0	1	.26	.441
Ln_NOMINAL	251	.0000	6.9078	3.984589	.9420946

Previous studies report that IPO underpricing varies widely across countries. For example, the U.S. experienced an 11.4% average underpricing in the 1960s, while global first-day returns have ranged from 10% to 80%. Notably, China's average underpricing is 77%, Indonesia's is 58.3%, South Korea's is 41.6%, and Mexico's is 1.8%, the lowest average underpricing (Zhang & Neupane, 2024). In Indonesia specifically, the 2017–2023 period shows an average underpricing of 36.96%, with past studies reporting figures from

18.15% (Madyan et al., 2020) to 58.3% (Zhang & Neupane, 2024). Furthermore, Hanafi & Hanafi (2022) found that the average underpricing of sharia and non-sharia stocks was not much different, around 19% for sharia stocks and 21% for non-sharia stocks.

The overall number of shares of IPO companies with shariah compliance, characterized by sharia status, dominates the IPO stock market in Indonesia at 68.54%. This condition is also supported by regulators, together with other supporting institutions, to ensure compliance. Shariah compliance status boosts investor confidence by aligning with their religious values (Mehmood et al., 2021). This can also attract public trust in the company and increase investor interest. Thus, Sharia status can be an added value for companies in attracting investors and expanding opportunities to grow in the global market. Abdul Rahim and Yong (2010) concluded that Islamic IPOs in Malaysia have shown higher returns and risks, while Indonesian Islamic IPOs tend to have lower initial returns and lower risk (Hanafi & Hanafi, 2022). This is likely due to stricter screening of business and financials.

Underwriters who can satisfy IPO company clients will have a good reputation. The Indonesian Stock Exchange annually issues documents, IDX Yearly Statistics, which contain statistical information, including IDX Members Activity, which contains ranking data of exchange members in transactions. There are three categories: 50 Most Active IDX Members in Total Trading Volume, in Total Trading Value, and Total Trading Frequency. There are differences in the selection of underwriter reputation metrics: Utomo and Kurniasih (2020) with the 10 most active underwriters, Rodoni et al. (2018) with the top 50, and Yuliani et al. (2019) used the top 20. Meanwhile, Hanafi & Hanafi (2022) used underwriter reputation by creating quartiles of total issuance for each underwriter.

The percentage of shares offered or free float in an IPO includes a small portion of the majority of the company's shares. The percentage of shares to be offered will be determined and agreed upon by the company's management and the underwriter. The amount of free float shares reflects the voting rights that minority investors have in a company. The higher the percentage of free float, the higher their voting rights will be. In addition, free float will also have an impact on adjusting the calculation of stock weights for stock indices. In 2021, the Indonesia Stock Exchange (IDX) emphasized the rule that listed companies must have a minimum of 7.5 percent free float shares or the equivalent of 50 million shares.

In general, oversubscription of IPO shares in Indonesia shows a high level of confidence from investors in the growth prospects and profit potential of companies that will conduct an IPO. In developed countries, there is little focus on factors influencing oversubscription because pricing mechanisms differ, and information on pre-market oversubscription is almost non-existent in book-building and pricing mechanisms (Tajuddin et al., 2018). Including in Indonesia, information on oversubscription is usually published after interviews with relevant companies and can be accessed on digital media such as business and financial news sites. In Malaysia, the average oversubscription ratio is 23.21x, while, if separated into sharia and non-sharia stocks, the average oversubscription

ratio of sharia stocks is 24.93x and non-sharia stocks is 13.55x (Tajuddin et al., 2018). Meanwhile, in Pakistan, the average oversubscription ratio of Islamic stocks is 2.56x and non-sharia stocks is 2.73x, but overall, it is 2.66x (Mehmood et al., 2021).

Sentiment related to COVID-19 has had a significant impact on capital markets around the world since the pandemic began. Uncertainty caused by the spread of the virus, social distancing measures, and economic uncertainty has created high volatility in the stock market. Sentiment related to Covid-19 has also affected the underpricing trend in initial public offerings (IPOs) in the capital market. Mazumder and Saha (2021) found that the initial return or underpricing rate in the presence of COVID-19 is higher than in the last four decades on the United States stock exchange. Mazumder and Saha (2021) measure covid sentiment with the fear index, namely, an index with equal weight for new cases and deaths related to the COVID-19 pandemic. At the same time, Baig and Chen (2022), Fedorova et al. (2023), and Zhang and Neupane (2024) made Covid-19 sentiment a dummy variable with different periods.

Nominal value is the value stated in the company's articles of association, which is explicitly stated in the company's balance sheet and written in the collective share certificate (Santoso, 2020). Based on the data processed, in 2017-2018, the average nominal value of IPO shares was above Rp100, but in 2019 it was below Rp100, which indicates a downward trend from the previous year. Since then, the trend of the nominal value of initial shares has continued to decline until companies with large assets can conduct initial public offerings with a nominal value, such as PT Goto Gojek Tokopedia Tbk (GOTO), becoming an issuer with the smallest nominal value of Rp 1 per share.

Table 4. Regression Analysis

Model		Unstandardized Coefficients	
		B	Std. Error
1	(Constant)	.064	.069
	SHARIAH	-.085	.026***
	RU10	-.116	.029***
	FLOAT	.638	.139***
	OVS	.000	.000***
	COVID	-.022	.027
	Ln_NOMINAL	.058	.013***

Notes: ***, **, *, significant at 1 %, 5 %, and 10 %. Number in the bracket is the probability.

The higher the level of Shariah compliance, the more qualified the company will be by the criteria for Shariah stocks, which will affect the level of underpricing when officially listed on the stock exchange. It can be concluded that Sharia compliance has a negative effect on underpricing. The results of this research are in line with the research of Mayes and Alqahtani (2015) and Mehmood et al. (2021) but reject Bakar and

Rosbi (2017) and Yaakub and Sherif (2019). Shariah compliance allows for more careful consideration of the offering price by the company, together with the underwriter. The existence of a significant negative influence indicates that companies that do not comply with sharia compliance price their offerings at relatively larger price discounts compared to companies that comply with sharia compliance. Therefore, with sharia compliance, the company has disclosed much information related to the condition of the company, thereby reducing information asymmetry. Apart from that, with sharia compliance, which means the stocks are categorized as sharia-compliant stocks, investors will receive a signal that the company is in good condition because it has passed the screening process and is included in the Sharia Securities List (DES). So, the share price offered is relatively close to the company's value, and investors are willing to pay more. The risk of underpricing accepted by the company will decrease, or underpricing will be minimized.

The underwriter's reputation is a key consideration when a company that is going to IPO chooses an underwriting company to be the company's underwriter. This is because in the IPO process, the underwriter is responsible for its obligations, especially for selling shares to the public. Prospective issuers need to be careful in choosing an underwriter because it will affect the risk of selling shares, which will also affect the level of underpricing. It can be concluded that the underwriter's reputation has a negative effect on underpricing. The results of this research are in line with the research of Rodoni et al. (2018), Setya et al. (2020), and Hu et al. (2021). However, not in line with research by Arora and Singh (2019), Abbas et al. (2022), and Hanafi and Hanafi (2022). Companies with underwriters with a high or good reputation can be a signal that the company is good. In addition, uncertainty regarding information asymmetry can be reduced when compared to underwriters with a low reputation. That way, a highly reputable underwriter will dare to set a higher offering share price because of the quality of the securities underwriting. So, the risk of underpricing received by the company will decrease, or underpricing will be minimized.

The free float ratio represents the proportion of company shares available to public investors. This ratio also determines the risks faced by the issuer. The free float ratio has a positive effect on underpricing. The results of this research are in line with the research of Madyan et al. (2020), Hanafi and Hanafi (2022), and Harjayanti et al. (2025). However, the results reject the research of Macit et al. (2015), Kavalenka (2018), Acedo-Ramírez et al. (2019), and Panda & Guha Deb (2023). The positive influence of the free float ratio indicates that the greater the free float ratio, the higher the level of underpricing. The free float ratio or percentage of shares offered will reveal information transparency so that investors will know the extent of available information in the company. The amount of uncertainty regarding information asymmetry will be seen in the free float ratio that has been agreed upon by the company together with the selected underwriter. As a result, the share price offered will be low given the significant uncertainty, so this will increase the level of underpricing.

Oversubscription is undoubtedly an investor sentiment because the high demand for shares from investors exceeds the number of shares offered by the company. The higher

the level of oversubscription, the more optimistic investor sentiment will be towards the company. So, it will affect the level of underpricing of shares when they are listed on the stock exchange. Oversubscription has a positive effect on underpricing. The results of this study are in line with research conducted by Mehmood et al. (2021) and Albada et al. (2023) but reject the results of Mayes and Alqahtani (2015) and Boulanouar and Alqahtani (2016). This result means that high or low investor demand or oversubscription reflects investors' confidence in investing in a company's shares, which ultimately influences investment decisions. Investors tend to be willing to buy IPO shares based on the sentiment of other investors who are also optimistic about companies that will be listed on the stock exchange. Oversubscription is considered a good investor sentiment signal by investors, so it can be used as a guide in making investment decisions because it can provide a high initial return. The higher the oversubscription, the greater the level of underpricing when listing on the stock exchange.

Apart from investor sentiment, there is also market sentiment, including the sentiment of the Covid-19 pandemic, which broke out in 2020 and 2021. COVID-19 sentiment also causes high uncertainty in the financial markets because it can influence many things, such as investment decisions, market behavior, and the price of an asset or instrument. Likewise, in the initial offering stock market, Covid-19 sentiment can influence the movement of newly IPO shares or the level of underpricing. It can be concluded that COVID-19 sentiment does not affect underpricing. The results of this research are not in line with research conducted by Baig and Chen (2022), İlbasım (2023), and Zhang and Neupane (2024), which stated that the COVID-19 variable had a positive effect on underpricing, and also Mazumder and Saha (2021), Indrawati & Kohardinata (2022), and Meliana and Nainggolan (2023), who state that the COVID-19 variable has a negative effect on underpricing. This result means that Covid-19 market sentiment is not a factor that can influence investors' investment decisions. Thus, the financial market is not completely influenced by the turmoil caused by the pandemic but instead focuses on other factors, such as the fundamental factors of the company itself, including both financial and non-financial information, overall market conditions, and the macroeconomic conditions of a country. Supported by investor optimism after the pandemic. Although in general the COVID-19 pandemic has a significant impact on the global economy, it has not significantly affected the initial public offering stock market. Therefore, it can be concluded that COVID-19 sentiment does not affect the rise or fall of underpricing.

Nominal value, also known as par value, is the value per share of a company, which is stated in the deed of establishment. The nominal value of shares does not directly reflect the share price, but can be useful data for comparing various investment options. Therefore, the nominal value can influence the level of underpricing. It can be concluded that nominal value has a positive effect on underpricing. The explanation that the nominal value can influence the level of underpricing is that the assumed nominal value can be used as a reference that the company has good quality, so that in the articles of association, it is not forced to lower the nominal value too much to

obtain larger IPO funds. A high nominal value can also give investors confidence that the company has valuable assets and has good growth potential. Therefore, investors are thought to see the nominal value as a positive signal from the company to reduce existing information asymmetry, so that investors dare to pay higher prices because the nominal value can reflect the company's credibility and prospects. Thus, the greater the nominal value, the greater the level of underpricing.

Overall, the difference between this study and previous studies lies in its exclusive focus on non-financial information. This study addresses a current phenomenon wherein investors increasingly consider factors such as Shariah compliance, underwriter reputation, free float ratio, market and investor sentiment, and the nominal value of stocks. In contrast, prior studies, such as Rodoni et al. (2018), Madyan et al. (2020), Bandi et al. (2020), and Sonu (2022) have typically combined both financial and non-financial information in their analyses.

Another difference with other studies is the metrics used to measure the variables. In this study, total trading value is employed as a measure of underwriter reputation, whereas prior studies have commonly employed metrics such as total trading frequency, total trading volume, and other related measures (Rodoni et al., 2018; Yuliani et al., 2019). The rationale behind this choice is that a higher total trading value reflects greater investor confidence in the broker, who also serves as the underwriter.

CONCLUSION

The results of underpricing research on 251 IPO shares in the 2017-2023 period were overall in the high category, namely 37.17%. Several factors affected underpricing, including sharia compliance, underwriter reputation, the free float ratio, oversubscription, and nominal value. 68.54% of the IPO stocks were Sharia-compliant. The underwriter reputation, measured by the top 10 most active by trading value, changed each year, and the free float ratio shows a downward trend from 2018 to 2022. Oversubscription varied each year, with an average of over 28 times. The Covid-19 sentiment shown influences the movement of an asset or instrument and investor behavior in general. Finally, the nominal value of shares fluctuates, and over time, their value becomes smaller. The study found that higher Sharia compliance and higher reputation of the underwriter led to lower underpricing. On the other hand, a higher free float ratio, higher oversubscription, and higher nominal value increased underpricing, while Covid-19 sentiment did not have a significant impact.

Based on the result, the implications of this research can be a reference for future researchers, investors, companies, and the government as a regulator. Policymakers are recommended to enhance regulatory frameworks that support robust Sharia compliance standards and promote the engagement of reputable underwriters, thereby fostering greater market stability and investor confidence. In addition, more straightforward guidelines on free float ratios and nominal share values, along with improvements in pricing mechanisms such as the book-building process, are advised to reduce underpricing and improve

transparency. Although Covid-19 sentiment did not show a significant effect, continued monitoring of market behavior remains important. These measures can strengthen IPO regulation, improve transparency, and support a more stable capital market in Indonesia.

Overall, these insights provide valuable guidance for investors, companies, and regulators in optimizing the IPO process. Investors can better assess the risk-return profile of new listings, while companies can refine their offering strategies. Regulators can utilize these results to develop targeted policies aimed at improving transparency and efficiency in the IPO market, ultimately contributing to a more resilient capital market in Indonesia.

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Do Macroeconomic and Green Factors Influence Stock Returns in Indonesia?

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JEL Classification:

E31
O47
M41
Q56
G12

Received: 24 December 2024

Revised: 14 May 2025

Accepted: 18 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study adopts a multidimensional framework that integrates environmental sustainability and macroeconomic pressures to assess stock market behavior over the period 2018 to 2022, encompassing both pre-pandemic and post-pandemic economic contexts.

Research Objectives: This research explores the impact of inflation, economic growth, green accounting, and environmental performance on stock returns of energy companies registered on IDXENERGY from 2018 to 2022.

Research Methods: This study uses panel data regression analysis based on secondary data from 33 energy sector companies over five years.

Empirical Results: Inflation has a statistically significant negative effect on stock returns, indicating that rising inflation tends to reduce investor returns in the energy sector. In contrast, economic growth, green accounting, and environmental performance do not show significant effects on stock returns, suggesting that these variables have no observable impact on firm performance in the capital market within the scope of this study.

Implications: The findings emphasize the need for enhanced green reporting standards, stronger policy incentives for sustainable practices, and increased investor awareness regarding environmental performance.

Keywords:

inflation; economic growth; green accounting; environmental performance; stock returns

How to Cite:

Irman, M., Rahman, S., & Wati, Y. (2025). Macroeconomic and Green Factors Influencing Stock Returns in Indonesia. *Etikonomi*, 24(2), 441 – 458. <https://doi.org/10.15408/etk.v24i2.43614>.

INTRODUCTION

Economists, policymakers, and international institutions have actively discussed the possibility of a global recession during 2022. Recession is generally characterized as a substantial contraction in economic activity, lasting for a minimum of two consecutive quarters, as indicated by a nation's gross domestic product (Jelilov et al., 2020). This global downturn resulted in downward revisions of global economic growth projections (Chiang & Chen, 2023). Notably, approximately 43% of countries with available quarterly data, 31 out of 72, representing over one-third of global GDP, either experienced or were forecasted to experience technical recessions during the 2022–2023 period (Cieslak & Pflueger, 2023; Muhammad et al., 2024). Energy plays a pivotal role in supporting economic activity, serving as a fundamental input in production across key sectors such as transportation, industry, and residential use (Abbas et al., 2023). The level of energy consumption often signals ongoing economic activity (Singh & Padmakumari, 2020), and a positive correlation generally exists between economic development and energy use (Meher et al., 2020). As economic output expands, energy demand tends to rise, highlighting the intrinsic connection between power consumption and GDP growth (Abbas et al., 2023; Chiang & Chen, 2023).

In Indonesia, this relationship is evident through parallel movements in GDP and energy consumption. Both indicators showed an upward trend in 2018 and 2019; however, the COVID-19 pandemic induced a contraction in 2020, resulting in declines in both GDP and energy consumption (Adebayo et al., 2022; Mishra & Mishra, 2021). Pandemic-induced restrictions on mobility and social interaction contributed to reduced energy demand (Sergi et al., 2021). As vaccination campaigns gained traction in 2021, GDP and energy consumption began to recover, and this upward trend continued into 2022, eventually returning to pre-pandemic levels (Abbas et al., 2023). Indeed, 2022 marked the strongest growth over the past decade (Chiang & Chen, 2023).

The 2019 Indonesian Energy Outlook projected continued increases in energy demand across different scenarios. The national final energy market was expected to grow annually by 5.0% in the Business-as-Usual scenario, 4.7% under Sustainable Development, and 4.3% in the Low-Carbon scenario. By 2050, energy demand is forecasted to reach 548.8, 481.1, and 424.2 million tonnes of oil equivalent (MTOE) in the respective scenarios, according to the Secretary General of the National Energy Council (2019). Given this critical role, energy sector companies are viewed as strategic and attractive, as they serve as the primary providers and distributors of energy essential for economic development (Abbas et al., 2023; Singh & Padmakumari, 2020).

An increase in energy demand generally translates into greater profitability for energy firms (Chiang & Chen, 2023; Meher et al., 2020). This dynamic was reflected in rising stock returns within the energy sector during 2022, largely driven by a surge in energy commodity prices, particularly coal, which peaked at USD 439 per ton in September 2022 (Rheynaldi et al., 2023). This price spike was primarily attributed to the Russia–Ukraine conflict, which disrupted international energy supply systems

(Karamti & Jeribi, 2023), compounded by rising post-pandemic energy demand (Mpofu et al., 2023). As a result, the energy sector outperformed other sectoral indices in 2022, supported by favorable commodity prices (Abbas et al., 2023; Rheynaldi et al., 2023). However, by July 2023, the energy sector experienced a 15.6% year-to-date decline, in line with a downturn in energy commodity prices. This decline was influenced by factors such as high U.S. inflation, declining industrial production, and declining global energy consumption (Chiang & Chen, 2023; Meher et al., 2020). These developments underscore the critical influence of energy on a nation's economic trajectory, particularly through the interdependence between energy usage, demand, and growth.

Energy companies must navigate these dynamics carefully, acting not only as distributors and storage facilities but also as economic bellwethers (Singh & Padmakumari, 2020). This volatility presents challenges for firms and investors, as reflected in stock market fluctuations. To sustain their market position, energy firms must closely monitor internal and external factors that could adversely impact performance (Abbas et al., 2023). Numerous studies have indicated that macroeconomic variables such as inflation, economic growth, green accounting practices, and environmental performance significantly influence stock returns (Meher et al., 2020; Molnár & Kocsir, 2023; Philips et al., 2022; Zhou et al., 2022).

Inflation, characterized by a prolonged rise in the general price level, diminishes the purchasing power of money and may erode the real returns for both firms and investors (Karagöz, 2024; Raghutla et al., 2020). While moderate inflation is considered beneficial to economic stability (Alqaralleh, 2020), high inflation increases production costs and diminishes consumer purchasing power (Cieslak & Pflueger, 2023; Muhammad et al., 2024). This dual pressure can negatively impact corporate profitability and dampen investor enthusiasm, ultimately affecting stock prices (Chiang & Chen, 2023; Philips et al., 2022). Empirical studies (Alqaralleh, 2020; Jelilov et al., 2020; Magweva & Sibanda, 2020) consistently demonstrate a significant negative effect of inflation on stock returns. However, Köse & Ünal (2021) report an insignificant effect, underscoring the sectoral and market-specific complexity of inflationary dynamics.

In contrast, economic growth, typically measured by GDP expansion, positively influences stock returns. As GDP rises, so does household purchasing power, enabling firms to increase sales and profits (Akash et al., 2023; Jiang et al., 2022; Moodley et al., 2022). These improved fundamentals often attract investors, raising share prices and shareholder returns (Adjei et al., 2021; Cederburg et al., 2023; Silva et al., 2023). This is supported by Adebayo et al. (2022) and Thampanya et al. (2020), although some studies (Ashraf, 2020; Lee et al., 2023) have found negative or mixed effects, suggesting sector-specific dynamics.

In line with environmental priorities, green accounting has emerged as a strategy to enhance corporate sustainability and investor confidence (Syarifah et al., 2023). When properly implemented, green accounting can improve firm reputation, employee satisfaction, and consumer trust, leading to higher profitability and share prices (Firdausa

& Budiayanti, 2023; Khan & Gupta, 2024). Although some studies (Ferrati et al., 2022; Olaoye & Alao, 2023) found no statistically significant association between environmental accounting disclosures and stock returns, the broader consensus supports a positive linkage, particularly when firms are perceived to be genuinely committed to environmental stewardship (Guo et al., 2020; Gupta & Jham, 2021; Ng & Rezaee, 2020). These findings align with legitimacy theory, which asserts that a firm's continued existence is contingent upon its ability to fulfill societal expectations, and stewardship theory, which emphasizes the role of managerial performance in achieving sustainable outcomes (Khan & Gupta, 2024; Meher et al., 2020).

Similarly, environmental performance, often reflected through ratings such as Indonesia's PROPER, can enhance a firm's public image and investor appeal (Ulupui et al., 2020). High environmental performance is associated with responsible corporate behavior, fostering public trust and enhancing firm valuation (Abrams et al., 2021; Al-Hiyari & Kolsi, 2024; Grewal et al., 2021; Kalash, 2021; Nguyen et al., 2021). Although some research (Chang et al., 2021; Ouadghiri et al., 2021) reports an insignificant relationship, others (Alessi et al., 2021; Barko et al., 2022; Brandon et al., 2021) provide strong support for a positive impact on stock returns.

The discourse on the intersection between environmental sustainability and financial performance has gained momentum, especially within the energy sector, which stands at the crossroads of ecological responsibility and economic contribution. The recent global economic uncertainty, amplified by geopolitical issues like the Russia–Ukraine conflict, the COVID-19 pandemic, and rising inflation, has brought renewed urgency to discussions surrounding corporate resilience and sustainability. In 2022, the world faced mounting concerns about a global recession, with nearly half of the countries experiencing or forecasted to experience technical recession (Cieslak & Pflueger, 2023; Muhammad et al., 2024). These macroeconomic shocks have intensified scrutiny on how energy companies, as strategic pillars of national development, manage performance while adapting to environmental and economic pressures.

Indonesia, as a developing economy with ambitious energy consumption growth projections, offers a compelling context for such inquiry. The correlation between energy demand and GDP growth in the country highlights the sector's critical role (Chiang & Chen, 2023). However, with increasing emphasis on environmental governance and climate commitments, energy firms are now expected to go beyond profit maximization to demonstrate sustainable practices that align with public expectations and regulatory standards. This dual challenge of ensuring financial returns amid volatile macroeconomic conditions while simultaneously meeting environmental standards raises critical questions about how market participants respond to green initiatives.

Despite the growing body of literature examining stock returns, much of the existing research remains fragmented in addressing how macroeconomic instability and environmental performance jointly shape firm valuation in emerging markets. Prior studies tend to isolate the impact of inflation or GDP growth on market performance (Adebayo

et al., 2022; Raghutla et al., 2020), or focus narrowly on the effects of environmental disclosure (Gupta & Jham, 2021). Few studies integrate these dimensions into a single analytical framework, particularly within Indonesia's energy sector, which is not only vital to economic growth but also under increasing pressure to comply with green regulations and improve transparency. Moreover, empirical evidence regarding the financial impact of environmental performance and green accounting remains inconclusive, with some findings showing significant relationships while others report none (Chang et al., 2021; Ferrat et al., 2022).

Previous studies on stock return determinants have primarily focused on conventional financial and macroeconomic indicators such as profitability, leverage, and interest rates. While several studies have begun exploring the role of environmental performance and green accounting on firm value or financial performance, they have largely overlooked their direct influence on stock returns, particularly within the energy sector in emerging markets. Furthermore, most prior research is conducted in developed economies, with limited attention to Indonesia's energy sector, which faces both environmental scrutiny and economic volatility. Additionally, studies often analyze these factors in isolation without integrating macroeconomic variables and green performance indicators in a unified framework.

This study introduces an original and integrative framework by concurrently examining the influence of macroeconomic variables (inflation and economic growth) and green performance indicators (green accounting implementation and environmental performance) on stock returns of energy sector companies listed on the Indonesia Stock Exchange during the 2018–2022 period. Departing from prior studies that tend to isolate either financial or environmental determinants, this research adopts a multidimensional approach that captures the intersection of macroeconomic dynamics and corporate environmental responsibility. Methodologically, the study advances the literature by operationalizing green accounting using the disclosure intensity of 34 specific indicators from the GRI G4 environmental category, and by quantifying environmental performance through the nationally standardized PROPER ratings. The integration of these rigorously defined green metrics within a capital market model is a significant methodological contribution, as such variables are seldom examined simultaneously in empirical financial research.

Moreover, the temporal scope of the study encompasses significant economic transitions, including the pre-pandemic, pandemic, and initial recovery phases, allowing for a more nuanced understanding of stock return behavior under varying economic and environmental pressures. By focusing on the energy sector, a critical industry with high environmental impact and regulatory scrutiny, the research provides targeted insights into how green initiatives and macroeconomic trends converge to influence investor responses. The findings are anticipated to offer practical implications for policymakers, investors, and corporate managers seeking to align financial performance with environmental sustainability in an increasingly ESG-sensitive investment landscape.

The findings of this research are expected to contribute to several stakeholders. For policymakers, the results can support the development of regulations that encourage better environmental disclosures and sustainable practices while maintaining economic stability. For investors, this study highlights the relevance of integrating environmental information and macroeconomic signals when evaluating investment opportunities in the energy sector. For company management, the research emphasizes the strategic importance of transparent green accounting and strong environmental performance as factors that may enhance investor trust and improve stock market outcomes in a competitive and sustainability-oriented investment environment.

METHODS

The study analyzes IDXENERGY companies from 2018 to 2022 using a quantitative methodology. The population consisted of 75 energy sector firms as of 2023. Using purposive sampling, 33 companies were selected based on the following criteria: exclusion of firms that conducted IPOs after January 1, 2018 (18 firms), companies suspended by the IDX during the observation period (21 firms), and firms with incomplete data (3 firms). This resulted in 165 firm-year observations (33 companies $\times$ 5 years). In this study, the time period from 2018 to 2022 was selected based on both data availability and methodological considerations. The year 2022 marks the latest year for which complete and verified data on macroeconomic indicators, stock returns, green accounting disclosures (based on the GRI G4 framework), and PROPER environmental performance ratings were publicly available and consistently reported across all sampled companies. Although data for 2023 or 2024 may have begun to emerge, they are often subject to reporting lags, revisions, or incompleteness, particularly in sustainability disclosures and government-issued PROPER ratings, which are typically published with a delay. Including incomplete or unverified data could compromise the reliability and comparability of the findings. Therefore, the 2018–2022 timeframe ensures robust and consistent analysis, capturing both pre- and post-pandemic economic conditions while maintaining high standards of data integrity. The following criteria in Table 1 were utilized for the selection of samples.

Table 1. Criteria for Sample Selection

No	Criteria for Sample Selection	Total Number of Firms
1	Energy sector firms listed on the IDX (2018–2022)	75
2	Energy sector firms with IPOs conducted after January 1, 2018	(18)
3	Energy sector firms suspended by the IDX during the 2018–2022 period	(21)
4	Energy sector firms with incomplete financial or environmental data (2018–2022)	(3)
	Final sample of companies	33
	Observation period (2018–2022)	5 years
	Total firm-year observations (33 $\times$ 5)	165

Source: Data processed, 2024

This research utilizes panel data regression analysis, integrating both time-series and cross-sectional data. This method helps control for differences across firms that are not directly observed, leading to more accurate and consistent estimates than single-dimension models. The analysis was conducted with EViews software, applying three models: CEM (Common Effect Model), FEM (Fixed Effect Model), and REM (Random Effect Model). The selection of the most appropriate model was based on a series of statistical tests: the Chow test for detecting individual effects, the Hausman test for identifying systematic differences between fixed and random effects, and the Lagrange Multiplier (LM) test for assessing the suitability of the REM over CEM. All estimations were performed using the Ordinary Least Squares (OLS) method within the panel framework. The regression model used in this study is formulated as follows:

$$\text{STR} = \alpha + \beta_1\text{CPI} + \beta_2\text{GDP} + \beta_3\text{GRI} + \beta_4\text{PRO} + \varepsilon \quad (1)$$

Stock returns were used as the dependent variable, derived from historical price changes, which reflect firm value changes over time (Raghutla et al., 2020). Inflation data, measured by the Consumer Price Index (CPI), were obtained from Indonesia's Central Statistics Agency, which updated its inflation measurement base in January 2020 to better reflect changes in consumer behavior (Cieslak & Pflueger, 2023). Economic growth was measured using GDP at constant prices as published by Indonesia's Central Statistics Agency (Akash et al., 2023). Green accounting was assessed using disclosure scores based on the Global Reporting Initiative (GRI G4) indicators (materials, energy, emissions, waste), adopting the binary scoring method of Ulupui et al. (2020). Environmental performance was quantified using the PROPER rating system, which assigns scores ranging from 0 (no participation) to 5 (gold rating).

Descriptive statistics, such as mean, maximum, minimum, and standard deviation, were calculated before the regression analysis to provide an overview of the dataset. Classical assumption tests were conducted to verify the model's validity and reliability. Multicollinearity was tested to identify any strong linear relationships among the independent variables, which could distort coefficient estimates. Heteroscedasticity testing was conducted to detect non-constant error variances that may result from firm-level differences or changing economic conditions. Autocorrelation was also examined due to the panel data's time-series structure, as it can bias standard error estimates and affect statistical inference. A statistically significant F-statistic (p-value < 0.05) indicates that the model yields meaningful insights into the determinants of stock returns. The F-test evaluated the regression model's fit by testing the significance of the independent variables. In addition, the coefficient of determination (R^2) was reported to assess model fit, measuring the proportion of variance in the dependent variable explained by the regressors. While a higher R^2 suggests stronger explanatory power, its interpretation in financial research must be cautious. A high R^2 does not imply causality or confirm the correctness of the model specification, nor does a low R^2 necessarily invalidate the findings, particularly in disciplines such as finance and accounting, where numerous external factors remain unobserved.

Table 2. Variable Explanation

Variables	Symbols	Measurements
Dependent:		
Stock returns	STR	Raghutla et al. (2020): (Share price _t - share price _{t-1}) / share price _{t-1} x 100%
Independent:		
Inflation	CPI	Cieslak & Pflueger (2023): (Consumer price index _n - Consumer price index _{n-1}) / Consumer price index _{n-1} x 100%
Economic growth	GDP	Akash et al. (2023): (Gross domestic product _t - Gross domestic product _{t-1}) / Gross domestic product _{t-1} x 100%
Green accounting	GRI	Ulupui et al. (2020): Total indicators disclosed / 34 GRI G4 indicators environmental category
Environmental performance	PRO	Ulupui et al. (2020): PROPER ratings are as follows: Gold (5) – Excellent; Green (4) – Good; Blue (3) – Fair; Red (2) – Poor; Black (1) – Very Poor; No Color (0) – Non-compliant with PROPER standards.

RESULTS AND DISCUSSION

This study investigates the influence of macroeconomic indicators (inflation, economic growth) and green performance factors (green accounting implementation, environmental performance) on stock returns for 33 energy firms listed on IDXENERGY (IDX Sector Energy) from 2018 to 2022. The empirical findings reveal that inflation exerts a statistically significant negative effect on stock returns, lending support to the hypothesis that cost-push inflation erodes profit margins and weakens investor confidence in capital-intensive industries. Conversely, economic growth demonstrates a weak and statistically insignificant negative relationship with stock returns, suggesting the potential influence of sector-specific constraints and macroeconomic disruptions, particularly those associated with the COVID-19 pandemic, which may have led to a decoupling of GDP growth from equity market performance. Green accounting and environmental performance both show positive but statistically insignificant effects on stock returns, indicating limited market recognition of sustainability disclosures in the Indonesian energy sector. These findings underscore the differential impact of macroeconomic and environmental factors on stock valuation in emerging markets and highlight the necessity for stronger institutional frameworks, investor awareness, and corporate transparency to enhance the market relevance of green performance metrics.

As presented in Table 3, the highest recorded inflation rate occurred in 2022 at 5.510%, primarily driven by rising global oil prices that significantly impacted domestic fuel costs. This surge in fuel prices created a cascading effect, driving up the costs of various

commodities and services. In contrast, the lowest inflation rate was observed in 2020, at 1.680%. Despite inflationary pressures, the rate remained within manageable limits, indicating it had not yet reached a level that would critically hinder economic activity. Economic growth peaked at 5.310% in 2022 and reached its lowest point at -2.070% in 2020. The average green accounting disclosure score for energy sector firms from 2018 to 2022 was 0.233, indicating limited alignment with the Global Reporting Initiative (GRI) environmental categories. This data suggests that green accounting practices remain underdeveloped in the sector. Notably, PT Bukit Asam Tbk. Recorded the highest green accounting score of 0.794 in 2022. The average environmental performance score, based on the Ministry of Environment's PROPER assessment, was 0.738, reflecting a generally low level of compliance with environmental management standards. PT Adaro Energy Indonesia Tbk. Consistently achieved the highest environmental performance score of 5 from 2019 to 2022. The highest observed stock return in the sample was 0.84, achieved by PT Dwi Guna Laksana Tbk. in 2019.

Table 3. Descriptive Analysis

Variables	Mean	Minimum	Maximum	Standard Deviation
Inflation	2.982	1.680	5.510	1.372
Economic growth	3.426	-2.070	5.310	2.808
Green accounting	0.233	0.000	0.794	0.226
Environmental performance	0.738	0.000	5.000	1.457
Stock returns	0.086	-0.713	0.840	0.191

Source: Data processed, 2024

Table 4. Empirical Results of Panel Regression Models

DV: STR	CEM		FEM*		REM	
	Coefficient	Std. Error	Coefficient	Std. Error	Coefficient	Std. Error
CPI	-0.218**	(0.015)	-0.286**	(0.006)	-0.211**	(0.012)
GDP	-0.034*	(0.002)	-0.121*	(0.001)	-0.031*	(0.004)
GRI	0.089*	(0.007)	0.145*	(0.002)	0.091*	(0.006)
PRO	0.052*	(0.011)	0.018*	(0.004)	0.054*	(0.009)
R Square	0.651		0.920		0.710	
Adjusted R ²	0.633		0.900		0.680	
F-statistic	4.326		7.942		5.124	
Prob(F-statistic)	0.002		0.000		0.001	

Note: (*)FEM (Fixed Effect Model) is identified as the most appropriate specification for this study based on model selection criteria. Significance levels are denoted as follows: **p < 0.05; *p < 0.10.

Source: Data processed, 2024

The subsequent stage after descriptive statistics involves inferential statistical analysis. Table 4 presents the regression outcomes across these models. The adjusted R-squared values obtained are 63.3% for the CEM, 90% for the FEM, and 68% for the REM, indicating varying explanatory power across the models. Furthermore, based on the F-test results, all three models demonstrate statistical significance, as evidenced by p-values below the 5% threshold, suggesting that the included independent variables jointly explain the variation in stock returns.

Table 5. Testing Results (Chow, Hausman, and Lagrange Multiplier Tests)

Test	Statistic	p-value	Decision	Model Selected
Chow Test	F = 6.35	0.0001	Reject H_0 (significant difference)	Fixed Effect Model
Hausman Test	Chi-Square = 7.80	0.005	Reject H_0 (significant correlation)	Fixed Effect Model
Lagrange Multiplier (LM) Test	Chi-Square = 4.90	0.02	Reject H_0 (significant random effects)	Random Effect Model (if Hausman test permits)

Source: Data processed, 2024

As presented in Table 5, the results from the model tests indicate that the Fixed Effect Model is the most appropriate specification for this research. The Chow test, with a p-value of 0.0001, suggests a significant difference between the Common Effect Model and the Fixed Effect Model, leading to the selection of the Fixed Effect Model for further analysis. Similarly, the Hausman test, with a p-value of 0.005, shows a significant correlation between individual effects and the regressors, further supporting the Fixed Effect Model. Although the Lagrange Multiplier (LM) test with a p-value of 0.02 suggests the presence of significant random effects across entities, the results from the Hausman test take precedence, confirming that the Fixed Effect Model is the preferred choice over the Random Effect Model.

Table 6. Diagnostic Test Results

Test	Variable	Result	Threshold/ Interpretation	Conclusion
Multicollinearity (VIF)	Inflation	1.620	VIF < 10	No multicollinearity
	Economic Growth	1.576	VIF < 10	No multicollinearity
	Green Accounting	1.355	VIF < 10	No multicollinearity
	Environmental Performance	1.303	VIF < 10	No multicollinearity
Heteroscedasticity (Glejser Test)	All Variables	p > 0.05	p-value > 0.05	No heteroscedasticity
Autocorrelation (Durbin-Watson)	All Variables	2.0514	DW $\approx$ 2	No autocorrelation

Source: Data processed, 2024

As presented in Table 6, the Variance Inflation Factor (VIF) values for inflation (1.620), economic growth (1.576), green accounting (1.355), and environmental performance (1.303) are all below the critical threshold of 10, indicating the absence of multicollinearity among the independent variables. The Glejser test results ($p > 0.05$) confirmed no heteroscedasticity issues, while the Durbin-Watson statistic of 2.0514 indicated no autocorrelation.

Table 7. One-Way Panel Data Regression Estimates

DV: STR	Fixed Effect Model - Robust Standard Errors
CPI	-0.286** (0.006)
GDP	-0.121* (0.001)
GRI	0.145* (0.002)
PRO	0.018* (0.004)
R Square	0.920
Adjusted R ²	0.900
F-statistic	7.942
Prob(F-statistic)	0.000
**p < 0.05, *p < 0.10	

Source: Data processed, 2024

As presented in Table 7, the adjusted R-squared value of 0.900 suggests that approximately 90% of the variance in stock returns can be attributed to the explanatory power of the model's independent variables, namely inflation, economic growth, green accounting, and environmental performance. The remaining 10% of the variation is attributable to other unobserved or omitted factors not incorporated in the current regression specification.

The first hypothesis, which posits a negative relationship between inflation and stock returns, is strongly supported by the regression results reported in Table 7. Inflation exhibits a statistically significant negative effect on stock returns ($p < 0.05$), aligning with an extensive body of literature (Alqaralleh, 2020; Chiang & Chen, 2023; Cieslak & Pflueger, 2023; Eldomiaty et al., 2020; Jelilov et al., 2020; Karagöz, 2024; Khan et al., 2023; Magweva & Sibanda, 2020; Mishra & Mishra, 2021; Mpofu et al., 2023; Muhammad et al., 2024; Philips et al., 2022; Raghutla et al., 2020; Sergi et al., 2021; Singh & Padmakumari, 2020). Theoretically, this finding aligns with cost-push inflation theory, which posits that rising input costs, particularly those essential to energy production such as oil, gas, and chemical feedstocks, tend to reduce firm profitability (Cieslak & Pflueger, 2023; Mishra & Mishra, 2021; Muhammad et al., 2024; Sergi et al., 2021). These cost increases reduce earnings per share and constrain dividend payouts, thereby diminishing investor confidence and market

valuations (Chiang & Chen, 2023; Jelilov et al., 2020; Khan et al., 2023; Magweva & Sibanda, 2020; Raghutla et al., 2020; Singh & Padmakumari, 2020). The capital-intensive nature of energy firms further exacerbates their vulnerability to inflation-induced volatility in operating costs and projected cash flows, increasing the risk premium demanded by investors and lowering stock prices (Alqaralleh, 2020; Eldomiaty et al., 2020; Karagöz, 2024; Mpofu et al., 2023; Philips et al., 2022). The empirical evidence thus highlights the sensitivity of energy sector firms to macroeconomic shocks, distinguishing them from sectors with lower input cost elasticity or stronger pricing power. However, the degree of impact may vary across firms depending on their ability to hedge against inflation, pass costs to consumers, or benefit from regulatory protections.

In contrast, the second hypothesis, which anticipates a positive effect of economic growth on stock returns, is not supported. Instead, the results reveal a weak and statistically insignificant negative relationship ($p < 0.10$). This finding runs counter to traditional macro-finance theory, which suggests that economic expansion should lead to increased corporate earnings, stronger investor sentiment, and higher equity prices (Adebayo et al., 2022; Adjei et al., 2021; Akash et al., 2023; Cederburg et al., 2023; Jiang et al., 2022; Molnár & Kocsir, 2023; Moodley et al., 2022; Silva et al., 2023; Thampanya et al., 2020). Instead, this unexpected outcome resonates with more recent empirical work by Ashraf (2020), Lee et al. (2023), Xu (2021), and Li et al. (2022), which suggests that the link between GDP growth and stock returns may be weakened during periods of systemic uncertainty or institutional inefficiency. In Indonesia, the 2018–2022 period was marked by considerable economic disruption due to the COVID-19 pandemic, which may have muted the translation of macro-level growth into firm-level profitability. Government stimulus and public investment may have driven GDP growth while simultaneously leaving equity investors unconvinced due to liquidity shortages, market volatility, and elevated risk aversion (Lee et al., 2023; Xu, 2021). Furthermore, GDP growth during this time may have been concentrated in sectors other than energy, meaning the sampled firms did not directly benefit from macroeconomic expansion (Ashraf, 2020; Li et al., 2022). These findings highlight the importance of contextual and sectoral heterogeneity in evaluating the economic-growth–stock-return nexus, particularly in emerging markets characterized by structural fragility and uneven growth transmission mechanisms.

The third hypothesis posits that the implementation of green accounting has a positive and significant effect on stock returns, based on the theoretical premise that the adoption of environmentally responsible financial practices enhances corporate legitimacy, reinforces stakeholder trust, and fosters the creation of sustainable long-term shareholder value (Abbas et al., 2023; Firdausa & Budiyaniti, 2023; Guo et al., 2020; Gupta & Jham, 2021; Khan & Gupta, 2024; Meher et al., 2020; Ng & Rezaee, 2020; Syarifah et al., 2023). While the coefficient for green accounting is positive, it fails to reach statistical significance ($p < 0.10$), thus offering limited empirical support. This finding mirrors previous research that reports similarly inconclusive effects of green accounting on market valuation (Ahmad et al., 2021; Ferrat et al., 2022; Olaoye & Alao, 2023; Shabbir & Wisdom, 2020). From a legitimacy theory perspective, green accounting serves as a mechanism for aligning firm

behavior with societal expectations, particularly in environmentally sensitive industries (Ahmad et al., 2021; Ferrat et al., 2022). However, its market relevance appears constrained in the Indonesian context, where the practice of green accounting is still nascent. This is evident in the modest average green accounting disclosure index (0.233) across the sample, suggesting limited transparency and weak institutional pressure for sustainability reporting. Furthermore, stewardship theory posits that such environmental responsibility should be rewarded through improved firm reputation and long-term value creation (Shabbir & Wisdom, 2020). Nonetheless, capital market participants, particularly in emerging markets, tend to prioritize short-term financial metrics over sustainability-oriented disclosures, which are often perceived as immaterial in investment decisions (Olaoye & Alao, 2023). The findings imply that while green accounting may hold long-term reputational benefits, its current implementation lacks the robustness and visibility necessary to influence investor behavior meaningfully.

The fourth hypothesis posits that environmental performance exerts a positive and significant influence on stock returns, grounded in the belief that superior environmental practices can enhance a company's reputation, improve operational efficiency, and increase its attractiveness to socially responsible investors (Abrams et al., 2021; Alessi et al., 2021; Al-Hiyari & Kolsi, 2024; Barko et al., 2022; Brandon et al., 2021; Grewal et al., 2021; Kalash, 2021; Meher et al., 2020; Nguyen et al., 2021; Zhou et al., 2022). The fourth hypothesis, which proposes a positive and significant effect of environmental performance on stock returns, is also not supported by the data. The relationship is positive but statistically insignificant ($p < 0.10$). This aligns with prior research that finds environmental performance often does not yield immediate financial returns, especially in emerging economies (Ahmad et al., 2021; Chang et al., 2021; Ouadghiri et al., 2021). While legitimacy and stewardship theories suggest that high environmental performance should enhance firm value by reinforcing social legitimacy and stakeholder trust, the empirical results indicate a disconnect between environmental actions and investor recognition (Chang et al., 2021; Ouadghiri et al., 2021). A key reason may lie in the low levels of participation and transparency in government-mandated environmental performance frameworks, such as Indonesia's PROPER system. Many firms received non-ratings or low scores, undermining the signaling value of environmental initiatives. Furthermore, during the observed period, investors likely concentrated on recovery and financial resilience rather than ESG factors, further limiting the impact of environmental performance on stock valuations (Ahmad et al., 2021). The findings suggest that while environmental performance is conceptually aligned with long-term firm value, it has not yet achieved materiality in investor decision-making in Indonesia's energy sector.

CONCLUSION

This study investigates how macroeconomic indicators (inflation and economic growth) and green performance factors (green accounting and environmental performance) affect stock returns in IDXENERGY-listed energy companies from 2018 to 2022. The empirical findings suggest that inflation exerts a statistically significant negative impact on

stock returns, while economic growth exhibits a weak negative relationship. In contrast, green accounting and environmental performance are positively associated with stock returns, although their effects are not statistically significant. These results partially support the theoretical assumptions underpinning legitimacy and stewardship theory, yet also reveal a gap between sustainability practices and investor responses in the Indonesian capital market. The findings suggest that although environmental performance and green accounting may enhance corporate image and long-term value, their impact on stock returns remains limited, potentially due to inconsistent disclosure, low investor awareness, and the voluntary nature of sustainability reporting.

From a policy standpoint, several implications arise. First, regulators and policymakers must strengthen sustainability disclosure requirements, particularly in high-impact industries such as energy, to ensure standardized, transparent, and comparable environmental reporting. Second, the government should provide incentives, such as tax relief or preferential access to green financing, for firms that adopt comprehensive green accounting practices and invest in environmentally responsible initiatives. Third, investor education programs are necessary to raise awareness about the value of sustainable investment and to foster demand for responsible corporate behavior. Finally, future research should incorporate broader firm characteristics and sectoral variations to enhance the explanatory power and generalizability of the results. A more holistic and enforced approach to environmental reporting could bridge the disconnect between sustainability performance and market valuation.

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Does Covid-19 Change the Stock Market Relationship with Interest-Exchange Rate?

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JEL Classification:

C320

G11

G15

Received: 10 June 2024

Revised: 20 April 2025

Accepted: 29 April 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: Despite numerous studies conducted on similar topics, this study uniquely examines the short- and long-run dynamics of the interest rate, exchange rate, and stock prices in China under two distinct epochs: pre- and Covid-19 periods.

Research Objectives: This study compares the impact of interest and exchange rates on the Chinese stock market during the COVID-19 and pre-COVID-19 periods. Furthermore, the study also investigated the speed of adjustment towards equilibrium following short-run shocks in the stock market.

Research Methods: This study employs monthly data on the Chinese stock market and the autoregressive distributed lag model-error correction model (ARDL-ECM) approach on a separate period.

Empirical Results: On COVID-19, the interest rate and exchange rate are not jointly and individually cointegrated significantly in explaining the stock prices. Nevertheless, the short-run relationship is identified as significant for both variables. Meanwhile, during COVID-19, the variables are jointly significant, with the exchange rate also identified to explain the stock market movement in the long run individually. In the short run, despite the greater impact of the exchange rate, the interest rates have a hysteretic impact.

Implications: The findings suggested that policymakers should leverage the exchange rate instrument as a better predictive tool in devising effective future policy-making.

Keywords:

stock price; auto regressive distributed lag model; covid-19

How to Cite:

Rui, S. H., Hui, J. N. L., Pinjaman, S., Yun, W. S., Jia, S. H., & Lu, Q. Q. (2025). Does Covid-19 Change the Stock Market Relationship with Interest-Exchange Rate. *Etikonomi*, 24(2), 459 – 476. <https://doi.org/10.15408/etk.v24i2.45853>.

INTRODUCTION

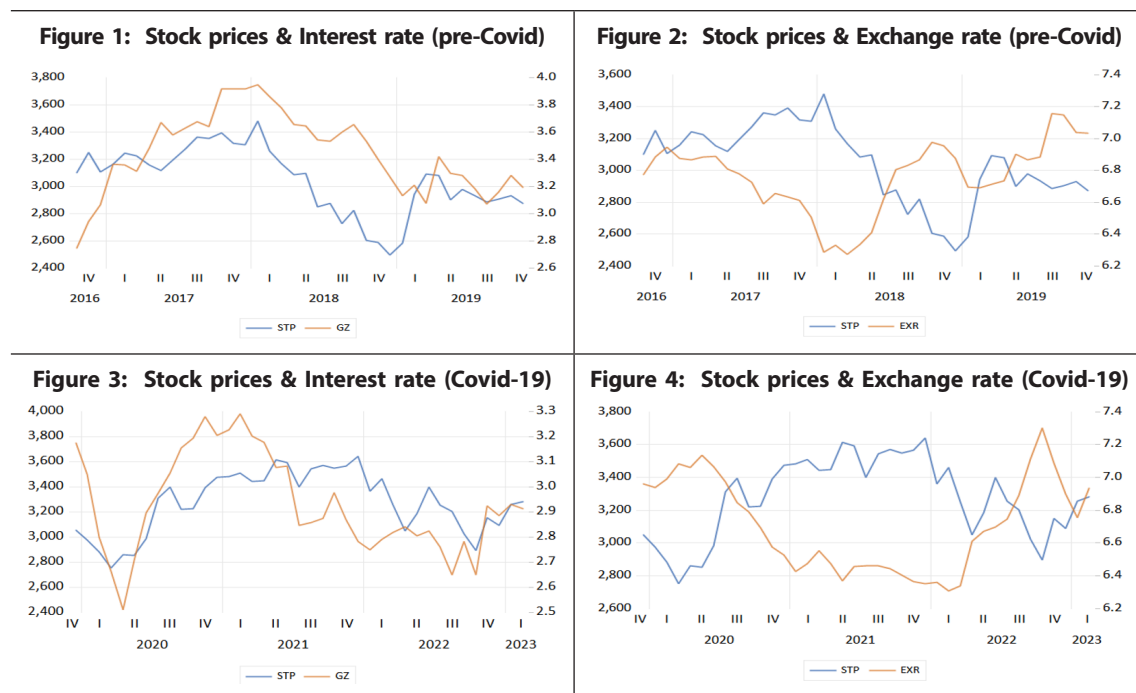
Historically, many research have been conducted on the relationship between the financial industry, particularly interest rates and stock prices. Most studies show that changes in interest rates have the most direct and immediate impact on the stock market. This is because interest rates have a substantial impact on firm stock values. Interest rate fluctuations can affect a company's borrowing costs. On the other side, as interest rates rise, market investors and fund managers may transfer from clearing equities to financial vehicles like bank savings or bonds, which are known for their consistent yields, resulting in lower stock demand and lower stock prices. Thus, when interest rates fall (Musawa & Mwaanga, 2017; Sia et al., 2025), stock prices rise. For example, Pokhrel et al. (2020) investigated the relationship between interest rates and the Nepal stock index and discovered a short-term negative correlation. El Abed and Zardoub (2019) show that interest rates have a considerable negative impact on the returns of German stocks. Türsoy (2019) found in Türkiye's financial market that there is a significant negative dynamic correlation between stocks and domestic interest rates. In Malaysia, this negative correlation is equally significant in both the short and long term (Qing & Kusairi, 2019).

Although research findings suggest that interest rates need to be a key determinant of stock price levels, in some developing countries, this relationship does not seem theoretically absolute. Assefa et al. (2017) studied the stock returns of 19 developing economies and 21 developed economies between 1999 and 2013. They found that interest rates have a statistically significant negative impact on stock returns in developed countries. In developing markets, stock returns largely depend on international investment portfolios, which is consistent with the assumption of expected cash flows. Wang and Li (2020) found that the puzzling positive correlation between interest rates and the Chinese stock market may indicate that the Chinese stock market is relatively underdeveloped and inefficient. Similar findings are not uncommon in China (Fang et al., 2016; Hu et al., 2020; Wang & Li, 2020).

Furthermore, exchange rate fluctuations are another key factor to consider when analyzing factors that affect the stock market. However, evidence from countries and regions with different levels of development suggests that the impact of exchange rate fluctuations of sovereign currencies on stock prices varies greatly depending on national and market conditions. (E'zazi and Sadegh, 2015; Nguyen, 2019; Türsoy, 2017; Bahmani and Saha, 2018; Liu and Lee, 2022; Bhargava & Konku, 2023). For example, Türsoy (2017) used portfolio integration technology and the ARDL boundary test to find that the fluctuation of Türkiye's real exchange rate will affect the short-term changes in stock prices. E'zazi and Sadegh (2015) found a significant short-term and positive impact of the overall German stock market index on exchange rates. Bahmani and Saha (2018) pointed out that the asymmetric effect between exchange rates and stock prices has been overlooked in previous literature.

The above investigations almost only captured significant short-term dynamic relationships rather than long-term evidence, but there are also many studies indicating the

existence of long-term relationships between exchange rate fluctuations and stocks (Khan et al., 2017; Gong & Dai, 2017; Sajor et al., 2023; Neifar, 2023; Bhattacharjee & Das, 2023). In addition, the positive and negative effects of exchange rates on stock markets vary significantly in different countries. For example, in some developing countries, exchange rate fluctuations have been found to have a positive impact on stock prices (Khan et al., 2017; Javangwe & Takawira, 2022; Sajor et al., 2023). This means that the impact of exchange rates on the stock market is specific to the dynamics of countries and market reactions, so traditional conclusions about these relationships are not always consistent, as their effects depend on current market scenarios.



Sources: Author's creation

Recently, in the research on issues during Covid-19, the study on the relationship between these financial variables has also received attention from different countries (Cox et al., 2020; Rahmayani & Oktavilia, 2020; Nurmasari & Nur'aidawati, 2021; Ikhsan et al., 2022; Gao et al., 2022; Tabash et al., 2022; Goh & Henry, 2024). For example, research from the early stages of COVID-19 in China and the United States shows that the Chinese stock market seems less sensitive to changes in domestic interest rate policies at different levels, which is opposite to the situation in the United States. However, investigations in both countries have found that interest rate changes seem insignificant compared to daily confirmed cases (Gao et al., 2022), and the intense stock market drive does not seem to be generated by interest rate fluctuations (Cox et al., 2020; Ikhsan et al., 2022). On the other hand, exchange rate fluctuations have shown a more severe impact on stock price fluctuations during COVID-19 (Lee et al., 2021; Nwosa, 2021; Rai & Garg, 2022; Ikhsan et al., 2022; Alimi & Adediran, 2023; Goh

& Henry, 2024), and even during non-pandemic periods, there is still a clear negative relationship between exchange rates and stock prices (Tabash et al., 2022).

Although the aforementioned studies include early examinations of this issue within their respective countries, most of them only focus on the pandemic period (Cox et al., 2020; Rahmayani & Oktavilia, 2020; Nwosa, 2021; Tabash et al., 2022), lacking a direct comparison between the pandemic and non-pandemic periods (Tabash et al., 2022). Moreover, although previous studies have explored the impact of the pandemic on the Chinese stock market (Gao et al., 2022), there is almost no evidence regarding the differences in the effects of exchange rates and interest rates on stock prices before and after the pandemic. Instead, they focus more on the impact of Covid-19 on stock price fluctuations themselves rather than the dynamic relationship between stock prices and other financial variables (Liu et al., 2020; He et al., 2020; Tan et al., 2022).

Therefore, this study will fill this research gap. Furthermore, this study differs from previous research in that we will directly examine and compare the variables of interest before and during the pandemic, rather than considering only the pandemic period. The objectives of this study are to (1) compare the differences in the impact of exchange rate and interest rate on stock prices before and after Covid-19, and examine the changes in the long-term and short-term dynamic relationship between the two sub cycles; (2) compare the short-term adjustment speed and long-term multiplier of each sub cycle; and (3) highlighting the structural fracture caused by Covid-19. The novelty of the study lies in (1) comparing the changes in the relationship between stock prices and exchange rates under shocks before and during Covid-19; (2) evaluating the changes in coefficient differences between variables affected by shocks during these two sub periods; and (3) uniquely examine the short-and long run dynamics of the interest rate, exchange rate and stock prices. Finally, our results indicate that during the pandemic, the short-term and long-term impact of exchange rate shocks on stock prices significantly increased. In contrast, the impact of interest rates on the stock market was almost ineffective. This finding is of great significance for macro financial policy design in times of crisis.

METHODS

The data of the pre-COVID-19 period selected in this paper is the monthly index of the Shanghai Stock Exchange in October, which returned to a stable trend after the collapse of China's stock market in 2015, as the starting time for Model 1. The data during COVID-19 is based on the first news coverage of COVID-19 in 2019 as the starting time, on February 23, 2023, experts from the epidemic response and disposal leadership group of the National Health Commission of China announced that "the epidemic is basically over". Therefore, we will use February 2023 as the end time for Model 2. The selected data are the closing prices of monthly market transactions. The U.S. dollar to RMB exchange rate is used in the foreign exchange data as a representative example for foreign exchange rates. The monthly closing price is used from the Shanghai (securities) composite index, and the yield of China's 10-year Treasury bonds will be

our interest rate. The data format is logarithmic, with Lnstp representing the Shanghai Composite Index price, Lnexr representing the USD/RMB exchange rate, and Lngz representing the interest rate. Due to the lack of suitable control variables during the investigation process, this study did not include control variables for examination. Table 1 shows more details about the data.

Our method involves applying the Phillips-Perron test and the Augmented Dickey Fuller unit root tests to determine the stationary nature of the time series. The lag order selection criteria in the VAR model are employed to determine the most efficient order for the variable lag.

Table 1. Descriptions of the variables

Variable	Description	Unit of measure	Source of data	Model 1 period	Model 2 period
Lnstp	Log form Shanghai Securities Index	Point	East Money investment information website	2016/10-2019/11	2019/12-2023/02
Lnexr	Log form U.S. dollar against RMB	CNY	Investing website	2016/10-2019/11	2019/12-2023/02
Lngz	Log form 10-year treasury bond bonds	CNY	Investing website	2016/10-2019/11	2019/12-2023/02

The research investigates the interconnection among various economic factors through the application of empirical methods. In this research, long-run relational assessments will employ Auto-regressive Distributed Lag Model (ARDL) bound testing. The ARDL model, as a time series analysis method, is commonly used to analyze the degree to which a variable is influenced by other variables and the long-run cointegration between all series. It is considered an extension of the ARIMA model and allows the model to include exogenous and lagged variables. Compared with early johansen cointegration tests and vecm error correction estimates, the ardl method has more relaxed requirements for the stationarity of variables, allowing for mixed stationarity between variables (Androniceanu et al., 2023). In addition, the ARDL method performs well in small sample situations and eliminates autocorrelation issues (Adebayo et al., 2021), making it suitable for the available data scale in this study.

Research by Pesaran, Shin, and Smith (Guan et al., 2015), as well as Shin and Pesaran (Tian et al., 2017), revealed the ARDL model's expression to be as follows:

$$\Delta \ln stp_t = \beta_0 + \sum_{i=1}^k \beta_{1i} \Delta \ln stp_{t-i} + \sum_{i=1}^k \beta_{2i} \Delta \ln exr_{t-i} + \sum_{i=1}^k \beta_{3i} \Delta \ln gz_{t-i} + \delta_1 \ln stp_{t-1} + \delta_2 \ln exr_{t-1} + \delta_3 \ln gz_{t-1} + \varepsilon_t \quad (1)$$

This examination includes an F-test to verify the enduring interconnection among the variables, assessing the combined importance of lagged variable coefficients. The theory asserting the absence of a prolonged balance among the variables is termed the null hypothesis. Based on equation (1), we use Pesaran et al.'s (2001) F-statistic boundary cointegration null hypothesis as follows:

$$H_{F0}: \beta_1 = \beta_2 = \beta_3 = 0.$$

Should the F-test value surpass the upper critical limit (UCB), the null hypothesis gets discarded, leading to the co-integration of the variable under study. This criterion dictates whether to dismiss or retain the null hypothesis. Dismissing the null hypothesis becomes redundant, since the F-value is smaller than the lower value (LCB). We consider the hypothesis:

$$H_{F1}: \delta_1 \neq 0, \text{ or } H_{F1}: \delta_2 \neq 0, \text{ or } H_{F1}: \delta_3 \neq 0.$$

The short-run dynamics coefficient of the variables is denoted by β_1 , β_2 , and β_3 , the error factor by ε_t , and the coefficient indicative of the long-run relationship is symbolized by δ_1 , δ_2 , and δ_3 . Δ represents differential operation. For evaluating the prolonged interplay among variables, the ARDL model proves superior to the conventional co-integration test and is applicable to both I(0) and I(1) unit root processes with identical order.

The error correction model (ECM) serves to characterize short-run correlations:

$$\Delta \ln stp_t = \beta_0 + \sum_{i=1}^p \beta_i \Delta \ln stp_{t-i} + \sum_{i=1}^p \delta_i \Delta \ln exr_{t-i} + \sum_{i=1}^p \lambda_i \Delta \ln gz_{t-i} + \alpha_1 ECM_{t-1} + \varepsilon_t \quad (2)$$

The α_1 represents the ECM_{t-1} term's coefficient (adjustment amplitude), while the ECM_{t-1} term's statistical significance lies in the primary difference element of residual in the initial sequence regression model. The significance of ECM_{t-1} indicates the speed of adjustment of the model to move back into the long-run relationship or equilibrium¹.

RESULTS AND DISCUSSION

The main finding of the study is that interest rates are positive in the short run, but there is a lag effect during COVID-19. The impact of exchange rates on the stock market is much greater than that of interest rates, especially during the COVID-19 pandemic. During Covid-19, the speed of correction of the impact of interest rates and exchange rates on stock prices is about 2.5 times that of pre-Covid-19 periods.

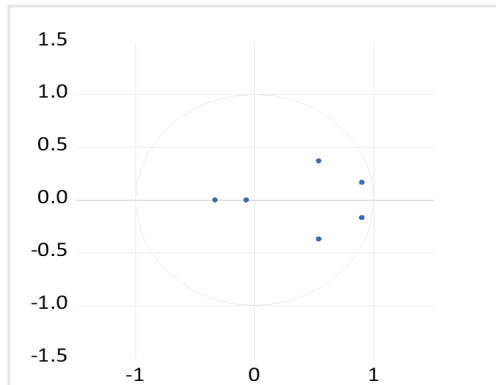
The amount of stationarity of the variables is examined using the Phillips-Perron and Augmented Dickey-Fuller methods. As shown in Appendix 1, the variables display mixed levels of stationarity, with the Shanghai stock market price and exchange rate stationary at I(1). Meanwhile, the interest rate remains stable at I(0). This supports the use of the ARDL model between the variables. Every variable from the Covid-19 era disproves the null hypothesis at the level-order difference; all are classified as I(1), which differs from pre-Covid-19.

Selecting an appropriate lag length is necessary before running the ARDL bound test. Furthermore, care should be taken when choosing a lag length because using the wrong one can produce biased results. The AIC, Akaike Information Criterion, looks for both models with the fewest free parameters that still interpret data the best. Appendix 2 shows that Vector Auto-regression Estimates were used to determine the best order

¹ To test the validity of the analyses, this paper includes the serial correlation, heteroskedasticity, normality and stability of the models.

of lag for the ARDL model, and all information criteria show that the first-order lag is the optimal order and is supported by the results of the polynomial graph (Figures 5 and 6). In this investigation, the AIC is primarily considered.

Figure 5: AR polynomial test of VAR



6. AR polynomial test of VAR

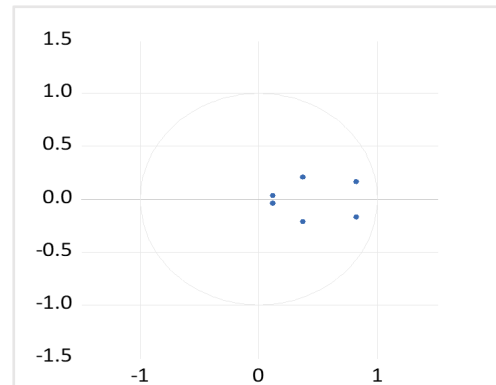


Table 2. Joint long run relationship

Statistic of Test	Value	Level	Critical Values(Pre Covid)		Critical Values(Covid)	
			(0)	(1)	(0)	(1)
Pre- Covid-19 Model		10%	2.63	3.35	2.63	3.35
F-Statistics	2.460254	5%	3.1	3.87	3.1	3.87
Covid-19 Model		2.5%	3.55	4.38	3.55	4.38
F-Statistics	2.676823*	1%	4.13	5	4.13	5

* 10% significance, ** 5% significance, *** 1% significance

The ARDL bound tests indicate that the F-statistic stands at 2.460254, equating to or falling short of the critical I(1) or I(0) value threshold of 10%. The null hypothesis of a lack of level relationship among the variables remains accepted in conjunction with the K-statistic. Consequently, this implies the absence of prolonged co-integration links among the variables before the pandemic. In Covid-19, bound test indicates that a 10% F-statistic value of 2.676823 exceeds the threshold set by the critical value I(0). Therefore, we infer that the Covid-19 scenario involves long-run co-integration connections.

Table 3. Individual Long Run Relationship

DV: Stock Market Price (Pre Covid-19)				DV: Stock Market Price (Covid-19)		
IV	coefficient	t-value	Pro.b	coefficient	t-value	Pro.b
Lnexr	-3.181886	-1.504028	0.1427	-1.19635***	-3.722712	0.0007
Lngz	-1.346162	-1.118639	0.2719	0.257649	1.244592	0.2220
C	15.74850***	2.947038	0.0060	10.09257***	14.06001	0.0000

*** 1% significance

Table 3 findings indicate a lack of significant for the individual impact of the selected variables on the stock market in the long run before Covid-19, even though the coefficients of the interest rate are negative. In Covid-19, the trend of the exchange rate is reverse to that of the stock market. Throughout a prolonged duration, a 1% increase in the exchange rate results in stock value being impacted and reduced by 1.196%. Yet, throughout Covid-19, there was still a lack of significance in the interest rate, despite a positive interest rate coefficient.

The data in table 4 reveal that the model demonstrates an average fitting effect, with D(Lnrxr) and D(Lngz) being significant at the 5% levels, The elastic coefficient of D(Lngz) for D(Lnstp) is 0.4325, and the elastic coefficient of D(Lnrxr) for D(Lnstp) is 0.92776. Respectively, R^2 value of 0.40225, the P-value for the F-statistic stands at 0.0173, meeting the significance threshold of 0.05, signifying the model's overall significance.

In this case, the error correction component of the standard ECM model is labeled as ECM(-1). The ECM(-1) P-value holds statistical significance at a 5% level. The ECM(-1) has a coefficient of -0.246029, suggesting the model's swift return to equilibrium at a pace of -0.246029. However, the findings from interest rate studies appear to be quite prevalent in instances within China (Hu et al., 2020; Wang & Li, 2020; Fang et al., 2016). To address this, further elaboration will be provided in the discussion segment.

Table 4. Short run Relationship ECM model

ECM Model DV: D(LNSTP)				
Variables	coefficient	S. E	t-value	Pro.b
ECM (-1)	-0.246029**	0.097225	-2.530499	0.0173
D(Lnstp (-1))	0.020154	0.170967	0.117884	0.9070
D(Lngz)	0.432516**	0.188401	2.295718	0.0294
D(Lnextr)	-0.927759**	0.439064	-2.113037	0.0436
D(Lnextr (-1))	-0.428404	0.493309	-0.868429	0.3925
D(Lnextr (-2))	-0.640549	0.418704	-1.529836	0.1373
C	-0.002093	0.005969	-0.350665	0.7285
R²	0.402253	Prob. F	0.017561	
Adjusted R²	0.274165			

* 10% significance, ** 5% significance

Table 5 presents the ECM estimation results for the Covid-19 period. The R^2 and adjusted R^2 are both higher than the pre-COVID-19 model. At the significance level of 1%, the P-value by ECM(-1) is statistically significant. The model will rapidly converge back to equilibrium at a rate of -0.583994, which is nearly 2.5 times faster than pre-COVID-19 convergence, according to the coefficient of the ECM(-1).

Table 5. Short run Relationship ECM model (Covid-19 period)

ECM Model DV: D(LNSTP)				
Variables	coefficient	S. E	t-value	Pro.b
ECM (-1)	-0.583994***	0.174748	-3.341922	0.0024
D(Lnstp (-1))	0.132674	0.179712	0.738256	0.4667
D(Lnextr)	-1.313890***	0.391492	-3.356111	0.0024
D(Lnextr (-1))	0.161483	0.525583	0.307246	0.7610
D(Lnextr (-2))	0.681786	0.437478	1.558448	0.1308
D(Lngz)	0.145517	0.154878	0.939559	0.3558
D(Lngz (-1))	-0.029043	0.144756	-0.200631	0.8425
D(Lngz (-2))	0.319061**	0.150941	2.113810	0.0439
C	0.004457	0.005405	0.824612	0.4168
R ²	0.601448	Prob. F	0.000625	
Adjusted R ²	0.483359			

** 5% significance, *** 1% significance

However, in the Covid-19 period, the D(Lnextr) show significant coefficients as usual. However, the interest rate showed a significant positive lag, with an elasticity coefficient of 0.32 with stock market D(Lnstp) and an elasticity coefficient of 1.314 with the exchange rate D(Lnextr), which had a much greater impact than the interest rate. Both coefficients of influence are greater than the pre-COVID-19 period and the exchange rate, but the current elasticity of interest rates D(Lngz) did not show significance in the COVID-19 period.

Table 6. Serial Correlation, Heteroskedasticity, and Normality Tests

(Pre Covid-19 Model)	Statistic	Prob.	(Covid-19 Model)	Statistic	Prob.
BG - LM Test 1 lag	0.01423	0.9059	BG - LM Test 1 lag	1.35E-05	0.9971
BG - LM Test 2 lag	0.00693	0.9931	BG - LM Test 2 lag	0.25273	0.7786
Heteroskedasticity Test	0.00247	0.9609	Heteroskedasticity Test	1.212324	0.3292
Normality Test	1.03691	0.5963	Normality Test	0.847141	0.6547

Furthermore, we tested models 1 and 2 using a variety of diagnostic testing techniques. Table 6 provides more information about the compatibility of the ARDL-ECM regression model for two statistically significant models. Furthermore, the verification methods for the stability tests of CUSUM and CUSUMSQ are provided. The results were presented in Figures 7 and 8 and Figures 9 and 10.

Figure 7 and 8. Model 1 CUSUM and CUSUMSQ

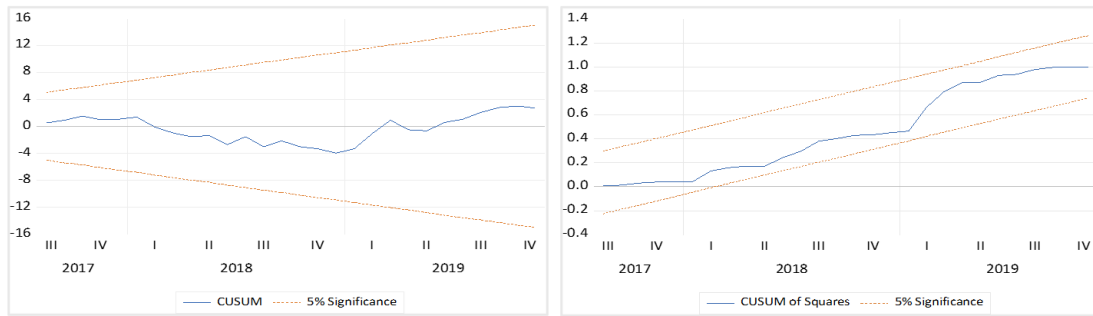
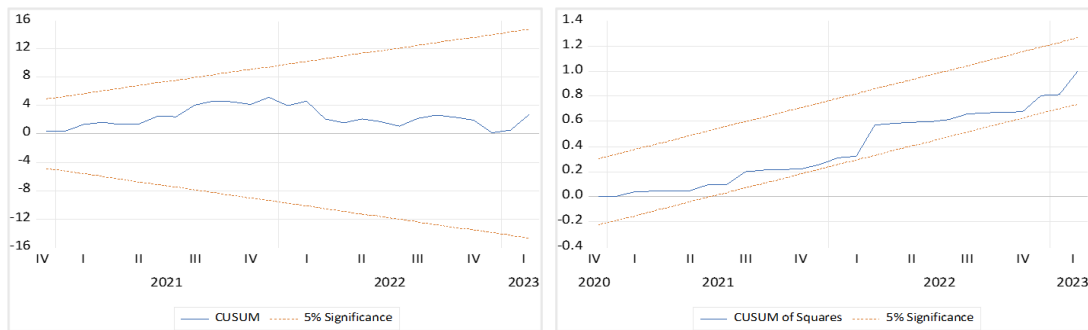


Figure 9 and 10. Model 2 CUSUM and CUSUMSQ



Throughout the results, we found a puzzling phenomenon: whether during COVID-19 or before COVID-19, the significant impact of interest rates seems to be positive. Compared with theoretical predictions and empirical results in developed markets, the situation is precisely the opposite, and this observation seems to have become a characteristic of financial markets in developing countries (Wang & Li, 2020; Assefa et al., 2017; Hu et al., 2020; Ikhsan et al., 2022; Sajor et al., 2023). The central bank's interest rate hike (rate cut) has a positive (negative) impact on the Chinese stock market (Fang et al., 2016; Hu et al., 2020). This phenomenon may be because when central banks raise interest rates, their targets are often driven by strong economic growth and rising inflation. However, in the context of strong economic growth, this also means an increase in corporate profits and leads to increased investor enthusiasm for stocks, thereby driving up the stock market. Therefore, this also leads to a positive impact of interest rates on stocks in the short term.

Furthermore, when the market is prosperous, deviations from expected returns and risk perception can affect investors' judgments. Compared with the adjustment of interest rate hikes, the expected increase in stock prices brought about by the expected returns of listed companies cannot reduce investors' enthusiasm for buying stocks. At the same time, in this situation, professional traders or institutions may push up stock prices, attracting individual investors to buy stocks, and the prosperity of the market will have an irrational impact on investors. Similarly, when the market is depressed, such as during COVID-19, the action or policy of lowering interest rates will further reduce investors' expectations of future market development and future earnings of listed

companies, leading to this strange phenomenon. Some argue that the phenomenon leading to differences in empirical evidence may be attributed to different proxies of interest rates chosen by researchers (Endres, 2020; Sajor et al., 2023).

However, during COVID-19, short-term fluctuations in interest rates had a lagged impact on stock prices by two periods, which was not the case during regular times. This discovery reflects the fact that during a pandemic, stock prices exhibit a very insensitive dynamic to current changes in interest rates (Cox et al., 2020). This result is similar to that of an investigation conducted in the early period of the COVID-19 pandemic (Gao et al., 2022). They believe that during the COVID-19 epidemic, the stock market is not sensitive to changes in domestic interest rate policies. The impact of interest rate policies on stock market volatility mainly exists in the short and medium term rather than the long run, which provides more favorable support for our Covid-19 model results. In the long run, neither of our two models has evidence to suggest that interest rates have a significant impact on stock prices, which is also different from the results observed in other markets (Musawa & Mwaanga, 2017; Qing & Kusairi, 2019; El ABED and Zardoub, 2019; Sia et al., 2025).

Finally, the results of the first and second models we studied both support the views of Gong and Dai (2017), Lee et al. (2021), and Tabash et al. (2022) that an increase in RMB/USD (RMB depreciation) will have a significant short-term negative impact on the stock market, especially during pandemics. The relationship seems to have been strengthened (Nwosa, 2021; Rai & Garg, 2022; Alimi & Adediran, 2023; Goh & Henry, 2024), and exchange rate fluctuations have a more pronounced impact on the stock market than interest rates. The exchange rates have a significant impact on stock prices, depending on whether the company is a multinational corporation. Variations in currency exchange rates influence the share values of global trading firms, as fluctuations in exchange rates alter the worth of the company's foreign operations. Besides that, under a floating exchange rate system, the stock market responds positively. According to a survey by the Chinese Ministry of Commerce, 2276 companies in the Chinese stock market disclosed their overseas business transactions with a total revenue of 667.31 billion yuan. During this period, the total number of listed companies in the stock market was 3760, accounting for over 60%. The rise in exchange rates may lead to a decrease in the competitiveness of domestic products internationally, which will lower the prices of company stocks.

Therefore, this is also why exchange rate fluctuations in the Chinese market have a more sensitive impact on the stock market than interest rates. However, in normal times, this long-term relationship does not seem significant (E'zazi & Sadegh, 2015; Türsoy, 2017). The standard norm theory in economics holds that exchange rates can affect a country's import and export, international trade balance, and subsequently impact corporate investment and national economy, which in turn affects stock prices in the capital market. For example, an increase in the local currency exchange rate may lead to a decrease in the competitiveness of domestic products internationally, which may lower the price of a company's stock. Transnational trading companies faced two challenges during the Covid-19

pandemic: on the one hand, they must deal with the situation of production reduction due to layoffs or internal stagnation; on the other hand, in order to meet the requirements of governments on import and export safety regulations, they must deal with the risks caused by additional import and export processes and health inspections.

During the Covid-19 period, the volatility of global trade (not to mention China, a major trading country) may have a greater impact on the stock market than the fluctuation of the exchange rate. The increase in R^2 further indicates that exchange rate fluctuations have had a greater impact on import and export business as well as investors' expectations throughout the entire pandemic period. During the crisis period of the pandemic, China's long-term blockade policy resulted in insufficient demand in the overall internal market, while the loose monetary policy of the central bank increased the competitiveness of exported products overseas by devaluing the local currency to ensure export trade, thereby driving up the stock prices of enterprises. It is worth noting that in the short-term model, we also found that the ECM model reported a faster correction speed during the COVID-19 period. This result indicates that during the pandemic, the stock market has shown greater sensitivity in the short term and increased concerns about future uncertainty than before (Liu et al., 2020; Baker et al., 2020; Chowdhury et al., 2022).

CONCLUSION

Based on the comparison of the differences in the impact of exchange rate and interest rate on stock prices before and after COVID-19, this study uses the ARDL-ECM method to find that in the normal period, exchange rate and interest rate are not cointegrated with the stock market. However, during the pandemic, the joint cointegration relationship exists. Whether during Covid-19 or before Covid-19, the significant impact of interest rates is positive in the short run without a long-run impact. Thirdly, the stock market's response to short-term interest rate fluctuations has become very insensitive during the pandemic. Whether during normal or pandemic periods, the impact of exchange rate fluctuations on the stock market has shown greater elasticity in the short term than interest rates. In addition, the elasticity of exchange rates relative to the stock market has shown long-run significance during the pandemic, while this situation is not significant during normal periods. Finally, the short-run dynamics will converge to a long-run equilibrium state at a faster rate during the pandemic.

For macroeconomic policymakers (government, central bank) who need to intervene in the stock market or stabilize prices, priority should be given to monetary policy regulatory measures (such as open market operations, reserve requirement adjustments, and exchange rate intervention window guidance) rather than overly relying on fiscal stimulus (such as large-scale government spending or tax cuts). Monetary policy is more flexible and targeted, able to respond more quickly to market changes, while significant exchange rate fluctuations should be viewed as key macroprudential signals. When adjusting interest rates, the primary goal is to maintain the stability and predictability of interest rate policies, ensuring the smooth operation of the credit market (especially

corporate loans) and domestic investment activities, while focusing on maintaining a stable interest rate environment to safeguard credit to the real economy and create a predictable market environment.

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Appendix 1. Unit root test

Variables	Pre Covid-19 period			Covid-19 period		
	ADF		P-P	ADF		P-P
	Trend Intercept	None		Trend Intercept	None	
lnstp	-2.02410	-0.31838	-2.08792	-1.83254	0.24892	-1.87153
lnexr	-1.99483	0.38525	-1.64591	-1.46726	0.07719	-1.19223
lngz	-3.35818*	4.55462	-3.69018**	-1.97025	-0.47211	-2.27492
Δlnstp	-5.93647***	-6.07929***	-5.93647***	-6.02884***	-6.12433***	-6.39159***
Δlnexr	-4.56539***	-4.54844***	-4.56261***	-4.44435***	-4.17574***	-3.48300*
Δlngz	-6.43073***	-5.97232***	-6.44080***	-5.50761***	-5.65899***	-5.50991***

*** 1% significance

Appendix 2. Information criteria test

Lag	LogL	LR	FPE	AIC	SC	HQ
Pre- Covid-19 Model						
0	156.0665	NA	1.88e-08	-9.276755	-9.140709	-9.230980
1	229.7499	129.5042*	3.74e-10*	-13.19696*	-12.65278*	-13.01386*
2	237.2811	11.86737	4.15e-10	-13.10795	-12.15562	-12.78752
3	244.1714	9.604692	4.91e-10	-12.98009	-11.61963	-12.52233
4	252.5465	10.15156	5.50e-10	-12.94221	-11.17361	-12.34713
Covid-19 Model						
0	176.3930	NA	7.46e-09	-10.19959	-10.06491	-10.15366
1	239.9190	112.1047*	3.03e-10*	-13.40700*	-12.86829*	-13.22328*
2	246.6961	10.76365	3.50e-10	-13.27624	12.33349	-12.95474
3	251.9635	7.436261	4.52e-10	-13.05667	-11.70989	-12.59738
4	255.9239	4.892237	6.52e-10	-12.76023	-11.00940	-12.16315

The Nexus among Green Financing: Companies in G20 Emerging Market Countries

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JEL Classification:

Q5

G3

F2

Received: 09 March 2025

Revised: 07 May 2025

Accepted: 23 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study addresses an urgent research gap by examining not only the relationship but also the underexplored role of national R&D capacity as a moderating factor, highlighting how emerging economies' innovation limitations may dilute the benefits of green capital inflows.

Research Objectives: This study analyzed the impact of green financing and FDI on firm profitability and productivity in G20 emerging markets, and assess how R&D expenditure moderates these effects.

Research Methods: Panel data from 57 multinational companies across ten G20 emerging market countries during 2016–2021 were analyzed using fixed-effect regression.

Empirical Results: Green financing and FDI both show significant positive impacts on firm profitability and productivity. However, R&D negatively moderates the green finance–profitability link and has no significant moderating effect on productivity or the FDI relationship, suggesting structural inefficiencies in R&D systems within emerging economies.

Implications: The findings call for urgent policy interventions to enhance R&D infrastructure and efficiency in G20 emerging markets. Redirecting subsidies from fossil fuels to green innovation, fostering public-private R&D collaboration, and strengthening institutional frameworks can help unlock the full potential of green finance and FDI in supporting a sustainable economic transformation.

Keywords:

green investment; green finance; profitability; productivity; emerging countries

How to Cite:

Imamah, N., Trinugroho, I., Arifin, L. N., & Fahri, L. O. (2025). The Nexus Among Green Financing: Companies in G20 Emerging Market Countries. *Etikonomi*, 24(2), 477 – 496. <https://doi.org/10.15408/etk.v24i2.45322>.

INTRODUCTION

Climate change poses escalating threats to global development, with 20-40% of the world's population experiencing warming above 1.5°C in at least one season (Intergovernmental Panel on Climate Change, 2014). This warming has triggered severe consequences, including extreme weather events, rising sea levels, biodiversity loss, and increased socioeconomic vulnerability across nations (D'Orazio, 2022; Fussler & Klein, 2006). In response, the 2015 Paris Agreement established commitments to limit global temperature increases to well below 2°C, with aspirations to cap at 1.5°C. Over 100 local governments and 800 cities have pledged to achieve net zero emissions by 2050 (Black et al., 2021), while countries have agreed to progressively strengthen their climate commitments through Nationally Determined Contributions (NDCs) (Kuramochi et al., 2021).

As the world's largest economies, G20 countries bear significant responsibility for reducing carbon emissions. Recent G20 summits, including the one held in Bali, Indonesia, have prioritized environmental concerns and energy transitions, focusing on energy accessibility, clean technology advancement, and green financing mechanisms. However, this transition requires substantial investment capital and coordinated policy frameworks.

Green financing—defined as investments yielding environmental benefits within sustainable development contexts (Yasmeen et al., 2020)—faces several implementation challenges. These include developmental hurdles in green technologies compared to established fossil fuel alternatives (Boye & Arcand, 2013), limited access to affordable conventional financing sources (Wang et al., 2020), information asymmetry regarding environmental data (Ng & Tao, 2016), lower returns on green investments due to high technology costs (Adams et al., 2011), and socio-demographic barriers in emerging markets. Notably, green finance development manifests differently across developed and emerging economies due to variations in education levels, environmental awareness, legal frameworks, and economic conditions (Ganda, 2019; Hafner et al., 2020; Prieur & Bréchet, 2013).

Foreign direct investment (FDI) offers another pathway to environmental improvement through technology transfer and innovation diffusion. FDI can positively impact both firm profitability (Cui & Xu, 2019) and productivity (Tong et al., 2022) while encouraging environmentally responsible practices. However, empirical evidence suggests FDI may sometimes increase carbon emissions, particularly when fossil fuel-intensive methods are employed (Shahbaz & Sinha, 2019).

Previous research has established that green finance positively influences firm productivity in emerging economies like China (Jiakui et al., 2022; Tong et al., 2022). Studies have also shown that Research and Development (R&D) significantly affects both profitability (Zhao, Cao, et al., 2022) and productivity (Holzner & Wagner, 2022). Green finance policies can enhance innovation capabilities by reducing financial constraints on green initiatives (Yu et al., 2021), while environmental regulatory policies encourage environment-driven R&D (Zhang, 2021). Similarly, the quality of FDI—characterized by

low pollution, low energy consumption, and high efficiency—influences host countries through technology spillover, demonstration effects, and industry correlation (Liu et al., 2022; Zhu, 2010).

While considerable research has explored aspects of green finance and FDI separately, significant research gaps remain. First, most existing studies have focused narrowly on green total factor productivity (Jiakui et al., 2022; Tong et al., 2022; Zhao et al., 2022), while overlooking the comprehensive interplay between green financing, FDI, R&D, profitability, and productivity from multiple methodological approaches. Second, the potential moderating role of R&D in amplifying the effects of green investments on firm-level outcomes remains underexplored, despite evidence suggesting that R&D can yield greater returns than traditional innovation when applied to green technologies (Kudratova et al., 2018; Romano et al., 2017).

This research addresses these gaps by examining how R&D moderates the relationship between green financing, FDI, and firm performance metrics. This integrative approach provides a more nuanced understanding of how these mechanisms interact within different economic contexts. Additionally, while previous studies have extensively documented the environmental benefits of green financing, our research investigates explicitly its economic viability at the firm level—a critical consideration for encouraging broader adoption among corporate stakeholders.

This study makes three principal contributions: (1) expanding the literature on green financing by examining its impact on both profitability and productivity using novel measurement approaches; (2) investigating the moderating role of R&D in enhancing the effectiveness of green investments; and (3) providing empirical evidence to inform policy development for green financial systems and sustainable economies, particularly in emerging markets currently struggling with environmental financing challenges. These insights are crucial for convincing stakeholders of the economic and environmental benefits of transitioning to sustainable business models.

METHODS

The empirical estimation uses panel data for 57 companies in all G20 emerging market countries spanning the period 2016 to 2021. The G20 emerging market countries in this study refer to the following countries: Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, and Turkey (Adams-Kane & Lopez, 2019). This study's population consists of G20 emerging market corporations listed on the 2020 Forbes Global 2000 list of the world's largest companies. The population in this study consists of G20 emerging market companies listed in the 2020 Forbes Global 2000. This list ranks the largest companies in the world and has a significant impact on the global economy, as it includes the top well-established companies in each country.

The study uses explicitly the 2016–2021 period for four main reasons: first, this timeframe reflects the post-ratification implementation of the Paris Agreement (2015),

where G20 emerging countries began aligning policy and business practices with their Nationally Determined Contributions (NDCs), making it an ideal window to examine green financing activities. Second, relevant firm-level data for key indicators—such as green financing, R&D, and FDI—became consistently available and reported during this period, enhancing the reliability and comparability of observations across countries and firms. Third, this timeframe encompasses significant policy evolution regarding environmental regulations and green investment incentives across G20 emerging markets. Lastly, it allows comparison between pre-pandemic (2016-2019) and pandemic-affected (2020-2021) periods, offering insights into how green finance and FDI relationships with firm performance adapt under different macroeconomic conditions.

Table 1. Size of Company Sample Quotas

Rank	Country	Annual GDP (USD)*	% of GDP G20 Emerging Market Countries	Company Sample Quotas Size	Company Sample Quotas Size (Adj)*
9	Argentina	491,492 M	2%	2 Company	1 Company
4	Brazil	1,608,981 M	5%	5 Company	4 Company
1	China	17,734,062 M	60%	60 Company	21 Company
2	India	3,173,397 M	11%	11 Company	9 Company
6	Indonesia	1,186,092 M	5%	5 Company	5 Company
5	Mexico	1,293,037 M	4%	4 Company	4 Company
3	Russia	1,775,799 M	6%	6 Company	6 Company
7	Saudi Arabia	833,541 M	3%	3 Company	3 Company
10	South Africa	419,946 M	1%	1 Company	1 Company
8	Turkey	815,271 M	3%	3 Company	3 Company
G20 Emerging Market Countries		29,331,618 M	100%	100 Company	57 Company

Note: (*) Sample quota size is determined by the number of each percentage represented by the country's GDP contribution proportion towards the total amount of G20 Emerging Market Countries GDP. Furthermore, the sample size chosen for research is based on the company report's English version availability and accessibility.

Due to the novelty of this research, which is in its initial phase, the data availability constraint becomes a consideration in selecting the sample size. The sample selection was carefully selected through the following steps: Initially, all G20 emerging market countries were sorted and ranked based on their GDP share. Based on the percentage contribution of each sample country and looking at the number of companies represented, a sample size quota of companies for each country will be drawn and distributed proportionally based on the GDP portion (see Table 1). Each percentage of GDP contribution becomes a proxy for the number of companies selected to represent from each country. Furthermore, top companies listed in the 2020 Forbes Global 2000 are selected based on the quota sample size from each country and assessed based on data availability and English version report accessibility. Finally, a total of 57 companies is selected, representing all G20

emerging market countries. All the targeted companies in the study are multinational companies that receive foreign capital.

Table 2. Definition of variables

Variables	Definitions	Source
Dependent variables		
Return on Asset (ROA)	Net income to average total asset, which shows the capacity of a firm to earn a profit by the utilization of its assets	Company Website
Asset Turnover (ATO)	Gross Revenues to total assets, which shows how efficiently a company generates its revenue from its assets	Company Website
Independent variables		
Green Financing	Investment flows on the energy sources or technologies that can help lower greenhouse-gas emissions (renewable energy technologies)	Bloomberg NEF
Foreign Direct Investment	Foreign direct investment refers to investments made by foreign investors with the aim of becoming major shareholders in domestic companies.	CEIC Data
Moderating Variable		
Research & Development (R&D)	Expenditures (both public and private) on research and development, which covers basic research, applied research, and experimental development, expressed as a percentage of Gross Domestic Product (G.D.P.).	The Global Competitiveness Report 2016-2021
Control variables		
Firm Size	Natural logarithm of the total assets	Company Website
Firm Age	The natural logarithm of a company's operating time in years	Company Website
Firm Growth	Firm growth posits the annual percentage increment in the sale volume of a company	Company Website
Labor Productivity Growth	Labor productivity growth is measured by the ratio of the value of changes in economic output per hour worked during a certain period	CEC Data

Note: **(1) Macroeconomics (Country) Data:** Green Financing, Foreign Direct Investment, Labor Productivity Growth, R&D; **(2) Firms Level Data:** ROA, ATO, Firm Size, Firm Age and Firm Growth.

The selection of companies, variables, and periods in the econometric models is based purely on data availability. Data on variables observed in this study are collected annually from companies' websites (ROA, ATO, firm size, firm age, and firm growth); Bloomberg NEF (Green Financing); CEIC Data (foreign direct investment and labor productivity growth); and R&D (The Global Competitiveness Report). This study follows Xu et al. (2022) in determining the proxies. Profitability is proxied by ROA, and the ATO captures productivity to reflect how efficiently a company generates revenue from its assets. In addition, green finance is measured by investment flows in renewable energy technologies; foreign direct investment is also considered another predictor. R&D is a moderator variable as measured by the national expenditures on research and development. Next, this study follows Xu et al. (2022) and Wen et al. (2021) in using the control

variables in the regression, such as firm size, firm age, firm growth, and labour productivity growth. Table 2 briefly defines these variables.

This research employs a systematic analytical approach using EViews (version 12) econometric software through four sequential steps. First, descriptive statistics analysis is conducted to understand variable distributions (mean, median, standard deviation, minimum, and maximum values) and identify potential outliers, along with correlation analysis to examine preliminary relationships between variables and detect potential multicollinearity issues. Second, panel data model selection tests are performed, including the Hausman Test to determine whether fixed or random effects models are more appropriate, Breusch-Pagan Lagrange Multiplier Test to evaluate between pooled OLS or random effects models, F-test for Fixed Effects to assess joint significance of firm-specific effects, and Panel Unit Root Tests to check for stationarity in the panel data variables. Third, based on these specification test results, panel data regression with appropriate estimators is implemented, including one-way Fixed Effects Models controlling for time-invariant unobserved heterogeneity, Two-way Fixed Effects accounting for both firm-specific and time-specific effects, and Three-way Fixed Effects incorporating firm, country, and year fixed effects, all using robust standard errors clustered at the firm level to address heteroskedasticity and autocorrelation concerns. Finally, moderation analysis employs interaction terms to test how R&D moderates relationships between green financing, FDI, and firm performance, with the significance of these interaction terms assessed using t-tests for individual effects and F-tests for evaluating the overall significance of the moderation effects. The two models are established to distinguish indicators of profitability and productivity.

$$\begin{aligned} ROA_{i,j,t} = & c + \beta_1 GRF_{i,j,t} + \beta_2 FDI_{i,j,t} + \beta_3 R\&D_{i,j,t} + \beta_4 (GRF_{i,j,t} * R\&D_{i,j,t}) + \beta_5 (FDI_{i,j,t} * R\&D_{i,j,t}) \\ & + \beta_6 Control_{i,j,t} + \text{Firm Fixed Effects} + \text{Country Fixed Effects} + \text{Year Fixed Effects} \\ & + \epsilon_{i,j,t} \end{aligned} \quad (1)$$

$$\begin{aligned} ATO_{i,j,t} = & c + \gamma_1 GRF_{i,j,t} + \gamma_2 FDI_{i,j,t} + \gamma_3 R\&D_{i,j,t} + \gamma_4 (GRF_{i,j,t} * R\&D_{i,j,t}) + \gamma_5 (FDI_{i,j,t} * R\&D_{i,j,t}) \\ & + \gamma_6 Control_{i,j,t} + \text{Firm Fixed Effects} + \text{Country Fixed Effects} + \text{Year Fixed Effects} \\ & + \epsilon_{i,j,t} \end{aligned} \quad (2)$$

Where in the above Equations (1)-(2) above, the dependent variables are profitability (ROA) and productivity (ATO) for the selected firms throughout the study. Furthermore, the independent variables abbreviated as GRF and FDI denote green finance and foreign direct investment. The moderator variable R&D means research & development at the macro level data where the firms are selected. Meanwhile, control reflects the control variables entitled firm size, firm age, firm growth, and labor productivity growth to comprehend the theoretical framework. The data for variables were collected and used on an annual basis during the study period. In conducting extensive estimates results, we separated our sample between groups of nations that implement carbon taxes and those that do not.

RESULTS AND DISCUSSION

This study finds that both green financing and foreign direct investment (FDI) have a significant positive effect on firm profitability and productivity in G20 emerging market countries. However, research and development (R&D) negatively moderates the relationship between green financing and profitability, while showing no significant moderating effect on productivity or the FDI relationship. These findings suggest that although capital inputs like green financing and FDI boost firm performance, the effectiveness of R&D in these countries remains limited due to structural inefficiencies.

Our analysis reveals significant differences in firm performance between countries with and without carbon taxes, providing preliminary evidence of how environmental regulations may influence financial outcomes in emerging markets. Table 3 presents comprehensive descriptive statistics for all study variables across the full sample and subsamples based on carbon tax status.

It is observed that the overall summary output for 57 companies has a mean value of ROA of 0.061 or 6.1%. The mean value of ROA for firms in countries without a carbon tax is 9.2%, higher than that of firms with a carbon tax, which is only 3.4%. The carbon tax referred to is a tax imposed on fuel use based on its carbon content. This result indicates that firms in countries without carbon taxes that utilize their assets are better off than those with carbon taxes. Interestingly, asset turnover (ATO) shows less dramatic variation, with means of 0.555 and 0.516 for countries with and without carbon taxes, respectively. This result suggests that while carbon taxes may impact profit margins through additional compliance costs, they have a minimal effect on firms' operational efficiency in generating revenue from assets. This finding indicates that regulatory environments may influence profitability metrics more substantially than productivity metrics in the short term.

Another notable finding is the substantial difference in green financing and FDI between the two groups. Countries with carbon taxes demonstrate dramatically higher green financing (mean = 226,407) compared to countries without carbon taxes (mean = 14,301). This fifteen-fold difference suggests that carbon taxation policies catalyze green investment flows, creating a potential offsetting benefit to the decreased ROA noted earlier. Similarly, FDI is nearly four times higher in carbon tax countries (mean = 111,019) versus non-carbon tax countries (mean = 28,094), indicating that environmental policy stringency may correspond with higher foreign investment levels in emerging markets. R&D intensity also shows meaningful variation, with carbon tax countries averaging 77.2 compared to 66.2 in non-carbon tax countries. This result suggests that more stringent environmental policies correspond with greater research and development activities, as firms seek innovative ways to reduce carbon emissions and compliance costs. The higher labor productivity growth in carbon tax countries (4.482 vs. 2.384) further supports this interpretation, suggesting that environmental policies correspond with efficiency improvements over time.

Overall, these descriptive statistics reveal that firms in countries with carbon taxes face profitability challenges but maintain similar productivity levels compared to their

counterparts in countries without carbon taxes. They also operate in environments with substantially higher green financing, FDI, and R&D intensity. These preliminary findings provide important context for the subsequent regression analyses examining how green investments influence firm performance metrics across these diverse regulatory environments.

Table 3. Descriptive Statistics

Variables	All countries samples			Countries with carbon tax			Countries without carbon tax		
	Mean	Min	Max	Mean	Min	Max	Mean	Min	Max
ROA	0,061	-0,237	0,619	0,034	-0,237	0,491	0,092	-0,093	0,619
ATO	0,537	0,001	2,557	0,555	0,001	2,221	0,516	0,001	2,557
Green Financing	129657	900	419866	226407	900	419866	14301	1200	34476
Foreign Direct Investment	73194	1419	180957	111019	2008	180957	28094	1419	64072
R&D	72,2	33,2	92,1	77,2	45,3	92,1	66,2	33,2	88,1
Firm Size	8,046	1,734	14,333	8,016	3,178	12,588	8,081	1,734	14,333
Firm Age	3,510	0,693	4,875	3,362	0,693	4,875	3,686	0,693	4,836
Firm Growth	0,148	-9,316	9,031	0,068	-9,316	9,031	0,243	-7,591	8,707
Labor Productivity Growth	3,525	-16,260	11,020	4,482	-4,180	8,690	2,384	-16,260	11,020

Note: **(1) Countries with carbon tax:** Argentina, Brazil, China, Mexico, and South Africa; **(2) Countries without carbon tax:** India, Indonesia, Russia, Saudi Arabia, and Turkey.

Table 4. Correlation Matrix

Variables	[1]	[2]	[3]	[4]	[5]	[6]	[7]
[1] Green Financing	1,00000	0.65924	0.57373	0.13205	-0.32066	-0.09712	0.61955
[2] Foreign Direct Investment	0.65924	1,00000	0.64292	0.12141	-0.30574	-0.09014	0.59896
[3] Research & Development	0.57373	0.64292	1,00000	0.04804	-0.22110	-0.01948	0.51372
[4] Firm Size	0.13205	0.12141	0.04804	1,00000	-0.02879	-0.05493	0.17470
[5] Firm Age	-0.32066	-0.30574	-0.22110	-0.02879	1,00000	0.04765	-0.24837
[6] Firm Growth	-0.09712	-0.09014	-0.01948	-0.05493	0.04765	1,00000	-0.03712
[7] Labor Productivity Growth	0.61955	0.59896	0.51372	0.17470	-0.24837	-0.03712	1,00000

Note: Table 4 reports the Pearson correlation between the main variables.

This study investigates the effect of green investment on the profitability and productivity of firms in G20 emerging market countries. Table 4 shows how the variables are correlated. The coefficient of correlation analysis for regressors reveals that there is no multicollinearity problem for all sample firms in the entire study period. The results of the Ordinary Least Squares (OLS.) models are presented in Table 5. First, we analyze the effect of green finance, foreign direct investment, and the moderating role of R&D

on ROA and ATO. Then the samples are separated based on the applied carbon tax regulations and analyzed in the same way.

Our analysis confirms four key findings. First, green financing positively impacts both firm profitability and productivity. Second, foreign direct investment enhances both profitability and productivity metrics. Third, R&D negatively moderates the relationship between green financing and profitability, but has no significant moderating effect on productivity. Fourth, R&D does not significantly moderate the relationship between FDI and either profitability or productivity in emerging markets. These findings provide critical insights into the complex dynamics of green investment in emerging economies and highlight the contextual differences compared to developed markets.

Table 5. Estimation Results

Variables	All countries samples		Countries with carbon tax		Countries without carbon tax	
	ROA (1)	ATO (2)	ROA (3)	ATO (4)	ROA (5)	ATO (6)
C	-36.868*** (0.0002)	-34.459*** (0.0006)	0.7493 (0.4547)	11.709 (0.2434)	-17.424*** (0.0841)	-11.259 (0.2625)
Green Financing	39.280*** (0.0000)	15.302* (0.0970)	0.2321 (0.8167)	-15.928 (0.1133)	14.817 (0.1411)	17.775* (0.0781)
FDI	16.799* (0.0940)	23.611** (0.0188)	25.818** (0.0107)	20.085** (0.0463)	25.618** (0.0116)	0.0521 (0.9584)
R&D	21.083** (0.0358)	19.880** (0.0477)	26.860*** (0.0080)	15.711 (0.1182)	19.542* (0.0531)	0.8118 (0.4185)
Green Financing*R&D	-22.192** (0.0272)	0.0167 (0.9866)	0.2273 (0.8204)	10.943 (0.2755)	0.8276 (0.4095)	-15.666* (0.0899)
FDI * R&D	-16.168 (0.1069)	-11.397 (0.2553)	-27.164*** (0.0073)	-13.542 (0.1777)	-19.686* (0.0514)	0.0326 (0.9739)
Firm Size	0.8953 (0.3713)	-42.059*** (0.0001)	-43.540*** (0.0001)	-62.633*** (0.0001)	-16.624* (0.0991)	-73.166*** (0.0001)
Firm Age	15.824 (0.1146)	32.454*** (0.0012)	25.173** (0.0128)	-61.830*** (0.0001)	20.611** (0.0415)	0.2335 (0.8156)
Firm Growth	-16.600* (0.0979)	0.4786 (0.6325)	0.9491 (0.3440)	0.0266 (0.9786)	-13.529 (0.1787)	0.9823 (0.3279)
Labor productivity growth	-36.868*** (0.0002)	-34.459*** (0.0006)	0.7493 (0.4547)	11.709 (0.2434)	-17.424* (0.0841)	-11.259 (0.2625)
Firm effect	Yes	Yes	Yes	Yes	Yes	Yes
Year effect	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.7986	0.9724	0.6491	0.8081	0.6915	0.8449
Adj R-squared	0.7521	0.9661	0.5578	0.7582	0.6006	0.7992
F-statistic	17.171	15.287	71.095	16.183	76.100	18.490
N	342	342	186	186	156	156

Table 6 presents the empirical results of green financing on ROA and ATO. Columns (1) and (2) use the whole sample as the main estimate. The test results show the impact of green financing on ROA and ATO. This result indicates a positive impact of green financing on a firm's profitability and productivity. In terms of the effect on profitability, green finance will increase efficiency. It demonstrates that financial development enhances liquidity, diversifies assets, and channels financial resources to the most profitable enterprises (Jiakui et al., 2022). This finding also proves the impact of green financing on a firm's productivity. These results are relevant to the findings of Jiakui et al. (2022) and Tong et al. (2022), who state that green finance is a significant positive predictor of green total factor productivity in China. This condition is because green funding can be used by companies to accelerate the transition to a green economy, thereby increasing company productivity. Supported by Lee and Lee (2022) study, stating that green productivity increases due to the maturation of the green finance sector.

Table 6. Hypothetical Test Results

Hypothesis	Correlation	Coefficient	p-value	Decision
H1a	Green Financing → ROA	39.280	0.0000**	Accepted
H1b	Green Financing → ATO	15.302	0.0970*	Accepted
H2a	Foreign Direct Investment → ROA	16.799	0.0940**	Accepted
H2b	Foreign Direct Investment → ATO	23.611	0.0188*	Accepted
H3a	Green Financing*R&D → ROA	-22.192	0.0272**	Accepted
H3b	Green Financing*R&D → ATO	0.0167	0.9866	Rejected
H4a	Foreign Direct Investment*R&D → ROA	-16.168	0.1069	Rejected
H4b	Foreign Direct Investment*R&D → ATO	-11.397	0.2553	Rejected

Note: *, **, *** represent significance at the 10%, 5%, and 1% levels (2-tailed), respectively.

Additionally, according to endogenous theory, "If the macroeconomics is to be saved from the century-old confusion and obscurantism, a new generation of economists must incorporate the paradigm shift of dynamic endogenous money analysis" (Yamaguchi & Yamaguchi, 2022). This is, of course, very relevant in the concept of the green finance sector. This result also aligns with the study by Hepburn et al. (2020) and Spash (2020), indicating that green expenditure and growth can cultivate a win-win culture for the environment and the economy; therefore, there is an urgent need to encourage green economic growth and recovery. Green finance is a structured financial activity or a strategy that results in significant and positive impacts on the environment and includes the outcomes of better environmental conditions (Park et al., 2018; Qamruzzaman & Jianguo, 2020). This dual benefit is particularly significant for emerging economies navigating the transition to sustainable development paradigms.

As capital resources, foreign direct investment inflows are more stable than portfolio investment because foreign direct investment pursues a long-term motive (Fahri et al.,

2022). The green economy is a new paradigm that requires a process of transition from fossil-fuel energy to renewable energy. This condition makes the stabilizing effect of foreign direct investment more needed by companies to overcome environmental uncertainties and transition to environmentally friendly technologies. The findings of this study confirm that FDI positively influences both firm profitability, as measured by ROA, and productivity, as measured by ATO. The results of the foreign direct investment test indicate a positive effect on the profitability and productivity of foreign direct investment firms. In line with a study by Choudhury & Khanna (2014), foreign direct investment positively influences the investing firm's profitability through diversifying the supplies of critical resources. The governments of emerging economies may maintain ownership control in specific strategic and sensitive industries such as defense, telecommunications, aviation, etc. In such industries, state-owned firms, as policy vehicles, are expected to produce positive externalities for the economy and society (Doh et al., 2004). However, these results contradict the findings of Cui and Xu (2019); there was some evidence of a positive effect of foreign direct investment on profitability in the short-term (3 years) but not in the medium-term (5 years). As such, firms may realize profits quickly, even only one year after entering a foreign market through foreign direct investment, but their profitability is hard to sustain over three years, as technological advancement in the industry will likely make the firms' existing advantages obsolete.

Meanwhile, foreign direct investment significantly affects a firm's productivity. Previous research findings show that foreign direct investment significantly predicts China's green total factor productivity (Tong et al., 2022). Foreign direct investment firms may still have higher average productivity than local firms because multinational companies have a flatter tail in their productivity distribution than local firms (Han et al., 2022). Foreign direct investment has become a productivity driver because of the substantial positive externalities associated with financial assistance. Through efficiency gains, foreign direct investment can significantly reduce friction in the economic system and contribute to productivity. The current findings are consistent with the study of Rehman Khan et al. (2022), who stated that foreign direct investment primarily influences productivity through technological advancement and capital allocation. Another reason is that the financial advantages and productivity advantages of foreign direct investment firms are interdependent, and this interdependence has strong policy implications. The financial advantages may allow foreign direct investment firms of low productivity to enter host countries (Han et al., 2022). However, this research contradicts the study of Wang et al. (2018), which showed that foreign direct investment has no significant effect on green productivity, and financial success does not always result in favorable capital allocation.

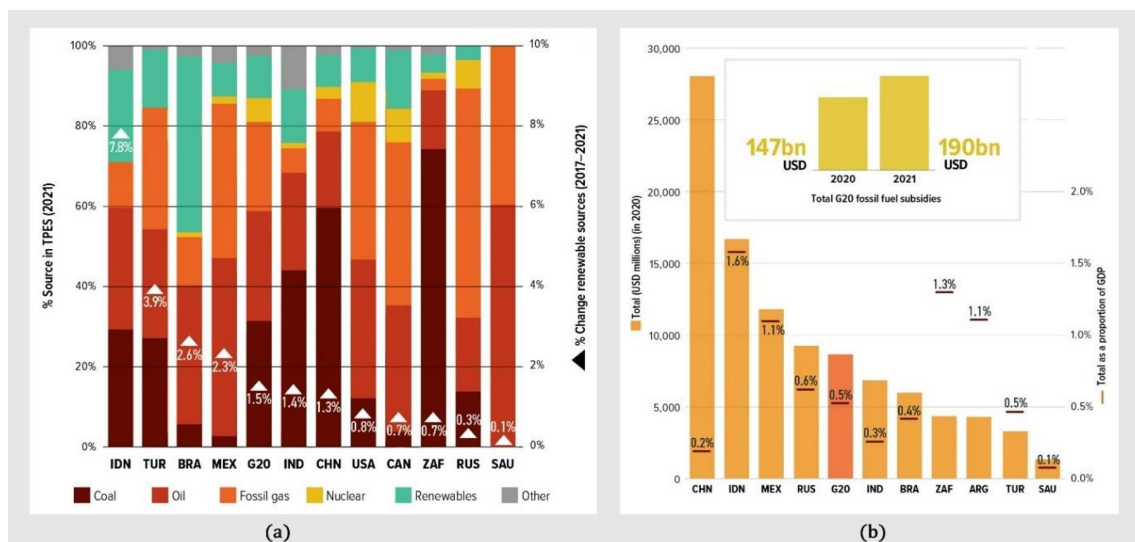
Importantly, our study highlights a critical policy consideration identified by Bermejo Carbonell and Werner (2018): FDI may not necessarily lead to rapid economic growth if funded by the receiving country's banking system. According to financial intermediation theory (Werner, 2014), locally-funded FDI competes for money with domestic investment, potentially offsetting growth benefits. This result suggests that policymakers should design

banking systems that reduce entry barriers, potentially by enabling greater participation of foreign banks in FDI transactions (Gelos & Roldos, 2004).

The results reveal a negative moderating effect of R&D on the relationship between green financing and firm profitability. This finding suggests that R&D expenditures in G20 emerging markets may dilute the returns from green financing due to inefficiencies in R&D systems. As shown in studies like Amores-Salvadó et al. (2014), the profitability of green innovation is higher in developed markets due to better institutional and technical capacities. Moreover, as shown in the Climate Transparency Report (2022), only a few countries in the sample—like Indonesia, Brazil, Turkey, and Mexico—have above-average renewable energy conversion rates. High costs and ineffective implementation, due to poor infrastructure and low-skilled human capital, likely diminish the intended benefits of R&D.

In terms of productivity, the moderating effect is statistically insignificant. This result supports Zhao et al. (2022), who argue that only specific forms of green R&D—like technology with high commercial applicability—can directly influence productivity. In the sample countries, R&D systems are often oriented more toward basic research or are underfunded, which limits their influence on firm-level productivity outcomes. Thus, the results of this study are not in line with the findings of Holzner & Wagner (2022), who found that R&D investment has significantly promoted green productivity, mainly because the research was aimed at developed countries (Germany) with very superior R&D. Therefore, sample selected for this study which focuses on exploring emerging countries resulting a new finding which contrary to the previous studies which were mostly done in developed countries.

Figure 1. (a) Energy Mix; and (b) Fossil Fuel Subsidies in G20 Emerging Market Countries



Source: Climate Transparency Report (2022)

Note: TPES (Total Primary Energy Supply)

This study examines the role of R&D in the relationship between foreign direct investment and ROA and ATO. This result indicates that R&D does not play a negative role or weaken the moderating effect of foreign direct investment on a firm's profitability and productivity. See Figure 1 (b), the average fossil fuel subsidies for all G20 members are 0.5% of GDP. 6 of the 10 sample countries subsidize fossil fuels above the average GDP. This condition is a big challenge for the development of R&D, which focuses on renewable energy technology. This figure is also consistent with the study conducted by Shaktawat & Vadhera (2021), which found that many energy subsidies are given to fossil fuel projects rather than those in the green economy. Another challenge considered is the lack of proper knowledge and resources to implement green financing strategies successfully by stakeholders (banks, investors, and governments).

Additionally, most emerging markets have underdeveloped green economy infrastructure compared to developed nations. Following the 2015 Paris Agreement, many emerging economies are still in the early stages of conceptualizing their green economy transition. This transitional state creates challenging conditions for R&D effectiveness, particularly for radical innovations that require time to diffuse and gain market share before becoming profitable. The cost dynamics of innovation in emerging markets further explain our findings. Initially, product development and launch costs exceed earnings, especially for more radical environmental products that may only become profitable after several years. This temporal mismatch between investment and returns explains why R&D does not enhance the performance impact of FDI in our sample.

Fujii and Managi (2019) provide additional theoretical insight, arguing that productivity improvements primarily come from "source reduction" rather than end-of-pipe technologies. The continued heavy subsidization of fossil fuels, shown in Figure 1(b), impedes this source reduction approach by maintaining artificially low prices for conventional energy. Similarly, Figure 1(a) illustrates the still-limited progress in converting to clean energy across our sample countries. These findings contrast with Holzner and Wagner (2022), who found that R&D investment significantly promoted green productivity in Germany. This divergence underscores the importance of contextual factors in shaping the effectiveness of innovation investments across different economic development stages.

We conduct the robustness checks in this section. First, this study uses control variables to manage the role of independent variables on the dependent variable because the control variables were proposed to affect the independent variable. Our study used a control variable as in the previous study by Xu et al. (2022) and Wen et al. (2021), including the following control variables in the regression: firm size, firm age, firm growth, and labor productivity growth. As a result, the control variables were significantly successful in controlling alternately or together in the four main research models. Second, we further utilize two alternative measures: countries with and without carbon taxes, following equations (1) and (2), respectively. Table 5 Columns (3), (4), (5), and (6) present the estimation results of the countries with and without carbon taxes sub-sample during the same period as the main estimation. These estimates imply that the significance and

magnitude of the coefficients are approximately or substantially the same across all four specifications. It confirms the robustness of estimates of the effect of green investment on the profitability and productivity of companies in G20 emerging market countries. Finally, our comprehensive robustness tests validate our core results, providing confidence in the reliability and generalizability of our findings within the context of emerging economies. These tests strengthen our contribution to understanding the complex dynamics of green investment, foreign direct investment, and R&D in shaping firm performance across diverse institutional environments.

CONCLUSION

The findings show that green finance and foreign direct investment have a significant impact on company profitability and productivity. Companies can use green funding to accelerate the transition to a green economy, thereby increasing company profitability and productivity. Next, R&D is proven to moderate the effect of green finance on company profitability significantly, but not significantly on company productivity. This result is in contrast to efforts to transition the economy to clean energy. Finally, R&D is not significant in moderating the effect of foreign direct investment on company profitability and productivity. This finding is because R&D capacity in emerging market countries is still lacking, particularly in renewable energy technologies. The purpose of this study is to investigate the role of green investment on the profitability and productivity of companies in G20 emerging market countries.

This study contributes new empirical evidence showing that green finance and FDI significantly enhance both profitability and productivity in G20 emerging market firms. However, the moderating role of R&D is found to be either negative (on profitability) or insignificant (on productivity and FDI relationships). These insights highlight the urgent need for institutional reform and innovation system development in emerging markets to maximize the potential of green and foreign investments. Policymakers should reduce fossil fuel subsidies, improve public-private R&D collaboration, and realign national innovation policies with the goals of a green economy. The implication of this study leads to potential future research on investigating green financing's effect on profitability and productivity in diverse industries within the G20 countries, especially when measured from different approaches and methods.

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Deconstructing Religiosity-Green Finance Relationship: The Role of Organizational Factors

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JEL Classification:

G21
Q56
M14
J53
L21

Received: 15 April 2025

Revised: 31 May 2025

Accepted: 11 June 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study links religiosity to green finance in emerging-market banks, highlighting internal drivers, green HRM, organizational identity, and leadership over external pressures. It uniquely shows how personal beliefs shape sustainable finance through cultural and theoretical pathways.

Research Objectives: The research aims to examine how religiosity affects the willingness of banks to engage in green finance, and under what conditions this relationship is strengthened.

Research Methods: The research employs a quantitative survey method involving employees across both private and state-owned banking institutions within the specified province, involving a cross-section of 43 banks. Structural equation modelling is used to test the hypothesised relationships.

Empirical Results: The results reveal that religiosity influences green finance indirectly through the enhancement of internal organisational capacities. Specifically, religiosity strengthens environmental values and practices within human resource systems, leadership approaches, and organisational identity, which in turn foster commitment to green financial strategies.

Implications: These findings highlight the strategic importance of cultural and leadership-based resources in promoting environmental sustainability in the banking sector.

Keywords:

human resource practices; organisational identity; religiosity; sustainable finance; transformational leadership

How to Cite:

Girindratama, M. W., Maulidi, A., Alnajar, A. E. A., & Mela, A. A. (2025). Religiosity and Green Finance in Emerging Market's Banking Sectors: The Mediating Effects of Green HRM, Organisational Identity, and Transformational Leadership. *Etikonomi*, 24(2), 497 – 516. <https://doi.org/10.15408/etk.v24i2.45856>.

INTRODUCTION

Green finance (GFIN) has emerged as an imperative within the banking sector, driven by escalating environmental crises and mounting global pressure for sustainable economic systems. The banking industry, traditionally anchored in profit maximisation and short-term returns (Moudud-Ul-Huq, 2021), now faces a paradigm shift that necessitates the integration of environmental, social, and governance (ESG) criteria into its core operational frameworks (Galletta et al., 2022). This transition is also underpinned by a plethora of empirical studies that elucidate the relationship between financial stability and environmental stewardship (Azmi et al., 2022; Houston & Shan, 2022). Furthermore, the advent of green finance aligns with international commitments, such as the Paris Agreement, which calls for a reallocation of capital towards sustainable investments. In such situations, the adoption of green financing practices within the banking sector is crucial, serving as a pivotal mechanism for facilitating the transition toward a more sustainable and resilient economic landscape (Di Tommaso & Thornton, 2020).

We agree with other scholars that green finance (GFIN) is instrumental in mobilising capital toward environmentally beneficial projects (Akomea-Frimpong et al., 2022). From the demand side, investors exhibit a pro-environmental preference (Vanwalleghem & Mirowska, 2020), reflecting a growing awareness and commitment to sustainability that transcends traditional financial considerations (Maulidi, 2025). We perceive that this pro-environmental preference is particularly pronounced among younger generations of investors, who are often more inclined to support companies and projects that demonstrate a genuine commitment to sustainability (Boermans et al., 2024; Bouman et al., 2020). The rise of socially responsible investing and impact investing further illustrates this trend (Olumekor & Oke, 2024). However, green financing practices in emerging markets still pose significant challenges and remain an issue. One of the foremost challenges is the scarcity of financial resources and a lack of investment in sustainable projects (Diaz-Rainey et al., 2023). This situation is exacerbated by underdeveloped financial institutions that may lack the expertise or willingness to engage in green financing (Akomea-Frimpong et al., 2022), thereby restricting the availability of innovative financial products such as green bonds and eco-friendly loans.

This study highlights critical research gaps in the existing GFIN literature. There are numerous studies on green finance; however, they frequently focus on particular topics, for example, green bonds, green loans, renewable energy financing, green technology, and innovation (Bhatnagar & Sharma, 2022; Bhutta et al., 2022; Sharma et al., 2022). Most of those studies are conducted in developed countries. Moreover, existing literature on green financing predominantly emphasises external drivers, such as regulatory pressures and market demand, in shaping sustainable practices. For instance, studies by Darko et al. (2018) and Kumar et al. (2024) highlight how regulatory frameworks serve as significant motivators for companies to adopt green financing initiatives.

Additionally, empirical investigations into the determinants of green financing often adopt a piecemeal approach, examining individual aspects such as corporate governance

or stakeholder engagement without integrating these factors into a cohesive theoretical framework. This disconnect is evident in work by Ning et al (2023), where findings suggest a correlation between stakeholder engagement and successful green financing strategies but fail to articulate how internal resource strengths facilitate this engagement. Particularly in emerging markets, the literature on banks' motivations for adopting green financing practices remains strikingly scarce, which highlights a significant gap in our understanding of how financial institutions can drive sustainable development within these contexts.

Therefore, the current study aims to provide substantial evidence and insight into such topical issues by exploring the drivers of green financing through the lens of the Resource-Based View (RBV) that remain conspicuously underdeveloped, particularly in emerging markets. While the RBV offers a robust theoretical framework for understanding how firms leverage their internal resources and capabilities to achieve competitive advantage (Nayak et al., 2023; Lin & Wu, 2014), its application to green financing is still in its infancy. For internal resource strengths, we focus on Green Human Resource Management (GHRM), Green Organizational Identification (GOI), and Green Transformational Leadership (GTL). In recent years, scholars have started to direct attention to those variables towards understanding the employees' level of attachment to the organisation's goals on sustainability (Al-Romeedy & El-Sisi, 2024; Choudhary & Datta, 2024; Priyadarshini et al., 2023). The results provide empirical evidence that supports the positive effects of the sustainability practices.

Contrary to most previous studies, we focus on green financing practices in the banking sector. The novelty of our research lies in positioning religiosity as the primary variable for predicting the banking sector's commitment to green finance. This approach diverges from prior models by incorporating RLG dimensions as a key driver of sustainable financial engagement. Additionally, we conceptualise and treat internal resources – GHRM, GOI, and GTL – as mediating factors in the RLG-GFIN relationship, providing a nuanced understanding of how personal beliefs are translated into organisational sustainability practices. Therefore, to our knowledge, it is the first study of its kind to offer a different theoretical understanding of how and under which conditions RLG is related to the willingness of banking sectors in supporting GFIN.

METHODS

Our questionnaire consisted of three parts. In the introductory section of the questionnaire, we outlined each critical element with precision to ensure participants were fully informed and aligned with the study's aims. This segment detailed the study's purpose, emphasising the academic and practical significance of their insights, while also clearly requesting their formal consent and reinforcing the confidentiality of their responses. In the second section of the questionnaire, we gathered essential demographic and professional background information, for instance, participants' educational qualifications and tenure within the banking industry. The third section served as the core of the survey, focusing

on eliciting participants' perspectives on key topics through a series of targeted questions. To enhance comprehension and contextual alignment, respondents were first presented with a brief scenario, designed to frame the subsequent questions and facilitate thoughtful, scenario-based responses. The survey used in this study was first created in English, then carefully translated into Indonesian to make sure Indonesian-speaking participants could understand it clearly. After translating, two experts performed a back-translation to check that the translated version matched the original English version closely. This process helped ensure that the meaning of the questions remained consistent in both languages, allowing for accurate and reliable responses.

We administered a structured questionnaire survey to employees across both private and state-owned banking institutions within the specified province, involving a cross-section of 43 banks. Out of 563 questionnaires distributed, an impressive 87.4% response rate was achieved, with 492 responses collected. The achieved response rate is mainly attributable to our strategic approach in encouraging participation. We offered a financial reward as compensation for the time and effort required to complete the questionnaire. According to some scholars, the incentive in research is not merely a participation motivator but part of a broader methodological strategy aimed at fostering a sense of ownership and engagement, helping to ensure that participants approached the survey with the seriousness and reflection necessary for high-quality data.

A 5-point Likert scale was employed to measure respondents' perceptions, with response options ranging from 1, indicating strong disagreement, to 5, indicating strong agreement. This scaling approach facilitates interpretation of attitudes, providing a balanced range that enhances both respondent engagement and data granularity, thereby strengthening the empirical depth of the study's findings. The green finance (GFIN) was measured using validated items from Kumar et al. (2024a). The construct captures the bank's strategic alignment with sustainable investment goals, including the development and implementation of green financial products such as green loans, bonds, and environmentally-focused credit allocation. We followed Karimi et al. (2022) to measure RLG based on the four-dimensional religious commitment theory (Glock and Stark, 1965: belief, knowledge, experience, and ritual practice). These dimensions provide a comprehensive assessment of an individual's religious commitment. The green human resource management (GHRM) was measured using items adapted from Saeed et al. (2019), which evaluate HRM practices oriented toward environmental sustainability. This includes green recruitment and selection, environmental training and development, performance appraisals linked to sustainability goals, and green rewards systems. The items were contextualised to reflect the specific practices relevant to the banking sector in emerging markets, ensuring cultural and industry relevance. Specifically, GHRM in the study captures how organisations internalise sustainability values through HR strategies that promote eco-friendly behaviours and competencies among employees.

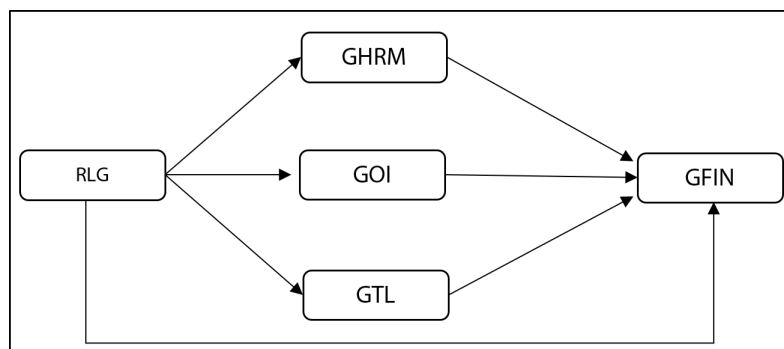
Moreover, Green organisational Identification (GOI) was assessed using the scale developed by Abdou et al. (2013), which measures the extent to which employees identify with their organisation's green values and sustainability goals. This construct

reflects the psychological bond between employees and their organisation, rooted in shared environmental values. High GOI indicates that employees view their organisational membership as a reflection of their own pro-environmental identity, which is critical in translating values into action for sustainable performance. Finally, Green Transformational Leadership (GTL) was measured using items from Singh et al. (2020), designed to capture leadership behaviours that inspire, motivate, and empower employees toward environmental objectives. Key dimensions include idealised influence, inspirational motivation, intellectual stimulation, and individualised consideration, all adapted within an environmental context.

In the initial stage, we organised the data using Excel, which was instrumental in detecting any missing values and ensuring data integrity before further analysis. Once verified, we advanced to Partial Least Squares – Structural Equation Modelling (PLS-SEM) to process the data, as this method aligns more effectively with the research objectives. Unlike Covariance-Based SEM (CB-SEM), which is centred on confirmatory analysis and theory testing, PLS-SEM provides greater flexibility and is well-suited for predictive research objectives, making it the more appropriate choice given the distinctive aims of this study (Dash & Paul, 2021). It can be argued that the selection of PLS-SEM in this study is theoretically and empirically justified, as it aligns with the growing consensus in the literature on the method's suitability for exploratory and predictive research contexts, particularly where model complexity and formative constructs are present (Astrachan et al., 2014; Dash & Paul, 2021).

Our study explores how religiously embedded ethical frameworks impact the adoption and internalisation of green practices within organisations. Given the local emphasis on moral stewardship, embedded from early education through social norms and organisational settings, this research offers a culturally nuanced understanding of how Islamic ethical principles align with and potentially enhance green finance initiatives, underscoring the role of religiously rooted values in driving ecological responsibility at an organisational level. Figure 1 shows the conceptual model of this study.

Figure 1. Conceptual Model



RESULTS AND DISCUSSION

Table 1 indicates that the participants consist of 58.91% females and 41.09% males. Regarding marital status, 53.67% are single, 45.07% are married, and 1.26% are divorced. Most respondents (97.27%) are employed full-time, while only 2.73% work part-time. Educationally, 81.13% hold undergraduate degrees, 18.03% diplomas, and 0.84% postgraduate qualifications. Notably, 92.03% state their companies are concerned with eco-friendly products, while 7.97% are unsure. Additionally, 90.15% confirm their companies have engaged in eco-friendly practices for more than five years, with 9.85% uncertain about the duration.

Table 1. Participants' Profile

Characteristics	Items	Number	Percentage
Gender	Male	196	41.09
	Female	281	58.91
	Total	477	100
Marital Status	Single	256	53.67
	Married	215	45.07
	Divorced	6	1.26
	Total	477	100
Employment Status	Full-time	464	97.27
	Part-time	13	2.73
	Total	477	100
Individuals' education	Postgraduate	4	0.84
	Undergraduate	387	81.13
	Diploma	86	18.03
	Senior high school	0	0.00
	Prefer not to say	0	0.00
	Total	477	100
Does your company care about eco-friendly products?	Yes	439	92.03
	No	0	0.00
	Not Sure	38	7.97
	Total	477	100
How long has your company cared about eco-friendly products?	Less than 5 years	0	0.00
	More than 5 years	430	90.15
	Not Sure	47	9.85
	Total	477	100

Table 2 demonstrates strong construct reliability and validity across all variables. Cronbach's Alpha values are high: GFIN (0.784), GHRM (0.876), GOI (0.897), GTL (0.911), and RLG (0.808), supported by corresponding rho_A values such as 0.788

(GFIN) and 0.912 (GTL). Composite Reliability scores—0.853 (GFIN), 0.903 (GHRM), and 0.934 (GTL)—exceed the threshold for internal consistency. At the same time, AVE values of 0.764 (GOI) and 0.738 (GTL) confirm strong convergent validity, reinforcing the model's robustness and measurement accuracy.

Table 2. Construct Reliability and Validity

Variables	Cronbach's Alpha	rho_A	Composite Reliability	AVE
GFIN	0.784	0.788	0.853	0.540
GHRM	0.876	0.888	0.903	0.573
GOI	0.897	0.904	0.928	0.764
GTL	0.911	0.912	0.934	0.738
RLG	0.808	0.803	0.873	0.634

The Fornell-Larcker Criterion in Table 3 confirms strong discriminant validity among all constructs. Each construct's square root of AVE exceeds its correlations with others—for example, GFIN (0.735) shows low correlations with GHRM (0.248) and GOI (0.417). At the same time, GOI (0.874) and GTL (0.859) also maintain moderate inter-construct values, such as 0.417 and 0.430 with GFIN, respectively. The RLG construct further supports this with a square root of AVE at 0.796 and correlations ranging from 0.253 to 0.344. These results indicate that each construct measures a distinct concept, ensuring low multicollinearity and reinforcing the model's structural clarity and theoretical soundness (Hair et al., 2019).

Table 3. Fornell-Larcker Criterion

Variables	GFIN	GHRM	GOI	GTL	RLG
GFIN	0.735				
GHRM	0.248	0.757			
GOI	0.417	0.098	0.874		
GTL	0.430	0.129	0.382	0.859	
RLG	0.275	0.316	0.253	0.344	0.796

Then, Table 4 reports the Inner VIF values, indicating that all predictor variables contribute independently to the model without multicollinearity issues. GHRM (1.112) and GOI (1.194) show minimal collinearity, while GTL and RLG have slightly higher values, with RLG peaking at 1.261, all well below the critical threshold. These values confirm that multicollinearity is not a concern and validate the robustness and reliability of the model's predictors for accurate estimation and interpretation (Hair et al., 2019).

Table 4. Inner VIF Values

Variables	GFIN	GHRM	GOI	GTL	RLG
GFIN					
GHRM	1.112				
GOI	1.194				
GTL	1.269	1.135	1.135		
RLG	1.261	1.135	1.135	1.000	

Table 5 presents the direct effects among constructs within the model, revealing significant pathways and their influences. The relationship between RLG and GFIN shows a coefficient of 0.054, indicating no significant support. In contrast, RLG significantly influences GHRM and also has meaningful effects on GOI and GTL, demonstrating support for these pathways. Additionally, GHRM, GOI, and GTL significantly impact GFIN, confirming their pivotal roles. However, GTL's effect on GHRM is not supported, while its positive influence on GOI is supported.

Table 5. Direct Effects

Paths	β	Sample Mean	SD	T Statistics	Sig,	Notes
RLG -> GFIN	0.054	0.055	0.044	1.229	0.220	Not Supported
RLG -> GHRM	0.308	0.309	0.048	6.383	0.000	Supported
RLG -> GOI	0.138	0.137	0.049	2.787	0.006	Supported
RLG -> GTL	0.344	0.346	0.042	8.147	0.000	Supported
GHRM -> GFIN	0.166	0.164	0.044	3.797	0.000	Supported
GOI -> GFIN	0.279	0.279	0.049	5.711	0.000	Supported
GTL -> GFIN	0.283	0.285	0.047	6.078	0.000	Supported
GTL -> GHRM	0.023	0.025	0.047	0.497	0.620	Not Supported
GTL -> GOI	0.335	0.338	0.051	6.563	0.000	Supported

Table 6 summarizes the indirect effects among the constructs, highlighting the pathways through which RLG influences GFIN via intermediary constructs. The indirect effect of RLG on GFIN through GHRM is evidenced by a coefficient of 0.051 (SD = 0.016, T = 3.166, p = 0.002), indicating this pathway is supported. Similarly, the pathway from RLG to GFIN through GOI shows a significant effect with a coefficient of 0.038 (SD = 0.016, T = 2.415, p = 0.016), also confirming support for this indirect relationship. Furthermore, the strongest indirect effect is observed through GTL, with a coefficient of 0.097 (SD = 0.020, T = 4.813, p < 0.001), demonstrating robust support for this pathway. Collectively, these findings underline the importance of intermediary constructs in facilitating the influence of RLG on green financial outcomes, illustrating the nuanced mechanisms through which religiosity can enhance green financial practices within organisations.

From the empirical results, religiosity does not directly influence green finance but significantly impacts it through three internal mediators: green human resource management, green organisational identity, and green transformational leadership. This pattern aligns with the RBV, which emphasises that competitive advantage and strategic outcomes often arise from leveraging unique internal capabilities rather than external pressures. Moreover, the study suggests that religiosity enhances each of these internal capacities, which in turn strengthens the bank's commitment to green finance. Among these, green transformational leadership serves as the strongest indirect pathway, followed by green human resource management and green organisational identity.

Table 6. Indirect Effects

Paths	β	Sample Mean	SD	T Statistics	Sig.	Notes
RLG -> GHRM -> GFIN	0.051	0.051	0.016	3.166	0.002	Supported
RLG -> GOI -> GFIN	0.038	0.038	0.016	2.415	0.016	Supported
RLG -> GTL -> GFIN	0.097	0.098	0.020	4.813	0.000	Supported

This study theoretically contributes to prior research by offering a refined understanding of the indirect relationship between RLG and GFIN, challenging earlier assumptions of a direct causal link (e.g., Jenkins & Chapple, 2011; Agusalim & Karim, 2024). Although previous studies have recognised RLG as a moral driver of pro-environmental behaviour (Astrachan et al., 2020; Samad et al., 2022), this research clarifies that its impact on GFIN is contingent upon intermediary organisational constructs, namely GHRM, GOI, and GTL. In doing so, it extends the theoretical work of Mousa and Othman (2020), Kumar et al. (2024), and Abbas (2024) by demonstrating how religiosity systematically shapes these internal mechanisms, which subsequently translate ethical values into structured green finance actions. Explicitly, this study contributes to the literature by bridging gaps between ethical orientation and financial behaviour by integrating moral capital as a strategic resource. For example, it advances the work of Koleva et al. (2023) by showing that ethical values, when institutionalised through GHRM, GOI, and GTL, can drive long-term sustainability outcomes. Moreover, it offers an alternative to models dominated by economic rationality and profit-maximisation (Wood and Friedline, 2024), suggesting that internal ethical infrastructures, rooted in religiosity, are critical for embedding and sustaining green finance practices. Therefore, this multi-layered theoretical model deepens the conceptualisation of how values-based systems influence institutional behaviour in environmentally responsible finance.

Moreover, the mediators – GHRM, GOI, and GTL – are shown to hold distinct yet interrelated roles in advancing GFIN. Each mediator independently contributes to the green financial agenda, demonstrating their intrinsic value as operational levers for GFIN when aligned with religiosity's principles. However, the study also suggests that GTL wields a unique position in influencing GOI, without extending this influence to GHRM, thus highlighting the differentiated pathways through which leadership can reinforce

organisational identity while remaining distinct from HR-focused green initiatives. This separation may reflect a leadership emphasis on strategic vision and identity cohesion, as opposed to procedural or HR-centric green practices. Consequently, GTL's selective impact on GOI but exclusion from GHRM could indicate a potential specialisation within green organisational dynamics, where leadership's influence is optimised by concentrating on identity rather than procedural aspects. This delineation within the pathways suggests a refined understanding of how organisational structures interact with green objectives, advancing the discourse on how ethical frameworks and leadership influence sustainability in finance. These results have theoretical and managerial implications.

The lack of a direct link between RLG and GFIN has important theoretical implications, showing that motivations for sustainable finance are complex and need rethinking in both environmental and finance theories. Although religiosity is connected to ethics and pro-social behavior (Taylor et al., 2020; Astrachan et al., 2020), it does not automatically lead to financial support for green projects. Studies show that religious people often care about the environment (Karimi et al., 2020; Agusalim & Karim, 2024), but this concern does not always result in active financial involvement. This result suggests a gap between values and real financial actions, as green finance tools like green bonds require more than good intentions. Different religions and cultures interpret environmental responsibility in various ways, causing inconsistent green finance practices rather than a unified effort. Banks prefer precise, measurable results, which religious motivations alone usually do not provide. According to Agusalim and Karim (2024), religious values do not directly guide investment decisions based on returns or market demand. Instead, green finance is often driven by financial benefits and regulations, such as lower interest rates or risk disclosures. Without these practical incentives, religiosity alone cannot direct banks toward green finance. This result means we need to better understand how moral values influence sustainable finance, as their impact depends on social norms and institutional rules (Samad et al., 2022). Hoff and Stiglitz (2016) also highlight that financial choices rely more on economics, risks, and regulations than on ethics. So, while religion may encourage caring for the environment, real financial decisions in green finance are shaped mainly by economic and structural factors.

Through which RLG contributes to GFIN, our study highlights the necessity of recognising the unique contributions of the mediator variables – GHRM, GOI, and GTL – as essential organisational resources that reflect and reinforce a commitment to sustainability. These mediators act as vital organizational resources that turn religious values into clear, measurable actions supporting sustainability. In the banking sector – where profit and compliance pressures are high – these mediators help align religiosity with green finance goals. For example, GHRM plays a crucial role by embedding environmental values into HR policies, such as hiring sustainability-focused staff, rewarding eco-friendly performance, and training employees on green practices. This institutionalizes religious ethics within the workforce, creating a culture of environmental responsibility that strengthens banks' green finance commitment. This finding supports earlier research (e.g., Mousa and Othman, 2020) showing that GHRM fosters a work environment receptive

to sustainable initiatives, effectively translating religious values into practical support for green finance.

The distinct roles of GOI and GTL highlight the complex nature of green finance, where identity and leadership uniquely strengthen environmental commitment, supporting the idea that sustainable practices stem from a blend of ethical and moral values (Kumar et al., 2024). According to Ashforth and Mael (1989), a strong organizational identity shapes employee attitudes and aligns behaviors with the organization's mission. In this study, a GOI rooted in religiosity helps employees and stakeholders see their work as part of a larger ethical purpose, turning religious values into concrete green finance actions. This condition allows banks to embed religiosity-driven values into their brand and operations, encouraging the adoption of green financial products like green bonds and sustainable loans, which enhances their reputation and appeal to sustainability-focused stakeholders (Abdou et al., 2023). Supporting this, Al-Romeedy and El-Sisi (2024) find that GOI strengthens institutional commitment and investment in green finance.

Regarding GTL, it acts as a key channel for religiosity to influence green finance by fostering ethical leadership focused on environmental responsibility and long-term sustainability. Extending Abbas' (2024) framework, our findings show that GTL not only inspires employees through environmental ethics but also aligns diverse ethical perspectives, including religious beliefs, with green finance objectives. Thus, GTL offers a flexible foundation for integrating personal moral values into secular organizational practices, explaining how religiosity can manifest in green finance leadership.

Framed within the RBV, our findings call for a broader understanding of organizational resources that includes both tangible and intangible assets, enriching the conversation on sustainable finance and encouraging more profound exploration of how firms can leverage internal capabilities for environmental responsibility. The apparent influence of RLG on GHRM, GOI, and GTL shows that religiosity serves as a core resource shaping organizational culture and practices. This religious foundation promotes GHRM practices focused on sustainability, signaling an ethical approach to managing human capital. By integrating religious principles into HR, organizations can develop a workforce that is not only capable but also internally motivated to support sustainability efforts, thus strengthening human capital as a key strategic resource. This synergy between religiosity and GHRM aligns with RBV theory, suggesting that effective human resource management can drive superior performance and competitive advantage in green finance.

This study advances prior work by demonstrating that RLG directly shapes GOI, positioning it as a core intangible asset. Although Ashforth and Mael (1989) and Abdou et al. (2023) highlight the role of identity in supporting behaviours with strategic goals, our findings extend this by showing how RLG embeds ethical coherence within GOI. Different from profit-driven models (Wood & Friedline, 2024), this identity is rooted in moral values, enabling organisations to present authentic sustainability commitments. The linkage supports Al-Romeedy and El-Sisi (2024), affirming that value-based identities foster trust and stakeholder support. Thus, RLG is reframed as a foundational mechanism that internalises environmental ethics into finance-related behaviours. Theoretically, this strengthens the

RBV by identifying RLG as a distinct intangible resource that enhances competitive advantage through GOI. It can also be argued that our results refine frameworks by Mousa and Othman (2020) and Kumar et al. (2024), who explore internal ethical drivers, by showing that RLG fosters a consistent, pro-environmental identity. In this sense, GOI, shaped by religious values, moves beyond branding to become a structural enabler of green finance practices. These challenges compliance-based models, suggesting that belief-driven organisations are better positioned to institutionalise sustainability. The study thus adds depth to green finance literature by linking cultural-religious ethics to organisational identity as a strategic driver.

Furthermore, the direct link between religiosity (RLG) and green transformational leadership (GTL) shows that personal religious beliefs can influence a leader's ability to guide organisations toward sustainability. Our findings suggest that religiosity does more than promote general ethics. It provides leaders with a clear moral foundation that supports real, practical actions for environmental responsibility and green finance. This supports Aguslim and Karim's (2024) view that religious values shape ethical decisions in finance by aligning leadership with environmental goals. Our study adds that these values can strengthen GTL, making it more effective and less vulnerable to short-term profit pressures. Although studies like Koleva et al. (2023) note that religious leaders tend to value social responsibility, they often do not explain how those beliefs translate into sustainable practices. Our research fills this gap by showing how religious values can deepen GTL's influence and embed a long-term ethical mindset into organisational practices. This makes religiously inspired leaders well-positioned to lead sustainable efforts without compromising ethical standards. Our results also align with Mo et al. (2023), Astrachan et al. (2020), and Chan et al. (2019), who found that religious individuals are more likely to act ethically in professional settings, supporting the idea that religiosity strengthens moral leadership in sustainability efforts.

Interestingly, the research indicates that while GTL can influence GOI, it does not extend the same influence to GHRM. This result suggests that leadership can inspire an organisation-wide ethos around sustainability (as seen in GOI), but operationalising these values within specific functional areas such as HR may require additional mechanisms, such as targeted policies, dedicated resources, sustainability-focused recruitment processes, or specialised training frameworks that fall outside the direct influence of GTL. These findings challenge a common assumption in RBV literature – that transformational leadership can universally drive all aspects of green resource development within a firm (AlNuaimi et al., 2021; Singh et al., 2021). Instead, our study supports a more nuanced view, aligning with recent RBV expansions, such as those by Khan et al. (2024) and Cooper et al. (2023), which emphasise that different resources may require targeted, context-specific strategies for effective development and utilisation. This also supports the work of Abdou et al. (2023) and Alrowwad et al (2020), who argue that while green-oriented leadership can foster a sustainability-focused culture, the translation of these values into functional areas requires specialised interventions within each department. This perspective enriches RBV theory by highlighting that leadership, while critical, may

need to be complemented with structural and procedural investments in certain areas, like HRM, to ensure the cohesive development of green resources.

The findings of this research provide practical insights for bank managers aiming to strengthen GFIN through religiosity (RLG) and its indirect pathways. First, since RLG does not directly influence GFIN, managers should create a work environment where ethics and sustainability go hand in hand. Promoting GTL is crucial, as such leaders can embed environmental values into the bank's strategy and operations. Second, leadership development programs should focus on combining ethics with environmental responsibility. Third, the mediating role of GOI suggests that embedding sustainability into a bank's culture and brand can boost its image in an eco-aware market. A strong green identity helps build stakeholder trust and differentiate the bank. Fourth, GHRM is essential for equipping employees with the skills and motivation to carry out green finance tasks. Managers should align HR strategies, like recruitment, training, and evaluations, with sustainability goals. Fifth, since leadership shapes culture broadly while HRM impacts daily behavior, tailored approaches are needed to address both levels. Finally, especially in emerging markets, using religiosity-inspired values can give banks a strategic edge while also meeting rising regulatory demands.

CONCLUSION

This study investigates how religiosity influences green finance adoption in the banking sector by examining its indirect effects through internal organisational resources. The findings reveal that religiosity does not directly drive green financial practices. Instead, it shapes key internal mechanisms—human resource practices, organisational identity, and leadership style—that translate religious values into sustainability actions. Each of these internal factors serves as a distinct channel that links ethical orientations with environmental finance practices, offering new insights into how value-based drivers support long-term sustainability goals. These results contribute to the literature by extending the Resource-Based View (RBV) to include religious values as a strategic organisational asset in emerging market contexts.

Based on these findings, banking institutions—especially in emerging markets—are encouraged to strengthen internal capacities that align with sustainability principles. Policies should focus on integrating environmental concerns into employee recruitment and performance evaluations, fostering a shared organisational identity committed to sustainability, and cultivating leadership that prioritises ethical and long-term goals. Regulatory bodies and policymakers may also consider providing incentives for banks that implement internal strategies promoting green finance, not only through external compliance but also through internal cultural transformation. A values-based and integrated approach can position banks as active contributors to environmental stewardship while enhancing their long-term competitiveness.

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Untapping the Determinants of Islamic Financial Behaviour among Young Generations

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JEL Classification:

D10

D14

D91

G41

Received: 31 December 2024

Revised: 21 May 2025

Accepted: 25 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: The originality of this research lies in its integrated examination of psychological, social, and educational determinants of Islamic financial behaviour within a localized Malaysian context.

Research Objectives: Grounded in the Theory of Planned Behaviour, the research investigates how Islamic financial literacy, financial risk attitude, parental financial socialization, and financial self-efficacy influence financial behaviour.

Research Methods: A structured questionnaire was distributed to 358 respondents aged 18 to 30, and the data were analyzed using covariance-based Structural Equation Modelling (CB-SEM).

Empirical Results: The study reveals two significant findings: parental financial socialization and financial self-efficacy strongly predict Islamic financial behaviour, while financial literacy and risk attitude show insignificant relationships.

Implications: Policymakers should embed Islamic financial literacy in national youth programs, educators must integrate hands-on financial training into curricula, and Islamic finance providers are encouraged to offer youth-friendly, Shariah-compliant products supported by educational outreach and family-involved financial awareness initiatives.

Keywords:

Islamic financial behaviour; Islamic financial literacy; parental financial socialization; financial self-efficacy; young generations

How to Cite:

Ishak, M. A. F., Muhammad Zuki, M. F. & Hassan, M. H. (2025). Untapping the Determinants of Islamic Financial Behaviour among Young Generations. *Etikonomi*, 24(2), 517 – 532. <https://doi.org/10.15408/etk.v24i2.43908>.

INTRODUCTION

Financial inclusion in Malaysia has made significant progress in recent years, driven by strong policy measures and technological advancements. The country has witnessed substantial improvements in the accessibility of financial services. The percentage of adults with access to formal financial institutions and digital financial services has increased from 46 percent in 2011 to 96 percent in 2020. Bank Negara Malaysia has played a pivotal role in fostering an inclusive financial ecosystem by promoting financial literacy, supporting microfinance initiatives, and facilitating the expansion of mobile banking. Additionally, Malaysia's commitment to the Sustainable Development Goals (SDGs) has underscored the importance of financial inclusion in reducing poverty and stimulating economic growth. According to a World Bank report, Malaysia's financial inclusion efforts have significantly reduced the unbanked population, contributing to overall economic stability and resilience (World Bank, 2023).

Previous studies have also shown that increased financial inclusion does not automatically translate into responsible financial behaviour. For instance, Indana & Pambekti (2022) stressed that in Islamic finance, balanced and ethical financial behaviour, including thrift, financial prudence, and Shariah-compliance, is central to both personal and societal well-being. However, such ideals are not always reflected in the daily financial choices of the young generation.

Nevertheless, the positive fact of financial inclusion in Malaysia is not aligned with the trends of personal financial behaviour. In fact, many personal financial behaviour issues arise among individuals in Malaysia. Among them, the ongoing issue of inadequate retirement savings among Malaysians presents a significant financial behaviour challenge. Despite various financial inclusion efforts, a substantial portion of the population remains financially vulnerable, with many individuals lacking sufficient retirement savings to ensure a secure and comfortable post-retirement life.

The matter at hand is fundamentally associated with financial behaviour, given the substantial living expenses, inadequate wage growth, and a dearth of robust financial literacy that collectively exacerbate this predicament. Of concern, the Employees Provident Fund (EPF) revealed that as of September 30, 2023, 6.3 million members under the age of 55, constituting 48 percent of such members, possessed less than RM10,000 in their accounts (New Straits Times, 2023). This confluence of factors imperils individual financial stability and strains the national economy, thus underscoring the compelling necessity for all-encompassing policy interventions and intensified financial education initiatives to foster improved financial behaviour and safeguard enduring financial well-being.

Then, the insurance penetration rate in Malaysia has achieved a commendable 40 percent, whereas family takaful penetration lags at 20 percent. This notable incongruity underscores a substantial disparity in the adoption of takaful within Malaysia's predominantly Muslim populace. This conspicuous variance draws attention to an underlying concern in Islamic financial behaviour, indicating that a significant proportion of Muslims abstain

from enrolling in takaful products. This occurrence necessitates comprehensive research into Islamic financial behaviour to comprehend the impediments to adoption.

This interest in youth financial behaviour is well-founded, as prior research has shown that financial knowledge, self-efficacy, and locus of control significantly influence Islamic financial behaviour among Generation Z (Pahlavi et al., 2022). These findings highlight the formative role of psychological and educational factors in developing ethical financial habits among young adults. Islamic finance has become a pivotal element of the global financial system, with Malaysia recognized as a leading hub for Islamic banking, takaful, and capital markets. Despite its progress, concerns remain about whether financial inclusion, especially among youth, translates into sound Islamic financial behaviour. University students, as part of the young generation, are transitioning into financial independence, making their financial behaviour a critical area of study.

Islamic financial behaviour refers to actions that comply with Shariah principles, including the avoidance of *riba* (interest), *gharar* (excessive uncertainty), and *haram* (prohibited) activities, while promoting *halal* investments and prudent money management (Indana & Pambekti, 2022). Past studies have emphasized the role of financial literacy in fostering sound financial behaviour (Antara et al., 2016; Nawi et al., 2018). However, evidence suggests that literacy alone may not be sufficient; psychological factors such as financial self-efficacy (Farrell et al., 2016; Mathew et al., 2024) and social influences like parental financial socialization (Mohamed, 2017; Sundarasan et al., 2016) also play significant roles.

Islamic financial knowledge influences the financial behaviours of youth. There is a positive link between Islamic financial attitudes and financial knowledge, as well as between financial knowledge and behaviour. Islamic financial awareness strengthens the relationship between financial attitudes and behaviours. This condition highlights the need for targeted financial education programs to improve young people's Islamic financial literacy and behaviour (Ergün, 2024). Moreover, while financial risk attitude has been widely examined in conventional finance (Cameron et al., 2014; Kannadhasan, 2015), its influence within the Islamic finance context remains underexplored. Islamic finance emphasizes ethical risk-sharing rather than speculative risk-taking, raising questions about how young Muslims perceive and act on financial risks (Kayed & Hassan, 2011).

Despite these insights, past literature has mainly remained fragmented. Many studies have isolated variables such as financial literacy or self-efficacy without considering their interaction in a single predictive framework. Few studies have been context-specific, and even fewer have addressed Islamic financial behaviour in smaller states like Perlis, which may feature distinct socio-cultural and economic dynamics. A notable gap in previous studies is their limited focus on integrated models that simultaneously examine multiple determinants of Islamic financial behaviour. Many existing studies have been fragmented, focusing solely on either financial literacy or singular psychological factors, without

considering their combined effect. Furthermore, there is a lack of research examining how these determinants interact within specific Malaysian states, such as Perlis, where cultural and socio-economic factors may uniquely shape financial behaviours. Most prior research also tends to generalize findings across broad youth populations, overlooking the unique context of university students who face distinctive financial pressures and opportunities.

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METHODS

This study investigates the determinants of Islamic financial behaviour among the young generation in Malaysia, with university students in Perlis serving as the representative sample. The respondents' criteria were clearly defined to ensure relevance to the study's objective: participants must (i) be aged between 18 and 30 years, (ii) be currently enrolled as full-time students, and (iii) be studying at one of the four higher education institutions in Perlis, namely Universiti Islam Antarabangsa Tuanku Syed Sirajuddin (UniSIRAJ), Universiti Malaysia Perlis (UniMAP), Universiti Teknologi MARA (UiTM), and Politeknik Tuanku Syed Sirajuddin (PTSS). These criteria were set to capture individuals within the young generation who are actively transitioning into financial independence.

The study employed a convenience of non-probability sampling technique to distribute the questionnaires, a method frequently utilized in behavioural intention research (Ali et al., 2015; Fernandes et al., 2017; Gerrard & Barton Cunningham, 2003; Lee, 2009). This technique was chosen for its practicality and efficiency in accessing a readily available pool of respondents, particularly in exploratory studies where comprehensive sampling may not be feasible. Moreover, convenience sampling is particularly suitable for studies focusing on specific populations, such as young generations among university students (Teddlie & Yu, 2007).

A total of 379 questionnaires were disseminated to the target population. From this distribution, 187 questionnaires were returned, reflecting a considerable initial response. However, upon further scrutiny, only 164 of these responses were deemed complete and usable for the study, resulting in a response rate of 43.27 percent. Of the total

participants, 64 were male (39 percent), and 100 were female (61 percent). Regarding age distribution, most respondents, as many as 96 (59 percent), were aged between 18 and 22 years, followed by 65 (40 percent) in the 23 to 27 years age bracket. A small percentage of 1 percent (2) fell within the 28 to 32 years age group, and 1 (1 percent) was over 32 years.

Regarding educational attainment, 121 students (74 percent) were pursuing a bachelor's degree, 35 (21 percent) had a diploma, 6 (4 percent) had completed SPM/STPM, and one each (1 percent) were pursuing a master's degree and a PhD. The students were from various universities: 83 (51 percent) were from Universiti Malaysia Perlis, 45 (27 percent) from Universiti Teknologi MARA Arau, 27 (16 percent) from Politeknik Tuanku Syed Sirajuddin, and 9 (5 percent) from Universiti Islam Antarabangsa Tuanku Syed Sirajuddin.

The year of study distribution showed that 78 respondents (48 percent) were in their second year, 37 (23 percent) in their first year, 35 (21 percent) in their third year, and 14 (9 percent) were in their fourth year or beyond. When it comes to income sources, 56 students (34 percent) relied on education loans, another 55 (34 percent) were self-funded or supported by family, 50 (30 percent) received scholarships, and 3 (2 percent) had part-time jobs. The total monthly income for most students (125, 76 percent) ranged from RM 1001 to RM 2500. About 13 respondents (8 percent) had a monthly income of RM 0 to RM 1000, 12 (7 percent) earned between RM 2501 and RM 4000, 4 (2 percent) had an income of RM 4001 to RM 5500, and 10 (6 percent) earned more than RM 5501.

All items measuring the constructs in this study were adopted from previously validated instruments based on the underlying Theory of Planned Behaviour. The dependent variable of this study is Islamic financial behaviour, which refers to financial practices that follow Shariah principles, such as avoiding *riba* (interest), saving and investing in *halal* products, and managing money responsibly. It was measured using five items adapted from previous studies (Potrich et al., 2016; Susan, 2020). These items assess behaviours like keeping savings in Shariah-compliant products, planning finances before big purchases, saving regularly, setting financial goals based on Islamic values, and investing in Islamic financial instruments.

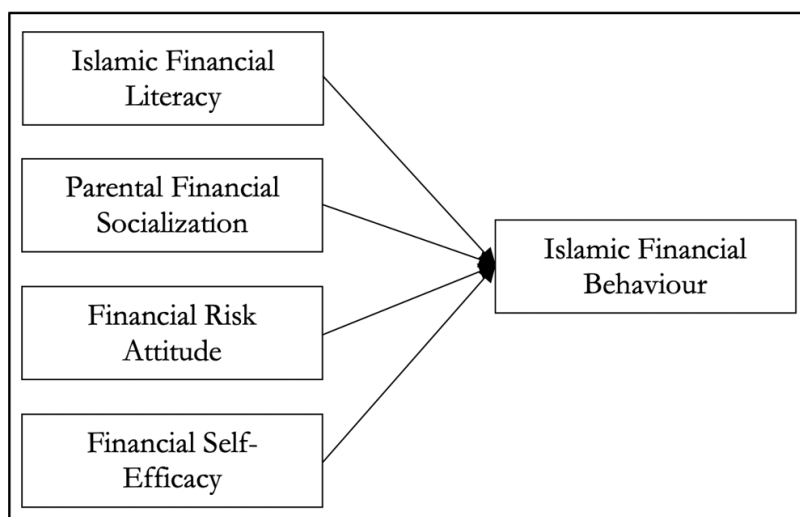
The independent variables in this study include Islamic financial literacy, parental financial socialization, financial risk attitude, and financial self-efficacy. Islamic financial literacy measures students' understanding of key Islamic finance concepts, such as *riba* (interest), *gharar* (uncertainty), and Shariah-compliant financial practices (Albaity & Rahman, 2019). Parental financial socialization assesses the influence of parents or guardians on students' financial habits, including discussions about money, saving, and role modelling responsible financial behaviour (Li et al., 2021; Shim et al., 2010).

Financial risk attitude captures youths' willingness to take risks in financial decisions, such as investing in Islamic financial products and managing credit (Ali et al., 2015; Keller & Siegrist, 2006; Potrich et al., 2016; Susan, 2020). Lastly, financial self-efficacy reflects

students' confidence in managing their finances, including their ability to solve financial problems, meet goals, and handle financial challenges effectively (Lown, 2011; Oquaye et al., 2022; Serido et al., 2013). These items were explicitly modified to examine university students' Islamic financial behaviour. All questions employed a five-point Likert scale, with one indicating "strongly disagree," 2 indicating "disagree," 3 indicating "neutral," 4 indicating "agree," and five indicating "strongly agree." The figure below illustrates the theorized framework for the current study.

The questionnaire responses were meticulously coded and entered into the Statistical Package for the Social Sciences (SPSS) Version 26 for initial data analysis. Additionally, the study employed partial least squares (PLS) using Smart-PLS Version 3.3.7 to evaluate both the measurement and structural models, in line with recommendations by Hair et al. (2010). Two primary considerations drove the choice of PLS. First, PLS is particularly well-suited for exploratory research, as highlighted by Henseler et al. (2009) and Chin & Newsted (1999). Its ability to handle complex models and smaller sample sizes makes it ideal for studies aiming to develop theoretical insights rather than confirm established theories. Second, PLS has recently gained significant traction in individual and service research fields, as noted by Sarstedt (2008). This growing popularity underscores its effectiveness in analyzing data where traditional covariance-based techniques may fall short.

Figure 1. Theoretical Framework



The measurement model was assessed to ensure the reliability and validity of the constructs. Convergent validity was first tested using factor loadings, composite reliability (CR), and average variance extracted (AVE), following Hair et al. (2010). Factor loadings above 0.708 indicate that items effectively measure their respective constructs. In this study, several items, including IFB5, IFL3, IFL5, FRA1, FRA2, FRA6, FRA7, FSE5, and FSE6, did not meet this threshold and were therefore removed from further analysis. The remaining items showed satisfactory factor loadings, confirming that they

appropriately represent their constructs. Composite reliability for all constructs exceeded the recommended value of 0.70, demonstrating strong internal consistency.

Similarly, AVE values were above 0.50 for all constructs, indicating that each construct captured a substantial proportion of variance in its indicators. Discriminant validity was also examined using the Fornell-Larcker Criterion, latent variable correlations, and the Heterotrait-Monotrait Ratio (HTMT). The square roots of the AVE for each construct were greater than the corresponding correlation coefficients, confirming that the constructs were distinct from one another (Fornell & Larcker, 1981). Overall, the results confirmed that the measurement model satisfied all criteria for convergent and discriminant validity, supporting its suitability for subsequent structural model assessment.

RESULTS AND DISCUSSION

The results of the structural model analysis, including significant standardized path coefficients, t-values for each relationship, and squared multiple correlations (R^2) for the constructs, are presented in Table 1 and visualized in Figure 2. The hypothesized model explained a moderate amount of variance in the dependent variable, Islamic financial behaviour, with an R^2 value of 0.245. This R^2 value indicates that 24.5 percent of the variation in Islamic financial behaviour can be explained by the four variables: Islamic financial literacy, financial risk attitude, parental financial socialization, and financial self-efficacy. At the same time, the other un-included variables may explain the other 75.5 percent.

Table 1. Results for the model's structural assessment.

H	Relationship	Standard Beta	Standard Error	t-value	Results
H1	IFL --> IFB	0.148	0.078	1.693	Unsupported
H2	FRA --> IFB	-0.034	0.102	0.312	Unsupported
H3	PFS --> IFB	0.194	0.091	2.068*	Supported
H4	FSE --> IFB	0.352	0.088	3.914**	Supported

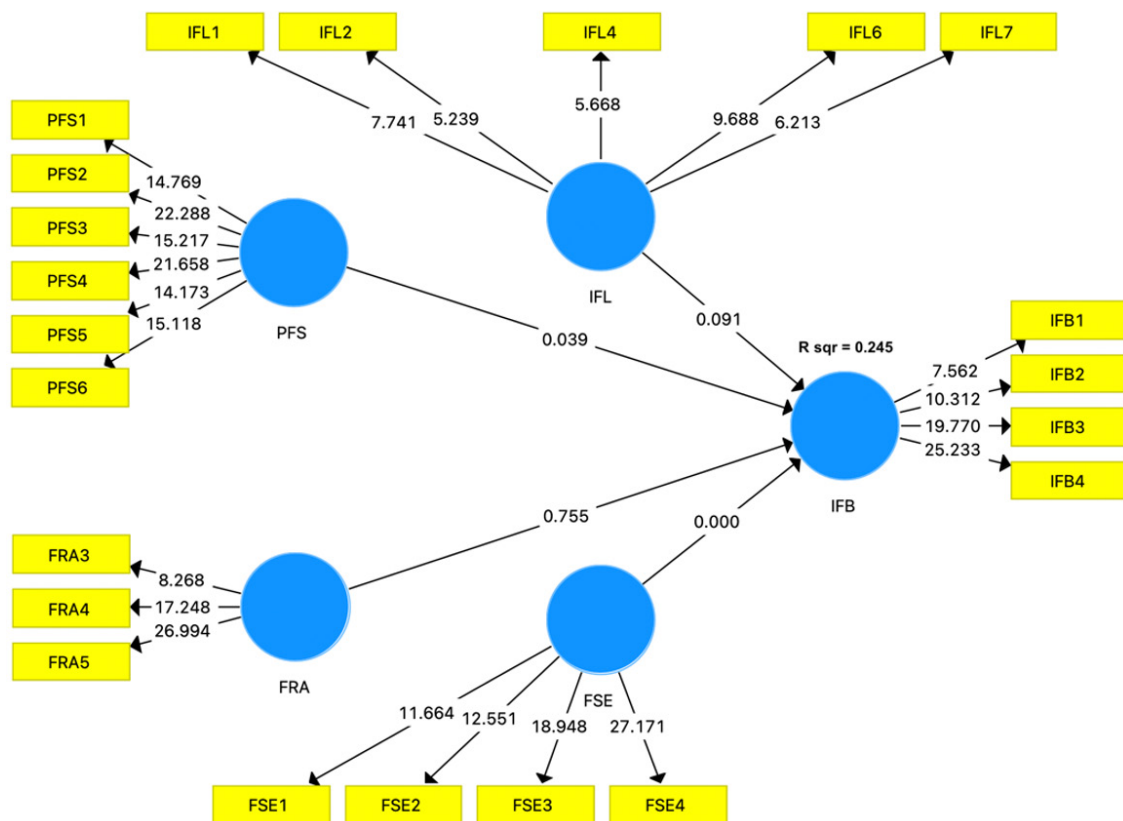
Note: ** $p < 0.01$; * $p < 0.05$
Source: Data processing.

Table 1 summarizes the results of the structural model assessment for the study's hypothesis testing. Two out of four hypothesized relationships indicated statistically significant findings. The two hypotheses are the relationship between parental financial socialization and financial self-efficacy toward Islamic financial behaviour. Specifically, parental financial socialization and financial self-efficacy toward Islamic financial behaviour were statistically significant. The other results portrayed an insignificant influence of Islamic financial literacy on financial risk attitude toward the measured variable.

The results demonstrated that the Theory of Planned Behaviour (TPB) model could explain 24.5 percent of the variance in Islamic financial behaviour among young university students. This finding underscores the model's moderate explanatory power in understanding the financial behaviours within this demographic. The analysis revealed that parental financial socialization and financial self-efficacy were significant determinants of youth's Islamic financial behaviour. Specifically, the influence of parents on youths' financial attitudes and practices, alongside the students' confidence and control over their financial decisions, were critical factors in shaping their adherence to Islamic financial principles.

The findings imply that parental financial socialization is crucial in shaping youth's Islamic financial behaviour. Youth who reported positive financial socialization from their parents or guardians are more likely to exhibit financial behaviours aligned with Islamic principles, such as prudent money management, avoidance of excessive debt, and ethical financial decision-making. This result aligns with previous research highlighting the importance of parental influence on financial attitudes and behaviours (Jorgensen & Savla, 2010; Shim et al., 2010). Studies have consistently shown that parental involvement in financial education significantly impacts young adults' financial literacy and behaviour, suggesting that early financial socialization at home sets the foundation for future financial practices (Gudmunson & Danes, 2011).

Figure 2. Results for Structural Model Assessment



The study suggests that interventions to improve the Islamic financial behaviour of young university students should involve parents or guardians. Financial education programs that include components for parental involvement can reinforce positive financial practices at home, thereby enhancing the overall effectiveness of these initiatives. This approach is supported by research indicating that family financial socialization is critical in shaping financial literacy and behaviours in young adults (Danes & Haberman, 2007). By fostering open communication about financial matters and demonstrating sound financial management, parents can significantly influence their children's ability to navigate financial decisions in accordance with Islamic values. This finding is consistent with findings that suggest parental financial teaching and modelling are linked to better financial outcomes in children and young adults (Shim et al., 2009).

Furthermore, involving parents in financial education programs aligns with the social learning theoretical framework, which posits that individuals learn behaviours and attitudes by observing and imitating significant others (Bandura et al., 1977). By actively engaging parents in their children's financial education, programs can effectively leverage this social learning process to promote Islamic financial principles. This finding is aligned with the previous empirical work by Albaity & Rahman (2019), Li et al. (2021), and Susan (2020).

The second significant finding is the relationship between financial self-efficacy and Islamic financial behaviour. Financial self-efficacy, which encompasses students' confidence in their ability to manage their finances, find solutions to financial challenges, and their enthusiasm to make progress toward financial goals, plays a crucial role in shaping their financial behaviour per Islamic principles. These findings parallel previous empirical work such as Danes & Haberman (2007), Dew & Xiao (2013), Jariwala (2015), Mindra & Moya (2017), and Shim et al. (2009).

The study's implications for this relationship are multifaceted. First, enhancing students' financial self-efficacy can lead to more prudent and responsible financial behaviours, as individuals who believe in their financial capabilities are more likely to make informed and ethical financial decisions. This finding aligns with previous research indicating that higher financial self-efficacy is associated with better financial management and lower levels of financial distress (Farrell et al., 2016; Kempson et al., 2017). By fostering a strong sense of financial self-efficacy, educational interventions can empower students to adhere to Islamic financial practices, such as avoiding excessive debt and engaging in ethical investments.

Moreover, the findings suggest financial education programs should include components that boost students' financial self-efficacy. Practical training that equips students with the skills to manage their finances, solve financial problems, and set and achieve financial goals can significantly enhance their confidence in their financial abilities. This approach is supported by the social cognitive theory, which posits that self-efficacy influences the choices individuals make, the effort they put forth, and their persistence in the face of challenges (Bandura, 1986). By increasing financial self-efficacy, students

are more likely to engage in consistent and disciplined financial behaviours that align with Islamic values.

Additionally, promoting financial self-efficacy can help mitigate the impact of financial stress and uncertainty. Students with higher financial self-efficacy are better equipped to handle financial setbacks and are more resilient in pursuing their financial goals. This resilience is critical in the context of Islamic financial behaviour, where adherence to ethical and responsible financial practices is paramount. By encouraging a proactive and confident approach to financial management, educational programs can support students in maintaining financial stability and adhering to Islamic financial principles, even in the face of economic challenges.

Nevertheless, two hypothesized relationships were found to be insignificant. Firstly, the relationship between Islamic financial literacy and financial behaviour did not yield significant. This finding is surprising given that numerous studies have typically shown a positive association between financial literacy and financial behaviour. The implications of this unexpected result suggest that while Islamic financial literacy is undoubtedly important, it alone may not be sufficient to drive Islamic financial behaviour among university students. This result implies that other factors, such as financial self-efficacy and parental financial socialization, may play more dominant roles in influencing these behaviours. It indicates a potential gap between knowledge and action, where students may possess theoretical understanding but fail to translate this knowledge into practice due to a lack of confidence or inadequate financial socialization.

Justifying this finding, it is essential to consider the context in which financial literacy is applied. Previous research has highlighted that financial knowledge does not automatically lead to better financial behaviour unless accompanied by the ability to apply this knowledge effectively in real-life situations (Lusardi & Mitchell, 2014). For instance, Lusardi & Mitchell (2011) argue that financial literacy must be complemented by self-efficacy and supportive social environments to be impactful (Lusardi & Mitchell, 2011). Similarly, Mandell & Klein (2009) found that without practical experience and reinforcement, financial education alone has limited effects on behaviour (Mandell & Klein, 2009).

Moreover, this finding may indicate that Islamic financial literacy, as measured in this study, might not fully capture the practical application or the emotional and psychological factors that influence financial behaviour. According to Huston (2010), financial literacy encompasses knowledge and the ability to use this knowledge (Huston, 2010). Therefore, interventions aiming to improve Islamic financial behaviour should not only focus on imparting knowledge but also on enhancing practical financial skills, building confidence, and creating supportive environments that encourage the application of financial knowledge.

Another unfavourable finding is the relationship between financial risk attitude and Islamic financial behaviour. Financial risk attitude, the maximum uncertainty an individual is willing to accept while making financial decisions, is crucial in influencing

financial behaviour. However, this study found no significant relationship between financial risk attitude and Islamic financial behaviour among university students. The finding is contrary to the previous empirical works such as García & Vila (2020), Oladapo et al. (2019), and Raut (2020).

The implications of this finding suggest that financial risk attitude may not play as pivotal a role in shaping Islamic financial behaviour as previously thought, at least within this demographic. This result indicates that university students' financial decisions aligned with Islamic principles may be influenced more by their self-efficacy and socialization than their risk tolerance. This finding challenges the assumption that willingness to accept financial risk is a primary driver of financial behaviour in the context of Islamic finance, where ethical considerations and adherence to religious principles may overshadow risk preferences.

Justifying this finding, it is essential to consider the unique characteristics of Islamic financial behaviour. Islamic finance principles emphasize ethical considerations, avoidance of excessive risk (*gharar*), and prohibitions on interest (*riba*), which might lead individuals to make financial decisions based on religious and ethical guidelines rather than personal risk tolerance. According to Kayed & Hassan (2011), Islamic finance principles promote risk-sharing and ethical investment, which might reduce the impact of individual risk attitudes on financial behaviour (Kayed & Hassan, 2011). Moreover, a study by Gerrans et. al (2015) suggests that while risk tolerance is a significant factor in conventional financial decision-making, its influence may be moderated by cultural and religious factors in the context of Islamic finance (Gerrans et al., 2015).

Additionally, the insignificance of financial risk attitude in this study may reflect the educational and socio-economic background of university students. Research by Roszkowski & Grable (2005) indicates that younger individuals, such as university students, may have less experience and lower financial stakes, resulting in less variation in their risk attitudes and financial behaviours (Roszkowski & Grable, 2005). This finding suggests that factors such as social influences and self-efficacy are more influential in shaping Islamic financial behaviour among this group.

CONCLUSION

This study examined the factors influencing Islamic financial behaviour among young generations, focusing on Islamic financial literacy, financial risk attitude, parental financial socialization, and financial self-efficacy. The findings revealed that parental financial socialization and financial self-efficacy are significant predictors of Islamic financial behaviour, highlighting the critical role of family influence and students' confidence in financial management. Conversely, Islamic financial literacy and financial risk attitude were not significantly related to financial behaviour, suggesting that knowledge and risk-taking attitudes alone do not guarantee Shariah-compliant financial practices. These results emphasize that while knowledge is important, confidence

and supportive social environments play a stronger role in shaping Islamic financial behaviour.

From a policy perspective, financial education programs should involve parents or guardians to reinforce positive financial habits at home. Additionally, programs should focus not only on increasing financial literacy but also on building youths' financial confidence and practical skills. Policymakers and Islamic financial institutions can use these insights to develop targeted interventions that foster responsible financial behaviour aligned with Islamic principles, contributing to broader financial inclusion and stability.

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Mediating Role of Self-Efficacy: Resiliency and Entrepreneurial Intention in the Young Generation

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JEL Classification:

L26

I23

O10

Received: 23 September 2024

Revised: 13 May 2025

Accepted: 23 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: While combining the TPB and Linan Model, this study provides novelty through its analysis of the underexplored role of financial resources and self-efficacy in shaping entrepreneurial intentions among the young generation.

Research Objectives: The research investigates the resilience factors that shape entrepreneurial ambition, focusing on the direct effects of entrepreneurship education, creativity, and financial resources, as well as the indirect effect of entrepreneurial self-efficacy on the relationship between these factors and entrepreneurial intention.

Research Methods: This study utilizes a questionnaire survey from 312 college students in Jakarta. Structural equation modeling (SEM) was used to analyze the data.

Empirical Results: The findings show that financial resources, entrepreneurial education, and creativity influence self-efficacy. The associations between creativity and entrepreneurial intention, as well as between entrepreneurship education and entrepreneurial intention, are significant for the indirect paths that use self-efficacy as a mediator.

Implications: We recommend that universities, governments, and other stakeholders prioritize initiatives that offer financial assistance and focus on educational programs and support systems that enhance confidence and belief in entrepreneurial capabilities.

Keywords:

entrepreneurship education; creativity; financial resources; self-efficacy; entrepreneurial intention

How to Cite:

Kurniawati, R. Z. A., Pangaribuan, C. H., Kembau, A. S., & Nilam, E. B. (2025). Mediating Role of Self-Efficacy: Resiliency and Entrepreneurial Intention in Young Generation. *Etikonomi*, 24(2), 522 – 546. <https://doi.org/10.15408/etk.v22i2.41426>.

INTRODUCTION

Despite the potential of entrepreneurship to bolster economic growth, Indonesia exhibits a relatively low rate of entrepreneurial activity, often attributed to limited access to formal financial institutions (Surya et al., 2021). The entrepreneurial rate in Indonesia stands at a mere 3.4% of the total population, notably lagging behind neighboring countries such as Singapore (8.6%) and Malaysia (4.5%) (Hutasuhut & Aditia, 2021). Although recent college graduates are often perceived as potential entrepreneurs, it is expected that they would actively engage in entrepreneurial pursuits, involving the innovative creation of new ventures and profit generation (Bagis, 2022). However, contrary to this expectation, entrepreneurship observers argue that most recent graduates are more inclined to seek employment rather than embark on entrepreneurial endeavors (Indrawati et al., 2021).

Entrepreneurship education has been identified as a substantial determinant of entrepreneurial intention (Jiatong et al., 2021). Equipping the younger generation with the necessary skills and knowledge can encourage individuals to pursue entrepreneurial ventures. However, conflicting findings by Yuliana and Soepatini (2024) suggest that entrepreneurship education may not always have a direct impact on entrepreneurial intention. Moreover, a positive relationship has been established between entrepreneurship education and entrepreneurial self-efficacy, which can, in turn, enhance entrepreneurial intent (Saoula et al., 2023). Self-efficacy reflects an individual's belief in their entrepreneurial capabilities and can influence their decision to launch a new venture (Caliendo et al., 2023). Through entrepreneurship education, students gain exposure to professional insights that foster motivation and strengthen entrepreneurial self-efficacy.

Furthermore, creativity plays a pivotal role in fostering entrepreneurial intentions. Students with a creative mindset are more capable of identifying and seizing opportunities, demonstrating a key entrepreneurial trait: the ability to transform challenges into advantages. As Anjum et al. (2023) note, students with higher levels of creativity are more likely to pursue entrepreneurial endeavors. To express their creativity, students must possess self-confidence and a strong belief in their ability to implement ideas and navigate unforeseen obstacles—qualities essential for entrepreneurial success (Gómez-Jorge et al., 2025).

Prior to launching a business, multiple preparatory steps must be undertaken, including developing a comprehensive business plan and securing necessary funding. Entrepreneurial ventures necessitate substantial resources, yet aspiring entrepreneurs often overestimate their chances of success due to resource constraints (Pham et al., 2025). Previous studies have established a positive correlation between financial resources and self-efficacy (Dharmanegara et al., 2022; Shahriar et al., 2024), suggesting that adequate funding can strengthen students' entrepreneurial aspirations. Furthermore, research indicates that financial resources influence the intention to start a business (Dharmanegara et al., 2022; Pham et al., 2025).

This study addresses a notable gap in the existing literature by examining the underexplored role of financial resources and self-efficacy in shaping entrepreneurial intentions among Indonesia's younger generation. Increasing students' entrepreneurial

intention is important, especially given concerns that graduates often seek employment rather than starting businesses, despite entrepreneurs being key drivers of innovation, job creation, and economic growth. The rationale for employing university students as the study's subjects lies in their constitution as a considerable cohort of potential future entrepreneurs. Situated at a pivotal juncture in their life trajectories, characterized by career exploration and skill acquisition, they represent a pertinent demographic for elucidating the genesis of entrepreneurial intentions.

This study addresses a notable gap in the existing literature by examining the underexplored role of financial resources and self-efficacy in shaping entrepreneurial intentions among Indonesia's younger generation. Increasing students' entrepreneurial intention is important, especially given concerns that graduates often seek employment rather than starting businesses, despite entrepreneurs being key drivers of innovation, job creation, and economic growth. While previous studies have investigated factors such as entrepreneurship education and creativity, their findings remain inconclusive, particularly regarding the specific impact of financial resources. This research aims to fill this gap by analyzing both the direct and indirect effects of creativity, education, and financial access on entrepreneurial intentions. By incorporating self-efficacy as a mediating variable, this study provides a more nuanced understanding of how these factors collectively influence entrepreneurial aspirations. Specifically, it offers a novel integration of the Theory of Planned Behavior and Linan Model, shedding light on the contextual factors driving entrepreneurial intentions in Indonesia, particularly in the Jakarta region. Acknowledging the distinct socioeconomic milieu and challenges encountered by nascent entrepreneurs within Indonesia, this geographically specific viewpoint is indispensable. It furnishes contextually resonant insights, exhibiting greater applicability and utility compared to broader, transcultural investigations.

Creativity is the ability to generate novel, practical ideas through the application of relevant information and expertise. It is an important factor that strongly impacts an individual's intention to start a business, with highly creative individuals more inclined to pursue entrepreneurial careers (Jiatong et al., 2021). Shi et al. (2020) surveyed undergraduate students in China and discovered that creativity positively impacts the intention to start a business. They found that by enhancing entrepreneurship-related knowledge and abilities, creativity supports the development of entrepreneurial intention. Based on this discussion, this study proposes that creativity influences entrepreneurial intentions among university students.

Previous studies indicate that entrepreneurship education enhances an individual's abilities that encourage entrepreneurial activity (Pham et al., 2023). Fan et al. (2024) demonstrated that a comprehensive entrepreneurial education enhances college students' entrepreneurial intentions. In contrast, Yuliana and Soepatini (2024) found no direct impact of entrepreneurship education on entrepreneurial intention, highlighting contradictory findings. The primary goal of entrepreneurial education is to improve students' knowledge, abilities, and perspectives on the subject (Jiatong et al., 2021). Based on this evidence, this study proposes that entrepreneurship education influences entrepreneurial intentions among university students.

Access to financial resources is a critical issue for young individuals intending to start or grow a business. Lakhan et al. (2021) report that individuals with access to capital are more likely to start their own businesses. Consequently, a high level of perceived financial accessibility may influence entrepreneurial activity. Rusu and Roman (2020) conducted research in Romania and found that encouragement for students to start their own businesses stems from easy access to financial resources. Conversely, a lack of financial resources increases risk and reduces the likelihood of success, thereby diminishing motivation and feasibility (Pham et al., 2025). Based on these findings, this study hypothesizes that financial resources influence entrepreneurial intentions among university students.

Kumar and Shukla (2022) analyzed the direct impact of creativity and the mediating role of entrepreneurial self-efficacy on entrepreneurial intention among university students in India. They discovered that self-efficacy fully mediated the relationship between creativity and entrepreneurial intention. This condition suggests that creativity alone is insufficient to ignite entrepreneurial intentions; individuals must have self-efficacy in their skills and belief in their capability to engage in entrepreneurial activity (Fauziyah & Pangaribuan, 2023). In other words, the extent to which an individual possesses self-confidence and efficacy to create a business determines how creativity is actualized (Christian et al., 2024). Jiatong et al. (2021) also demonstrated that self-efficacy mediates creativity and entrepreneurial intention. They argued that encouraging students' creativity can enhance entrepreneurial intentions by boosting their confidence in their capability to perform an entrepreneurial activity. Therefore, this study hypothesizes that entrepreneurial self-efficacy mediates the relationship between creativity and entrepreneurial intentions among university students.

Entrepreneurial intention demonstrates confidence, readiness, and persistence in starting a new business. Syaputri et al. (2021) found that entrepreneurship education positively influences entrepreneurial intentions, with this effect being mediated by self-efficacy. Similarly, Lubada et al., (2021) confirmed the mediating role of entrepreneurial self-efficacy between entrepreneurship education and entrepreneurial intention. These studies suggest that fostering students' entrepreneurial self-efficacy enhances their entrepreneurial intentions. The effectiveness of entrepreneurship education in raising self-efficacy consequently influences students' motivation to engage in entrepreneurial activity. Therefore, it can be stated that students who receive entrepreneurship education develop higher confidence, which stimulates their entrepreneurial aspirations. Accordingly, this study hypothesizes that entrepreneurial self-efficacy mediates the relationship between entrepreneurship education and entrepreneurial intentions among the young generation.

Lack of resources results in decreased self-confidence in achieving desired outcomes (Pham et al., 2025). Dharmanegara et al. (2022) found that financial resources have a positive impact on self-efficacy, suggesting that individuals with greater financial resources exhibit higher entrepreneurial self-efficacy. In other words, financial resources enhance students' confidence in starting a new business, thereby strengthening their intention to be entrepreneurs. Moreover, Lakhan et al. (2021) found that self-efficacy mediates the relationship between perceived financial resources and entrepreneurial intention among university students. Additionally, this is supported by Svotwa et al. (2022), who found

that the influence of perceived access to capital on entrepreneurial intention is mediated by self-efficacy. Access to financial resources shapes individuals' perceptions of the ease or difficulty of establishing a business, thereby promoting entrepreneurial intentions. Thus, this study infers that entrepreneurial self-efficacy mediates the relationship between financial resources and entrepreneurial intentions among the young generation.

This study aims to fill a critical gap in the literature by examining both the direct and indirect relationships among entrepreneurship education, creativity, financial resources, and entrepreneurial intentions. Although prior studies have investigated these variables individually, their combined effects—particularly the roles of financial resources and entrepreneurial self-efficacy—remain underexplored, especially within the Indonesian context. By analyzing how these factors interact, both directly and through the mediating influence of self-efficacy, this research offers a more integrated understanding of the determinants of entrepreneurial intentions. The proposed framework provides a comprehensive perspective on how entrepreneurship education, creativity, and financial access influence students' entrepreneurial mindset.

METHODS

This study employed a descriptive analysis using a quantitative approach. To ensure the accuracy of the findings, validity and reliability tests were conducted. In this approach, data were collected through online questionnaires, yielding measurable and primary data. Regression analysis was used to analyze the data. The sample consisted of college students, based on the assumption that higher education provides individuals with the knowledge, skills, and networks conducive to entrepreneurial activities. Respondents were drawn from both public and private universities, specifically those who had completed entrepreneurship education in the Jabodetabek area.

This study was conducted in Indonesia, particularly in the Jabodetabek region, including Jakarta and its vicinities: Bogor, Depok, Tangerang, and Bekasi. Based on population, income, and consumption level data from BPS, the Jakarta area has a huge market potential. Therefore, this study decided to focus on university students in the Jabodetabek area due to its high entrepreneurial prospects. A simple random sampling method was employed, ensuring that every individual in the population had an equal chance of being selected (Noor et al., 2022). In 2022, the number of private and public university students in Jabodetabek exceeded 700,000. However, as specific data on students who had completed entrepreneurship were unavailable, the population for this study is considered unknown.

The minimum sample size for this study is determined using statistical power analysis for multiple regression models (Hair et al., 2014). Hence, the required minimum sample for this study is 137 respondents. Following the distribution of online questionnaires, a total of 312 valid responses were collected for analysis.

This study uses questionnaires as the measurement method. The questionnaire's items are presented as statements to gather the respondents' perspectives and awareness regarding a particular subject. It comprises 23 items measured using a Likert-type scale to evaluate

all variables included in the online questionnaire. A five-point Likert scale was employed, with the following response options: 1 – Strongly disagree, 2 – Disagree, 3 – Neutral, 4 – Agree, and 5 – Strongly agree. The measurement items are presented in Table 1.

To ensure the validity and reliability of the survey items, a comprehensive assessment was conducted. The average variance extracted (AVE) for each variable should ideally exceed 0.5 (Solaiman & Pangaribuan, 2024). According to the validity results presented in Table 2, all variables demonstrated acceptable levels of validity, with AVE values exceeding 0.5. Similarly, the reliability of the variables was assessed using Cronbach's alpha and composite reliability, with a threshold of 0.7 considered acceptable (Jevica & Pangaribuan, 2024). As shown in Table 3, all variables met this criterion, indicating their reliability for further analysis. The total sample consisted of 163 female students (52%) and 149 male students (48%). The respondents' ages ranged from 17 to 24 years, with a majority falling within the 17-20 age group. The respondents were enrolled in both public (51%) and private universities (49%), with a concentration in the fourth semester.

Table 1. Measurements

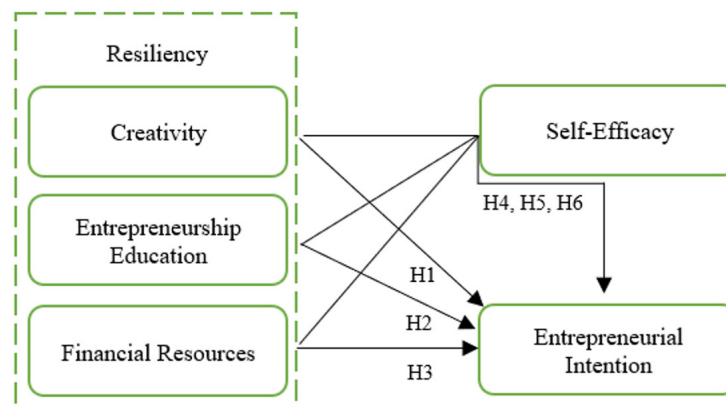
Construct	Dimension	Items
Entrepreneurship Education	EE1-5	Entrepreneurship education helps me to generate creative ideas; Entrepreneurship education provides knowledge needed for entrepreneurship; Entrepreneurship education helps me improve my entrepreneurial skills and abilities; Entrepreneurship education can increase the chances of success of a business; Entrepreneurship education encouraged me to become an entrepreneur
Creativity	CR1-4	I can solve a problem with a creative solution; I can generate new innovative ideas; I am good at generating creative ideas; I often give ideas to others
Financial Resources	FR1-4	I will start a business in the future with my savings; I will be looking for capital support to start a business; If I want to start a business, I know several ways to find sources of funding; In my opinion, the availability of funds is important in starting a business
Self-Efficacy	SE1-5	I believe that I can successfully find new business opportunities; I believe that I can think creatively; I believe that I can successfully realize my idea; I believe that I can plan and realize a business; I believe that I know the practical details needed to create a business
Entrepreneurial Intention	EI1-5	I want to be an entrepreneur; I will attempt to find experience and prepare important things to become an entrepreneur; I will make every effort to start and run my own business; I am determined to create a company in the future; I have a strong intention to start a business someday

As illustrated in Figure 1, the proposed conceptual framework highlights the complex interrelationships among entrepreneurship education, creativity, financial resources, and entrepreneurial intention, with self-efficacy serving as a key mediating variable. This research offers a novel contribution to the field by integrating the Ajzen's (1991) Theory of Planned Behavior and Linan and Chen's (2009) Linan Model, providing new insights into the contextual factors that influence entrepreneurial intention in Indonesia, a country that remains underrepresented in current entrepreneurship studies.

Table 2. Reliability and validity

Construct	Average Variance Extracted (AVE)	Alpha	Composite Reliability
Entrepreneurship Education	0.607	0.782	0.859
Creativity	0.526	0.777	0.847
Financial Resources	0.551	0.759	0.859
Self-Efficacy	0.555	0.734	0.830
Entrepreneurial Intention	0.687	0.885	0.916

Figure 1. Proposed Research Framework



RESULTS AND DISCUSSION

All of the direct hypotheses in this study were found to be significant, with the primary conclusions indicating that financial resources are the most influential factor affecting entrepreneurial intention. The bootstrapping results provided t-statistics and coefficients for each variable in the model. As shown in Table 3, creativity, entrepreneurship education, and financial resources positively influence entrepreneurial intention. Moreover, self-efficacy in creativity and self-efficacy in entrepreneurship education mediate the relationship between the respective determinants and entrepreneurial intention. Meanwhile, self-efficacy does not mediate the relationship between financial resources and entrepreneurial intention.

Following data analysis, this study discovered several findings. First, this results support H1, which investigates the effect of entrepreneurship education on entrepreneurial intention. Entrepreneurship education positively influences entrepreneurial intention. This finding contrasts with the study by Yuliana and Soepatini (2024), who discovered that entrepreneurship education does not affect entrepreneurial intention. However, this study aligns with several studies stating that university students' entrepreneurial education has a positive effect on their entrepreneurial intention (Jiatong et al., 2021; Lubada et al., 2021; Pham et al., 2023). The studies indicate that students have a stronger intention to become entrepreneurs when they receive more education on entrepreneurship. Providing the younger generation with opportunities to learn about entrepreneurship in higher education settings can encourage students to pursue careers in business. According to Jiatong et al. (2021), students' entrepreneurial intentions are effectively stimulated by

exposure to entrepreneurial education. Hence, students are more likely to start their own businesses if they receive an entrepreneurship education that helps them develop the skills and abilities necessary to launch their own ventures (Wang et al., 2023).

Table 3. Hypothesis Testing Results

Hypothesis	Path	R^2	β	t	P
H1	Creativity → Intention		0.139	2.217	0.027
H2	Education → Intention	0.384	0.174	2.471	0.014
H3	Financial Resources → Intention		0.280	4.069	0.000
H4	Creativity → Efficacy → Intention		0.056	2.451	0.015
H5	Education → Efficacy → Intention	0.336	0.044	2.218	0.027
H6	Financial Resources → Efficacy → Intention		0.056	1.862	0.063

Second, this study revealed that H2 is accepted. There is a positive influence of creativity on entrepreneurial intention among university students. Creativity is widely recognized as a key component of entrepreneurial behavior, and this study corroborates previous research by confirming a positive relationship between creativity and entrepreneurial intention. This finding aligns with studies by Jiatong et al. (2021) and Shi et al. (2020), which emphasize the importance of creativity in entrepreneurial decision-making. However, our study reveals that creativity has a relatively weaker influence on entrepreneurial intention compared to financial resources, which may overshadow its effect in practice. This weaker influence, aligns with Kumar and Shukla (2022) findings, which suggest that while creativity is an essential entrepreneurial trait, its impact may be mitigated without adequate external support, such as financial capital or entrepreneurial education. This nuanced understanding emphasizes the complex interplay between individual creativity and external factors, suggesting that creativity alone may be insufficient to drive entrepreneurial intention without proper support structures.

Third, hypothesis H3 is confirmed by this study. Financial resources emerged as the most influential factor affecting entrepreneurial intention, with a coefficient of 0.280, the highest among all variables. This finding contradicts that of Svtwa et al. (2022), who reported no direct effect of financial resources on entrepreneurial intentions. In contrast, this study confirms that financial resources are crucial for enabling entrepreneurial decision-making, particularly among university students. Access to financial capital enables students to seize entrepreneurial opportunities and reduces barriers to starting a business, supporting previous studies by Lakhan et al. (2021) and Rusu and Roman (2020). These findings underscore the importance of integrating financial support into entrepreneurship programs and policies, as financial capital plays a decisive role in fostering entrepreneurial activity. The dominant influence of financial resources observed here highlights the critical need for funding and resource accessibility in driving entrepreneurial ambition.

Fourth, this study supports H4, which states that self-efficacy positively mediates the effect of entrepreneurship education on entrepreneurial intention among university students.

This finding aligns with earlier studies that identified entrepreneurial self-efficacy as a mediator in the relationship between entrepreneurship education and entrepreneurial intention (Jiatong et al., 2021; Wang et al., 2023). According to Wang et al. (2023), entrepreneurship education effectively enhances entrepreneurial self-efficacy. When university students have high levels of self-efficacy, they are more likely to develop their entrepreneurial skills, strengthen their confidence, and enhance their entrepreneurial intention. In addition, entrepreneurship education can increase self-efficacy, thereby influencing students' intentions to pursue entrepreneurship. Therefore, more exposure to both theoretical and practical components of entrepreneurship education fosters self-confidence and strengthens entrepreneurial intention.

Fifth, this study supports H5, which claims that self-efficacy mediates the relationship between creativity and entrepreneurial intention. This finding aligns with previous research, which discovered that creativity and entrepreneurial intention are mediated by self-efficacy (Lubada et al., 2021; Kumar & Shukla, 2022; Jiatong et al., 2021). Creative individuals often have multiple approaches to problem-solving and a greater ability to turn their ideas into reality. It can enhance their self-confidence and stimulate their entrepreneurial intentions. Furthermore, the results indicate that self-efficacy strongly mediates the relationship between creativity and entrepreneurial intention. This result aligns with Biraglia and Kadile (2017), who discovered that entrepreneurial self-efficacy in the model serves as a strong mediator. This result suggests that, regardless of individuals perceived creativity, their belief in their ability to start a business plays a more significant role in shaping entrepreneurial intentions.

Lastly, this study examines the mediating role of self-efficacy in the relationship between financial resources and entrepreneurial intention. H6 is not supported in this study; a non-significant indirect path suggests that the proposed mediating variable (self-efficacy) is not acting as a crucial link in explaining how financial resources influence entrepreneurial intention. This could be because the direct effect is more substantial, the relationships between the variables in the path are weak, or other factors are more influential. While one might assume that having more money increases confidence, this is not always the case. Individuals might have financial resources due to inheritance, a high-paying job unrelated to entrepreneurship, or other factors that do not inherently foster their *entrepreneurial* skills. Their confidence in managing finances might be high, but their belief in their ability to navigate the challenges of starting and running a business might remain unchanged.

The findings indicate that all the examined determinants exert positive effects on entrepreneurial intention. Notably, financial resources have the most pronounced influence on the decision to start a business, exceeding both entrepreneurship education and creativity in their impact. These results directly address the research objectives by showing that financial access plays a critical role in shaping entrepreneurial ambitions. At the same time, self-efficacy serves as a key mediator, enhancing the effectiveness of education, creativity, and financial resources in fostering entrepreneurial intentions.

Entrepreneurship education is widely acknowledged as a vital determinant in shaping entrepreneurial intentions. The results of this study strongly support this assertion, demonstrating a positive association between entrepreneurship education and entrepreneurial

intention, facilitated by the enhancement of self-efficacy. Specifically, the study reveals that students who engage in entrepreneurship education programs acquire both the skills and confidence necessary to initiate their businesses. This finding aligns with the research objectives by clearly illustrating how entrepreneurship education influences entrepreneurial intentions through the development of self-efficacy. By fostering entrepreneurial confidence, education plays a pivotal role in motivating students to pursue entrepreneurial ventures.

Entrepreneurship demands both intellectual knowledge and creative ingenuity. This study demonstrates that university students possess the capacity to generate creative ideas and innovative solutions. A creative mindset empowers individuals to identify and capitalize on market opportunities, as well as develop creative strategies for optimizing resource utilization. Consequently, university students with great creativity exhibit a strong inclination towards entrepreneurial pursuits. Moreover, the study reveals that self-efficacy mediates the relationship between creativity and entrepreneurial intention, highlighting the importance of individuals believing in their ability to overcome the challenges associated with launching a new venture.

Financial resources emerged as the most influential factor in determining entrepreneurial intentions among university students. This study found that access to financial capital enhances students' determination to pursue entrepreneurial ventures. The impact of financial resources was particularly notable in comparison to other factors such as creativity and entrepreneurship education, confirming the research objective to evaluate the relative importance of financial access in entrepreneurial decision-making. These findings emphasize the importance of providing students with adequate financial support to enhance their confidence and willingness to take entrepreneurial risks. This study emphasizes that financial capital is not merely a resource but a crucial enabler of entrepreneurial intention, directly addressing the research question regarding the role of external resources in fostering entrepreneurship.

Creativity was found to exert both direct and indirect influences on entrepreneurial intention. The mediating effect of self-efficacy was particularly pronounced in the relationship between creativity and entrepreneurial intentions among university students. Furthermore, this study revealed that financial resources have the most direct impact on entrepreneurial intention, confirming the propensity of individuals with access to capital to engage in entrepreneurial activities. Notably, the study also demonstrated the mediating role of self-efficacy in this relationship. This finding contributes to the existing body of literature by examining the interplay among these variables, as research analyzing the specific model remains relatively scarce.

Even though the indirect effect of financial resources on entrepreneurial intention through self-efficacy did not reach statistical significance in this study, examining self-efficacy as a potential mediator within the broader model remains a crucial contribution. By simultaneously investigating creativity and entrepreneurship education alongside financial resources, this research offers a more holistic understanding of the psychological mechanisms driving entrepreneurial intention. Specifically, identifying self-efficacy as a mediator for creativity and entrepreneurship education highlights its vital role in translating these enabling factors into a stronger inclination towards starting a business.

This nuanced finding underscores that while mere financial availability might directly influence intention in some cases, the belief in one's own capabilities is particularly critical in leveraging the potential of creative thinking and the knowledge gained through entrepreneurship education to foster the desire to become an entrepreneur ultimately.

CONCLUSION

This study investigates the impact of entrepreneurship education, creativity, and financial resources on entrepreneurial intentions among university students, with a specific focus on the mediating role of self-efficacy. The findings indicate that all the examined determinants exert positive effects on entrepreneurial intention. Notably, financial resources were found to have the most pronounced influence on the decision to start a business, surpassing both entrepreneurship education and creativity in their impact. These results directly address the research objectives by showing that financial access plays a critical role in shaping entrepreneurial ambitions, while self-efficacy acts as a key mediator, enhancing the effectiveness of education, creativity, and financial resources in fostering entrepreneurial intentions.

This research offers valuable theoretical implications. The integration of the Linan Model and TPB demonstrates a positive influence on entrepreneurial intention. Furthermore, the study develops a model elucidating the mediating role of self-efficacy in shaping entrepreneurial intentions. These findings provide empirical evidence to validate existing hypotheses and establish a useful framework for future research. To foster entrepreneurial aspirations among the younger generation, universities can organize entrepreneurship training programs and policy frameworks. These programs, facilitated by business faculty, should focus on providing mentorship and developing entrepreneurial competencies. Curricula should encompass personal growth, self-motivation, sales techniques, and business management and evaluation. Additionally, students should be trained to develop comprehensive business models and plans, which can subsequently be submitted to entrepreneurial competitions. Universities can further enhance the learning experience by organizing guest lectures featuring successful entrepreneurs, allowing students to engage in dialogue and gain valuable insights. Moreover, encouraging participation in entrepreneurial competitions can bolster self-confidence and ignite a passion for launching one's own ventures.

Future research could explore other mediating variables, such as fear of failure, which may further enhance the understanding of entrepreneurial intention. By broadening the scope and deepening the analysis of psychological and environmental factors, subsequent research can provide a more comprehensive framework for understanding entrepreneurial behavior in emerging economies. To enhance the generalizability of findings, future studies could expand their sample size by including other major cities in Indonesia and incorporating diverse higher education institutions, such as vocational schools. Additionally, comparing results across different university samples could provide insights into which types of institutions are more conducive to nurturing entrepreneurial potential. Furthermore, future research could explore the inclusion of additional mediating variables, such as fear of failure, within the model framework.

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The Impact of Female Labor Force Participation on Regional Economic and Income Convergence

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JEL Classification:

I25
J21
E12
J20

Received: 04 October 2024

Revised: 02 May 2025

Accepted: 15 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: Women tend to be chosen as the non-labor force, even though they are potential workers who can contribute directly to the economy. Their level of education influences this contribution.

Research Objectives: This research examined the impact of female labor force participation on regional economic and income convergence.

Research Methods: Pooled Least Squares (PLS) and panel data estimation were conducted using cross-sectional data on 472 cities/districts across Indonesia between 2016 and 2022.

Empirical Results: The findings reveal that female labor force participation significantly enhances regional economic growth only when women have at least a senior high school education. However, their contribution to accelerating economic convergence remains suboptimal, as most female workers are elementary school graduates.

Implications: To improve the contribution of the female workforce to the economy, the government should extend compulsory education from 9 to 12 years, expand access to non-formal education for women, and establish a female-friendly labor market through job flexibility and improved childcare access.

Keywords:

childcare; education; labor force; women

How to Cite:

Panjaitan, D.V., Nuryartono, N., Pasaribu, S. H. (2025). The Impact of Female Labor Force Participation on Regional Economic and Income Convergence. *Etikonomi*, 24(2), 547 – 568. <https://doi.org/10.15408/etk.v24i2.41688>.

INTRODUCTION

The majority of women in Indonesia are not in the workforce and are regarded as homemakers. However, they can contribute to the economy as laborers. Increasing women's economic participation is necessary to improve their social and economic status. In addition, their participation reduces the gender gap, which leads to overall economic growth. With nearly half of the Indonesian population being women, their contribution to economic activity should be equal to that of men. Education is a significant factor influencing women's contributions to the economy (Altuzarra et al., 2019). As women's education increases, their economic opportunities should also increase. However, Tables 1 and 2 show the opposite; although the education levels of women and men are almost the same, the Female Labor Participation Rate (FLPR) is lower than that of men.

Table 1. Population Demographic Statistics by Gender (%)

Categories	2018			2022			2022-2018	
	Male	Female	Total	Male	Female	Total	Male	Female
A. Population aged 15-64 years old	50.25	49.75	100	50.63	49.37	100	0.38	-0.38
B. Labor force	61.37	38.63	100	61.06	38.94	100	-0.31	0.31
B1. Employed	61.34	38.66	100	61.02	38.98	100	-0.32	0.32
B2. Open Unemployment	61.99	38.01	100	61.82	38.18	100	-0.17	0.17
C. Non-Labor Force	26.39	73.61	100	25.68	74.32	100	-0.71	0.71
C1. School	49.36	50.64	100	48.36	51.64	100	-1.00	1.00
C2. Homemaker	9.79	90.21	100	8.78	91.22	100	-1.01	1.01
C3. Other	63.06	36.94	100	64.54	35.46	100	1.48	-1.48
D. Participation Rate	82.80	51.80	-	83.87	53.41	-	1.07	1.61
E. Proportion of Informal Employment	53.90	61.90	-	55.81	64.25	-	1.91	2.35

Source: Central Bureau of Statistics (2024)

The FLPR increased by 1.61 percent in 2022 compared to 2018, accompanied by a rise in informal employment of 2.35 percent. This increase was greater than that observed in the male labor participation rate and informal employment for men during the same period. This aligns with the increasing number of women who graduate from high school to university and the number of women as homemakers in 2022. They tend to choose to enter the non-labor force category despite being potential human capital for the economy.

This study addresses a critical development challenge in Indonesia: optimizing women's economic potential despite achieving near-parity in educational attainment with men. The topic gains urgency from Indonesia's demographic dividend, where women constitute 49.37% of the productive-age population (Table 1). However, their FLPR

remains 25–27 percent below men's (38.94% vs. 61.06% in 2022). This topic is important due to its significant economic potential. An increase in female labor participation could contribute to Indonesia's GDP. Increasing Indonesia's female labor participation to the G20 target of 58.5% by 2025 could increase annual GDP growth by 0.67 percent, equal to \$123 billion by 2025 (Cameron et al., 2018). Other estimates suggest that a 25% increase in female labor participation could add \$62 billion to Indonesia's GDP by 2025. Women face persistent structural barriers despite comparable education levels (Table 2). They face occupational segregation into informal sectors (64.25% in 2022 vs. 55.81% for men) and disproportionate domestic roles (91.22% of homemakers are female) (Table 1). Equity and convergence implications emerge in regions of high growth, such as Java and Sulawesi, which have significant inequality (Gini coefficients >0.38) and low gender development indices (Gender Development Index /GDI <91.63), despite robust economic growth (Table 3). Closing gender gaps could accelerate income convergence, as Sala-i-Martin (1996) posited, by redistributing labor productivity gains across regions.

Table 2. Total Productive Age Population by Gender and Education Level (%)

Categories	2018		2022		2022-2018	
	Male	Female	Male	Female	Male	Female
No schooling	2.79	5.97	2.49	4.32	-0.30	-1.65
Not/Not Yet Completed Primary School	12.50	14.77	8.25	9.95	-4.26	-4.83
Primary School (ele)	25.47	25.79	24.56	25.10	-0.92	-0.69
Junior High School (jun)	21.53	20.94	22.87	22.23	1.35	1.29
Senior High School (sen)	29.18	23.54	32.13	27.79	2.95	4.25
University (uni)	8.52	8.99	9.70	10.61	1.17	1.62
Total	100.00	100.00	100.00	100.00	-	-

Source: Central Bureau of Statistics (2024)

The Solow model can be used to show how human capital contributes to the economy. Previous research on this theme has been conducted in China (Chiengmai, 2018; Wu et al., 2022) and Sub-Saharan Africa (Thaddeus et al., 2022). However, prior studies have primarily focused on case studies in specific regions of Indonesia and failed to distinguish between the labor participation rates of women and men. Additionally, they did not examine the effect of the female labor participation rate, stratified by education level, on economic growth and convergence. Therefore, the novelty of this research lies in its analysis of the impact of women's participation rates on economic growth and economic convergence, considering both geographic location and education level.

This study advances the existing literature in three key ways. First, it provides a disaggregated gender analysis within growth models. Unlike prior studies in Indonesia, this research separates the labor contributions of women and men within the Augmented Solow framework, revealing that only women with senior high school education significantly drive

growth (see Table 2). Second, it contrasts with global models (e.g., Chiengmai, 2018) by incorporating education-stratified data, demonstrating that women with only elementary education hinder convergence despite their numerical dominance, and highlights island-level convergence dynamics. Third, it examines the relationship between the FLPR and regional economic disparities, showing that areas with higher FLPR experience faster convergence than high-growth, high-inequality regions such as Java (Gini coefficient of 0.399) (see Table 3).

Table 3. Indicators of Inequality and Women's Contribution in the Economy (%)

Island	Economic Growth		Gini Coefficient		GDI		Women's Income Contribution	
	2018	2022	2018	2022	2018	2022	2018	2022
Sumatera	4.71	4.63	0.325	0.311	91.12	91.55	32.38	32.53
Java	5.75	5.26	0.385	0.399	90.86	91.48	32.59	32.81
Bali-Nusa	2.31	4.95	0.371	0.359	92.23	92.80	38.75	39.15
Kalimantan	4.75	5.29	0.331	0.303	87.05	87.75	31.41	31.14
Sulawesi	8.79	6.27	0.375	0.365	90.73	91.27	31.55	32.11
Maluku-Papua	6.84	9.81	0.363	0.348	82.92	84.15	35.17	35.14
Indonesia	5.17	5.31	0.384	0.381	90.99	91.63	36.70	37.17

Source: Central Bureau of Statistics (2024)

The Solow model can also be used to examine how the FLPR affects economic convergence. According to Sala-i-Martin (1996), convergence is interpreted as a tendency for economic disparities between regions to narrow over time. This is particularly important given that inequality in Indonesia remains relatively high (Novianti & Panjaitan, 2022). Inequality can be assessed through the Gini coefficient, which is notably higher in high-growth regions such as Java and Sulawesi (see Table 3). Table 3 also indicates a low GDI and a limited contribution of women's income to family income in these high-growth areas. These conditions suggest that women's potential to contribute to the economy has yet to be fully optimized. Therefore, this study analyzes the effect of FLPR on regional economic growth, as measured by two indicators: Gross Regional Domestic Product (GRDP) and income convergence.

METHODS

This research used secondary data, consisting of Gross Regional Domestic Product (GRDP) from the Central Bureau of Statistics (BPS), and investment data from the Indonesia Investment Coordinating Board. Meanwhile, data on the total labor force is calculated from the National Socioeconomic Survey (SUSENAS) from 2016 to 2022. GRDP is a key indicator that measures the total value added generated by all business units in a specific region. This indicator helps policymakers track economic growth and

convergence or divergence among regions. Investment comprises domestic and foreign direct investments, including realized investment values, sectoral breakdowns, and regional distributions. Investment data is crucial for understanding the flow of capital into different regions and sectors, influencing economic growth, job creation, and regional development. Meanwhile, the labor force includes all employed or actively seeking work. This research only focuses on the female labor force.

To estimate the contribution of FLPR to regional economic, this research begins with a version of the Augmented Solow Growth (ASG) model by Mankiw, Romer, and Weil (1992) or the MRW model. This model considers saving rates/investment, population growth, and technological progress as exogenous. There are three inputs: physical capital, human capital, and labor. Due to data limitations, domestic and foreign investment refers to physical capital in this research. Assuming the Cobb-Douglas production function, production at time t is given by:

$$Y = AK^\alpha H^\beta L^{1-\alpha-\beta} \quad (1)$$

Where Y is output, K is capital, H is human capital, L is labor, and A is technology. Assume that female and male labor force account for the total labor force of an economy ($L_f + L_m = L$). So, both female and male labor force participation can be incorporated into the model separately as an additional explanatory variable. However, female and male labor is still one entity so that the elasticity will be the same. The Augmented production is as follows:

$$Y = AK^\alpha H^\beta (L_f + L_m)^{1-\alpha-\beta} \quad (2)$$

Production function in per capita form:

$$\begin{aligned} \frac{Y}{L} &= \frac{AK^\alpha H^\beta (L_f + L_m)^{1-\alpha-\beta}}{L} \left(\frac{L^\alpha L^\beta}{L^\alpha L^\beta} \right) \\ y &= \frac{Ak^\alpha h^\beta (L_f + L_m)^{1-\alpha-\beta}}{L^{1-\alpha-\beta}} \\ y &= Ak^\alpha h^\beta \left(\frac{L_f + L_m}{L} \right)^{1-\alpha-\beta} \\ y &= Ak^\alpha h^\beta (f + m)^{1-\alpha-\beta} \end{aligned} \quad (3)$$

Where $k = K/L$, $h = H/L$, $y = Y/L$, $f = L_f/L$, and $m = L_m/L$.

Let s_k be the fraction of income invested in capital and s_h in human capital. The evolution of k is governed by:

$$\dot{k} = s_k y - (n + g + \delta)k \quad (4)$$

$$\dot{h} = s_h y - (n + g + \delta)h \quad (5)$$

Where δ is the rate of depreciation of both capital and human capital. L and A are assumed to grow exogenously at rates n and g , which are also constant across districts. Equation (4) and (5) imply that the economy converges to a steady state defined by:

$$k^* = \left[\frac{s_k^{(1-\beta)} s_h^\beta}{n+g+\delta} \right]^{(1/1-\alpha-\beta)} \quad (6)$$

$$h^* = \left[\frac{s_k^\alpha s_h^{(1-\alpha)}}{n+g+\delta} \right]^{(1/1-\alpha-\beta)} \quad (7)$$

Substituting (6) and (7) into the production function in (2) and taking logs, we get an estimating equation as follows:

$$\ln y = \ln A + \frac{\alpha}{1-\alpha-\beta} \ln s_k + \frac{\beta}{1-\alpha-\beta} \ln s_h - \frac{\alpha+\beta}{1-\alpha-\beta} \ln(n+g+\delta) + (1-\alpha-\beta) \ln f + (1-\alpha-\beta) \ln \left(\frac{m}{f} + 1 \right) \quad (8)$$

Where $\ln y$ is GRDP at constant price, $\ln s_k$ is the share of investment to GRDP at a constant price, $\ln s_h$ is human capital based on the indicator of the number of labor force graduates of elementary/junior high school/junior high school/university or total, $\ln(n+g+\delta)$ Is the growth rate of the labor force and technology depreciation. Based on the MRW model, the value of $g+\delta$ is fixed at 0.05. The variables are the number of female and male labor force members in the productive age group. Human capital and labor force variables are estimated according to the combination of education levels. The best model is selected based on the highest Adj R-squared value, the lowest Akaike Information Criterion (AIC) and Bayesian Information Criterion (BIC) values, and the coefficient of $\ln f$ and $\ln m$ are positive. This is because the female and male labor force are expected to contribute positively to economic growth. The term $\ln A$ reflects not just technology but resource endowments, climate, institutions, etc. It may differ across districts. We assume that:

$$\ln A = \alpha + \epsilon$$

Where α is a constant and ϵ is a country-specific shock. Thus, long income per capita at a given time. We assume that the saving and population growth rates are independent of district-specific factors shifting the production function. That is, s and n are independent of ϵ . Moreover, this implies that equation (8) can be estimated using Ordinary Least Square (OLS), as in the paper of Mankiw et al (1992).

To further analyze the dynamic results of specific labor, the production functions in the classical Solow and MRW models were augmented to account for female and male labor forces separately (Islam, 1995). PLS assumes that an individual's behavior is not different over various periods. This condition is not based on the situation where the condition of each object will be different for each individual and time, so the panel data method is used. Even though this model may not be complete, it can give answers related to the purpose of this research. Assume a Cobb-Douglas production function and follow the Solow growth model; production of I district at time t is given by:

$$Y_{it} = K_{it}^\alpha (L_{fit})^\beta (L_{mit})^{1-\alpha-\beta} \quad (9)$$

Dividing both sides by L_{it} And taking logs, we get an estimating equation as

$$\ln y_{it} = \alpha \ln k_{it} + \beta \ln f_{it} + (1 - \alpha - \beta) \ln m_{it} \quad (10)$$

Following the ASG model as suggested by Mankiw et al., production of *i* district at time *t* is given by:

$$Y_{it} = K_{it}^{\alpha} H_{it}^{\beta} (L_{fit})^{\gamma} (L_{mit})^{1-\alpha-\beta-\gamma} \quad (11)$$

Dividing both sides by L_{it} and taking logs we get an estimating equation as

$$\ln y_{it} = \alpha \ln k_{it} + \beta \ln f_{it} + (1 - \alpha - \beta) \ln m_{it} \quad (12)$$

Equation (12) was estimated using panel data from 2016 to 2022 for 472 districts categorized by island (Sumatera, Java, Bali-Nusa Tenggara, Kalimantan, Sulawesi-Gorontalo, and Maluku-Papua). α is capital (investment) elasticity, β is human capital elasticity, γ is female labor force elasticity, and θ is male labor force elasticity.

Furthermore, the Solow model was used to analyze the impact of the FLPR on the regional economy's convergence speed. The Solow model makes quantitative predictions about convergence speed to steady state. Let *y* be the steady-state income level per worker given by equation (8), and *y*(*t*) be the actual value at time *t*. Approximating around the steady state, the speed of convergence is given by:

$$\frac{d \ln(y(t))}{dt} = \lambda [\ln(y^*) - \ln(y(t))] \quad (13)$$

where $\lambda = (n + g + \delta)(1 - \alpha - \beta)$. Equation (13) implies that:

$$\ln(y(t)) = (1 - e^{-\lambda t}) \ln(y^*) + e^{-\lambda t} \ln(y(0)) \quad (14)$$

Where *y*(0) is the income per worker at some initial date. Subtracting $\ln(y(0))$ from both sides:

$$\ln(y(t)) - \ln(y(0)) = (1 - e^{-\lambda t}) \ln(y^*) - (1 - e^{-\lambda t}) \ln(y(0)) \quad (15)$$

We call Equation (15) unconditional convergence. The absolute beta convergence hypothesis is used to test the neoclassical growth model theory that developing regions tend to grow faster than developed regions. The neoclassical growth model states that developing regions grow faster than wealthier regions without requiring other economic characteristics (Barro & Sala-i-Martin, 1992).

Finally, substituting for *y*:

$$\begin{aligned} \ln(y(t)) - \ln(y(0)) = & (1 - e^{-\lambda t}) \frac{\alpha}{1-\alpha-\beta} \ln s_k + (1 - e^{-\lambda t}) \frac{\beta}{1-\alpha-\beta} \ln s_h - \\ & (1 - e^{-\lambda t}) \frac{\alpha+\beta}{1-\alpha-\beta} \ln(n + g + \delta) - (1 - e^{-\lambda t}) \ln(y(0)) \end{aligned} \quad (16)$$

We called Equation (16) as conditional convergence. Conditional convergence looks at the behavior and characteristics between districts. Conducting a conditional beta convergence hypothesis test will yield more significant benefits, namely finding out what determinants affect the level of regional economic growth in the long term by including selected variables that are considered to affect the level of regional economic growth, by including selected variables that affect the level of regional economic growth in the equation. The hypothesis for unconditional and conditional convergence is if the estimate of *b* is significant and negative. Where $b = -(1 - e^{-\lambda t})$ is the coefficient

of the variable $\ln(y(0))$. Then, the speed of convergence to reach a steady state can be calculated as follows:

$$\lambda = -(\ln(1 + b)) * 100 \quad (17)$$

Then, when the speed of convergence has been able to be estimated, the next step is to determine the length of half-time convergence, which means the time needed to eliminate half the gap that occurs through the equation to eliminate half the gap that occurs through the following equation:

$$\text{half time} = ((-\ln(0.5)) / \lambda) * 100 \quad (18)$$

RESULTS AND DISCUSSION

The analysis results at the national level show that the female labor force positively affects economic growth if they have at least a junior high school education, similar to the human capital variable. Highly educated women affect development through increased productivity and income (Obiageli et al., 2022). This underscores education's inspiring and hopeful role in breaking the vicious cycle of poverty and inadequate education.

The impact of the female labor force on regional economic varies across Indonesia's islands. It differs significantly, with the most pronounced effect observed on Kalimantan Island, where women who are high school graduates contribute significantly to regional economic (Table 4). In contrast, the impact on the island of Java is relatively small. This variation is influenced by the types of employment available and the accessibility of business opportunities for women, both formal and informal. These factors can enhance family welfare through increased income.

The analysis results presented in Table 4 indicate that the production elasticity of female and male labor factors is greater than that of investment and human capital. An increase in the labor force with at least a junior high school education by 1 percent can lead to a 0.60 percent increase in the economy's total output. The most significant effect among the production factors is attributed to human capital, highlighting that improving the quality of human resources is a crucial factor for the economy, particularly given Indonesia's large population.

This research supports previous studies and theories related to the impact of educational attainment on a country's economic growth. Aprina et al. (2021) underscore the role of domestic investment in education as a crucial determinant of improved economic performance, positing that such investments are essential for recovery following the pandemic. Additionally, Fitriady et al. (2022) confirm that Foreign Direct Investment (FDI), which is influenced by the education system, has a significant impact on the growth of GRDP. Furthermore, Asnawi et al. (2020) explain that the differences in the effects of domestic and foreign investments at the provincial level suggest the existence of regionally defined educational contexts; regions that prioritize improving educational standards tend to derive greater benefits from these investments.

There is an intricate relationship between the three levels of education and regional economic, progressing sequentially from primary to tertiary education, with the latter fostering greater growth (see Table 4). A lack of participation in the education system negatively impacts a country's long-term economic development, suggesting that addressing issues related to fundamental education may enhance growth indicators (Meilisa et al., 2024). Similarly, Dini and Aji (2022) emphasize the significant positive influence of secondary and tertiary education on economic growth across several provinces.

Furthermore, Sabur et al. (2021) explain the relationship between economic growth, poverty alleviation, and education by stating that individuals can escape the cycle of poverty through higher educational attainment, which in turn fosters further economic growth. This relationship illustrates that improved education enhances individuals' economic opportunities and strengthens the overall resilience of the economy. In addition, several studies have attempted to evaluate the impact of educational inequality on economic issues. Liyana (2023) concludes that unequal educational opportunities significantly affect the economy in certain regions, such as South Sulawesi. Mendy and Widodo (2018) provide strong evidence that the demand for qualified human capital with higher education is critical, as it yields the greatest returns on economic growth. Both formal education and informal skill acquisition should be emphasized, as their effects vary across provinces in Indonesia, suggesting the need for province-specific policies.

Table 4. The Effect of FLPR on Regional Economic (Method: PLS)

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Indonesia	Sumatra	Java	Bali-Nusa	Kalimantan	Sulawesi	Maluku-Papua
	Ins _h : sen Inf : jun	Ins _h : jun Inf : sen	Ins _h : sen Inf : jun	Ins _h : sen Inf : jun	Ins _h : uni Inf : sen	Ins _h : sen Inf : uni	Ins _h : sen Inf : sen
Ins _k	.089	.101	.13	.063	.08	.054	.053
Ins _h	.571	0.034	.439	1.321	.375	.328	.494
ln(n+g+δ)	-.391	-0.103	-0.095	-0.153	-0.18	0.04	0.09
Inf	.268	.228	0.039	.209	.553	.309	0.206
$\ln(\frac{m}{f} + 1)$	.029	-.759	-.54	1.129	.604	.504	.037
_cons	15.924	16.785	17.757	15.369	15.954	15.828	15.742
Observations	3,036.00	953.00	786	214	350.00	466.00	267.00
R-squared	0.15	0.20	0.32	0.51	0.19	0.10	0.16
Adj R-squared	0.15	0.20	0.32	0.50	0.17	0.09	0.14
Akaike's Crit	9,336.40	2464.53	1,953.77	442.97	883.33	1,217.71	802.70
Bayesian Crit	9,372.51	2493.69	1,981.77	463.17	906.48	1,242.58	824.22
Implied α	0.05	0.09	0.08	0.03	0.05	0.04	0.03
Implied β	0.34	0.03	0.28	0.55	0.26	0.24	0.32
1- α- β	0.60	0.88	0.64	0.42	0.69	0.72	0.65

$p < .01, p < .05, p < .1$

ele: primary school; jun: junior high school; sen: senior high school; uni: university

In summary, the amalgamation of these educational currents presents a clear narrative: throughout the provinces of Indonesia, the quality of education, rather than its quantity, serves as the centerpiece for effective growth within the country. Neither traditional learning nor informal skill acquisition can be overlooked. The impact of each varies by province, indicating that educational policy must be adapted to the specific needs of each region. The most crucial aspect of education in Indonesian provinces is not its numerical value but its meaningful existence, as it significantly influences economic growth.

The results of the Partial Least Squares (PLS) method are consistent with those obtained from the panel data method, indicating that the female labor force with at least a junior high school education has a positive impact on economic growth. However, the proportion of the female labor force consisting of junior high school graduates is only 16 percent of the total labor force, despite the existence of a 9-year compulsory education policy in Indonesia. Historical data from 2016 to 2022 shows that, on average, 38 percent of women have an elementary school education, 26 percent have a high school education, and 19 percent hold a university degree. The contributions of the labor force with high school and university education remain minimal, despite their considerable potential in terms of knowledge (Wang & Liu, 2016). Women also make significant contributions and have opportunities to develop skills comparable to those of men; however, this potential has not yet been fully realized. In addition, the tendency of women not to enter the labor market results in their roles in the economy being less than optimal. It is important to note that the roles referred to in this analysis can be quantified when they generate income; however, the study does not account for other roles that women fulfill as homemakers.

The estimation results presented in Table 4 indicate that the value of production elasticity falls between 0 and 1. Therefore, the use of inputs is rational, as the additional use of variable inputs has begun to reduce both average and marginal output. This stage represents a rational phase of production, where an increase in input will lead to an increase in total output, albeit with decreasing returns. The estimated coefficients in Table 5 demonstrate the significant influence of the FLPR on the growth rate of Indonesian districts, showing the strongest associations with sub-education indicators, particularly in secondary and tertiary education awareness. The coefficients associated with the FLPR are predominantly positive across these dimensions, although they vary in size and statistical significance. For instance, the effect size of the coefficient for labor force participation in Java (0.091) and Bali-Nusa (0.09) illustrates the diverse regional growth of the economy influenced by gender relations. This finding is consistent with previous empirical evidence that underscores the necessity of women's economic participation in shaping national economic outcomes. According to Purba (2024), women's roles significantly contribute to economic growth in Indonesia, further supporting these regional findings.

Table 5. The Effect of FLPR on Regional Economic (Method: Panel Data)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variable	Indonesia	Sumatra	Java	Bali-Nusa	Kalimantan	Sulawesi	Maluku-Papua
	Inh: jun Inf : jun Inm: sen	Inh: jun Inf : uni Inm: uni	Inh: jun Inf : uni Inm: uni	Inh: jun Inf : total Inm: jun	Inh: uni Inf : jun Inm: sen	Inh: ele Inf : jun Inm: jun	Inh: jun Inf : uni Inm: jun
Lnk	.002	.003	0.001	-0.003	-0.001	0.003	0.007
Ln timer	.044	.084	.09	.09	.091	0.002	0.014
Ln timer	.057	.026	.019	.072	.064	0.015	.048
Ln timer	.035	.053	.036	0.016	.073	.186	0.053
_cons	16.394	16.371	17.485	15.704	16.55	16.08	14.991
Observations	3116	978	799	226	360	482	270
R-squared	0.034	0.172	0.25	0.459	0.162	0.035	0.069
Adj R2	0.033	0.169	0.246	0.449	0.153	0.027	0.055
AIC	-1427.14	-2273.6	-2154.08	-785.267	-605.236	553.21	-77.806
BIC	-1402.96	-2254.06	-2135.34	-771.585	-589.692	569.922	-63.412
($\alpha + \beta + \gamma + \theta$)	0.138	0.166	0.146	0.175	0.073	0.186	0.053

Notes: p<.01, p<.05, p<.1

ele: primary school; jun: junior high school; sen: senior high school; uni: university

The positive influence of the FLPR in Indonesia is also evident in other countries, such as China (Chiengmai, 2018; Baerlocher et al., 2021), as well as in member countries of the Organization of Islamic Cooperation (OIC) (Barin et al., 2020). The results indicate a significant contribution of female labor force participation and female education (both secondary and higher) to China's economic growth (Wu et al., 2022). Additionally, there is a positive correlation between the Gender Development Index and average years of schooling with economic growth in the case of Java Island.

Moreover, comparative studies using data from other Organization of Islamic Cooperation (OIC) countries highlight the necessity of increasing female workforce participation and educational levels. This result underscores that enhancing the FLPR is a global imperative for economic development, as countries with higher FLPR have demonstrated notable GDP growth (Barin et al., 2020). This is particularly evident in Java (Sulisto et al., 2023). The research conducted by Sulisto et al. (2023) further illustrates how a strong Gender Development Index, in conjunction with educational attainment, promotes economic growth.

More general contexts also significantly reflect the growing awareness of gender roles in economic sustainability. Verick (2018) observes that access to education is crucial for maximizing labor force contributions, particularly for women. As noted by Kurniawan et al. (2020), policies aimed at enhancing education and aligning women's skills with labor market demands provide a strategic approach to improving economic productivity and addressing key challenges in labor markets.

Regional differences require targeted interventions, even though Indonesia shows encouraging trends in FLPR and educational integration for economic development. Based on the evidence, Indonesia could significantly enhance its economic performance through effective policies aimed at eradicating educational disparities and increasing women's employment opportunities. Several studies, including those by Tsaurai and Ndou (2019), and Mishra et al. (2020), demonstrate that gender equality in labor dynamics significantly influences economic development trajectories across countries. In Indonesia, sustainable economic development largely depends on incorporating gender perspectives and supporting female empowerment through political and financial policies. This approach aligns with global development goals and helps address the fundamental socioeconomic inequities currently present in local labor markets.

The relationship between women's labor force participation and economic development is complex, reflecting changes in economic activity, educational attainment, fertility rates, social norms, and other factors. However, education is a critical means of increasing participation and enhancing the quality of the female labor force. Expanding access to secondary and higher education (Verick, 2018) can empower and motivate women to contribute more effectively to the labor force, thereby driving economic development.

Improving the quality of the labor force can enhance productivity and reduce the gap between the skills of the workforce and the demands of the labor market. Low labor productivity often results in many workers being employed in the informal sector. Additionally, a low level of education leads to low wage levels for laborers and prevents many educated workers from entering the labor market, which increasingly demands high skill levels. However, policies that address both the demand and supply sides of women's labor quality can encourage participation by aligning women's education with appropriate job creation (Omran & Bilan, 2022). This reassures us that, with the right policies in place, we can confidently increase the contribution of the labor force by improving education quality.

Solow's growth theory proposes the concept of economic convergence, wherein declining returns to capital enable poorer economies to grow at faster rates than richer ones, thereby leveling per capita incomes across countries. Recent empirical research employing a Fixed Effect Model (FEM) within the context of Indonesia reveals absolute economic convergence among its provinces (see Table 5). Specifically, the negative coefficient associated with the initial per capita income parameter ($\ln(y(0))$) in the model indicates that areas with lower starting incomes are indeed catching up to their more affluent counterparts, thereby supporting the predictions of Solow's framework (Leško et al., 2022). With absolute convergence in Indonesia projected to be at 22.03 percent annually, policy interventions aimed at reducing income inequality will have significant implications. This rapid convergence rate underscores the necessity for government involvement in addressing inequalities, as unequal distributions may hinder convergence by promoting adverse backwash effects and diminishing diffusion benefits.

Previous research has demonstrated the critical role that public finance management and governance quality play in influencing economic growth outcomes (Lien, 2018; Johnson & Papageorgiou, 2020).

Furthermore, the empirical results align with the broader theoretical framework articulated by Barro and Sala-i-Martin (1992), suggesting that, depending on regional characteristics such as governance, human capital, and institutional frameworks, convergence can manifest in both absolute and conditional forms (Johnson & Papageorgiou, 2020; Albalade et al., 2021). These studies indicate that while absolute convergence addresses the overall economic development of regions regardless of their specific attributes, conditional convergence necessitates adjustments based on particular variables that influence earning potential and growth dynamics, such as infrastructure investment and educational attainment (Zhang et al., 2019; Wagner & Zeileis, 2019).

The empirical data from Indonesia support Solow's theory of economic convergence, which has significant implications for policymaking aimed at reducing inequality and promoting economic development globally. Addressing these factors is crucial for maintaining long-term economic cohesion and ensuring continuous convergence toward higher per capita income levels. The region with the highest absolute convergence speed is Kalimantan Island, while the lowest is Maluku-Papua Island. With a convergence speed of 114 percent per year, the region in Kalimantan Island is projected to reach a steady state within six months. In contrast, the region in Maluku-Papua Island will reach half of the steady state in nearly 17 years if no other variables affect economic growth in the region. Numerous factors influence a region's economic growth, including natural resources, human capital, and capital. The level of ownership and control of each factor also varies by region, prompting further analysis to calculate conditional convergence.

Table 6. Empirical Results of Absolute Convergence

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variable	Indonesia	Sumatera	Java	Bali-Nusa	Kalimantan	Sulawesi	Maluku-Papua
$\ln(y(0))$	-0.198	-0.226	-0.206	-0.292	-0.680	-0.182	-0.0404
_cons	3.212	3.651	3.572	4.485	10.97	2.903	0.631
Obs.	3304	1036	819	252	364	511	322
R-squared	0.0756	0.151	0.230	0.325	0.353	0.0626	0.00406
Adj R2	0.0753	0.150	0.229	0.323	0.352	0.0608	0.000952
AIC	-4361.2	-3356.6	-3347.2	-1027.3	-595.9	134.3	-503.4
BIC	-4355.1	-3351.7	-3342.5	-1023.7	-592.0	138.6	-499.7
speed (%)	22.03	25.66	23.10	34.53	114.0	20.10	4.123
halfLife (years)	3.146	2.701	3.000	2.007	0.608	3.448	16.81

p<.01, p<.05, p<.1

Source: primary data, 2024 (processed)

The conditional convergence analysis in this article focuses on how the female labor force affects the growth of GRDP. In the conditional beta model for Indonesia, the annual convergence speed is estimated at 23.70 percent. This figure indicates that economic growth in developing regions is 23.70 percent higher than in developed regions, and it takes approximately 2.92 years to close the halftime gap between underdeveloped and developed regions.

The female labor force with primary and junior high school education negatively influences GRDP. However, if women attain high school and university education, they can positively impact economic growth, as observed in Kalimantan Island and Maluku-Papua. This phenomenon is also evident in Sub-Saharan Africa (Thaddeus et al., 2022) and Nigeria (Olanrewaju et al., 2021). In contrast, the male labor force, including primary and junior high school graduates, can positively affect economic growth, indicating that the productivity and participation rates of male labor are higher than those of women. Furthermore, the impact of labor on economic growth depends on the capacity of the regional economic system to absorb and productively utilize labor. If the FLPR increases, regional output is expected to rise, assuming that a corresponding rise in labor productivity accompanies this increase.

Previous research conducted in Indonesia indicates that higher educational attainment among women is essential for maximizing their economic contributions. Specifically, primary and junior high education levels often result in less favorable economic outcomes, while higher education (high school and university levels) correlates positively with economic growth (Apire et al., 2023; Sajid, 2021). Studies from regions such as Kalimantan Island and Maluku-Papua support this finding, as they demonstrate that increased educational levels among women enhance their participation in the labor market and contribute to improved economic performance (Iqbal et al., 2021; Aturupane, 2018). The data indicate that while educated males tend to have higher labor force participation rates and productivity levels, women's participation is significantly enhanced through greater educational opportunities (Hasan, 2023; Verick, 2018).

The disparities in labor force participation rates based on gender reflect broader systemic issues. As Klasen (2019) notes, historical differences in economic structures significantly influence women's economic opportunities. An increase in FLPR can lead to output growth, particularly when improvements in labor productivity align with regional economic growth (Umair et al., 2024; Scarborough, 2020). Strategic investments in women's education are critical for promoting equity and fostering economic development, especially in developing countries like Indonesia. The positive correlation between FLPR and economic growth underscores the need for policymakers to enhance educational infrastructure and facilitate women's integration into the labor market to sustain growth trajectories in the long term (Fozia et al., 2022; Mujahid & Zafar, 2022).

Higher education levels correlate with improved human resource quality. High-quality human resources can produce quality goods and services, innovate to enhance production

factors, and exhibit high competitiveness, thereby increasing GRDP. Consequently, when the quality of human resources is elevated, productivity rises, leading to increased income. Enhanced productivity and income can accelerate economic growth. Therefore, barriers to increasing FLPR and promoting women's active involvement in the labor market must be minimized (Bawazir et al., 2022). When women have greater access to secondary education and labor market equality, this leads to a positive impact on the economy (Cabeza-García et al., 2018).

Table 7. Empirical Results of Conditional Convergence

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variable	Indonesia	Sumatra	Java	Bali-Nusa	Kalimantan	Sulawesi	Maluku-Papua
	Inh: jun Inf : ele Im: tot	Inh: ele Inf : jun Im: tot	Inh: uni Inf : ele Im: jun	Inh: jun Inf : tot Im: ele	Inh: jun Inf : uni Im: ele	Inh: sen Inf : ele Im: tot	Inh: ele Inf : sen Im: sen
ln(y(0))	-.211	-.262	-.274	-.465	-.86	-.187	0.002
Lnk	-0.001	0.002	.001	-0.001	-0.001	-0.013	.006
Ln h	-0.004	-.051	.018	.037	.052	0.118	.069
Ln f	-.033	-.015	-.027	0.042	.092	-0.085	0.018
Ln m	.161	.141	.01	-.029	-.114	.092	-.07
cons	3.475	4.191	4.756	7.274	14.023	3.145	0.022
Obs.	3117	978	799	226	360	482	272
R-squared	0.084	0.173	0.278	0.422	0.488	0.083	0.086
Adj R2	0.083	0.169	0.274	0.409	0.481	0.073	0.069
AIC	-3999.91	-3299.67	-3303.766	-934.176	-661.78	152.301	-418.146
BIC	-3969.68	-3275.24	-3280.349	-917.074	-642.349	173.19	-400.117
speed (%)	23.70	30.38	32.02	62.55	196.611	20.70	
halfLife (year)	2.92	2.28	2.16	1.11	0.353	3.35	

p<.01, p<.05, p<.1
Source: primary data, 2024 (processed)

Recent studies have closely examined the relationship between human resource quality and educational levels. Higher-quality human resources associated with greater educational attainment contribute to increased economic production and innovation. This trend reflects the growing competitiveness of products, which stimulates the upward trajectory of GDP. Effective human resource management in educational institutions is crucial, as it significantly enhances the quality of education and aligns it with societal needs (Rawis et al., 2024; Karoso et al., 2024; Darimus & Hanif, 2023; B et al., 2023). As the quality of human resources in education improves, the learning environment also benefits, leading to more effective learning outcomes. A workforce that is economically empowered and capable of producing high-quality goods and services relies on this

development (Alvi et al., 2021; Qutni et al., 2021). For instance, the application of total quality management in educational settings has demonstrated that systematic approaches to regulating educational quality can enhance learning outcomes, thereby producing more competent and competitive graduates (Ikhsannudin & Pakpahan, 2021; Purwanto & Madhakomala, 2023). Additionally, including women in the workforce significantly boosts output and economic activity.

Studies indicate that increasing access to secondary education can help lower barriers to female labor participation, thereby contributing to gender equality in the workforce (Nuryanto & Pambuko, 2019; Binh, 2021; Destari, 2023). Research emphasizing the necessity of equitable educational opportunities for women supports the economic benefits of increasing female participation, enhancing skills, and diversifying the labor pool in various ways (Pratikno et al., 2022; Guomin, 2023; Tazliqoh, 2023). The production and economic growth depend on the quality of human resources, which is significantly influenced by educational performance. Reducing barriers to women's employment participation and improving access to education can enable societies to experience notable changes in economic performance and quality of life (Subaidi et al., 2021; Kumaravelu & Suresh, 2021). Therefore, policies that prioritize the development of human capital are essential for defining economic progress.

CONCLUSION

Female labor force participation contributes to economic growth, particularly when women have a senior high school or higher (university) education. Education has proven to be the most important factor, as higher levels of education enhance human resources, thereby increasing production and economic development. However, the impact of FLPR on economic development varies across different regions. Despite its large population, FLPR in Java is not yet fully realized, whereas it has a more significant impact in Kalimantan.

Under absolute income convergence, less developed areas grow faster than more developed ones; however, the speed of convergence varies. Kalimantan shows rapid convergence, while Maluku-Papua faces structural gaps and progresses more slowly. FLPR among individuals with lower educational attainment (elementary or junior high school) hampers the growth of GRDP per capita, highlighting the demand for quality female workers. Research has demonstrated that enhancing women's capacity and increasing funding for education can accelerate growth and reduce regional disparities.

To enhance the contribution of FLPR to economic development, the government should reform the 9-year compulsory education policy and extend it to 12 years. In addition to formal education, the government should provide broader opportunities for women to access non-formal education. Support, participation, and the fundamental involvement of all stakeholders, including the community and local government, are essential for creating a labor market that is conducive to women workers. Implementing job flexibility and increasing access to childcare can help achieve this goal.

Formal jobs that are friendly to women should be created, and adult women, especially those without a completed education, should obtain greater skill development. Community-based learning and employment policies should be supported. Kalimantan and Papua require specific plans to involve highly educated women more actively. Intervention strategies should focus on local elements such as job access, culture, and the economy. Educational programs should be adapted to meet the demands of the job market. Establishing partnerships with businesses can facilitate job placement for newly graduated women. It is also essential to enhance teacher capacity, improve management quality, and elevate the overall standards of educational institutions. Such efforts are crucial for enabling digital-based educational innovations to reach women living in remote areas. Future research should analyze the factors influencing women's decisions to enter the workforce.

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Economic Turbulence in Indonesia: The Effects of Instability and Crisis

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JEL Classification:

F41

E32

O53

Received: 18 January 2025

Revised: 25 May 2025

Accepted: 31 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study presents a novel perspective by examining Indonesia's economic growth over three crisis periods. It uniquely highlights how global economic uncertainty can strengthen Indonesia's growth resilience when met with credible domestic policy responses.

Research Objectives: The research investigates the effects of exports, imports, production value, interest rates, economic globalization, exchange rates, and state obligations on Indonesia's economic growth at constant prices.

Research Methods: Using quarterly time-series data from 1991Q1 to 2024Q1, the study employs a Dummy Variable–Autoregressive Distributed Lag model.

Empirical Results: Exports have a direct negative effect on economic growth but when influenced indirectly by the global crisis and the pandemic, exports can actually contribute to growth. On the other hand, imports directly boost growth, but their impact is negatively affected by the global crisis. Additionally, interest rates support long-term growth but hinder it in the short run; however, crises may moderate this impact positively.

Implications: These findings underscore the need for policymakers to craft dynamic, adaptable economic strategies that can safeguard Indonesia's growth against future global shocks and uncertainties.

Keywords:

economic shock; crisis phase; global political tension; structural transformation

How to Cite:

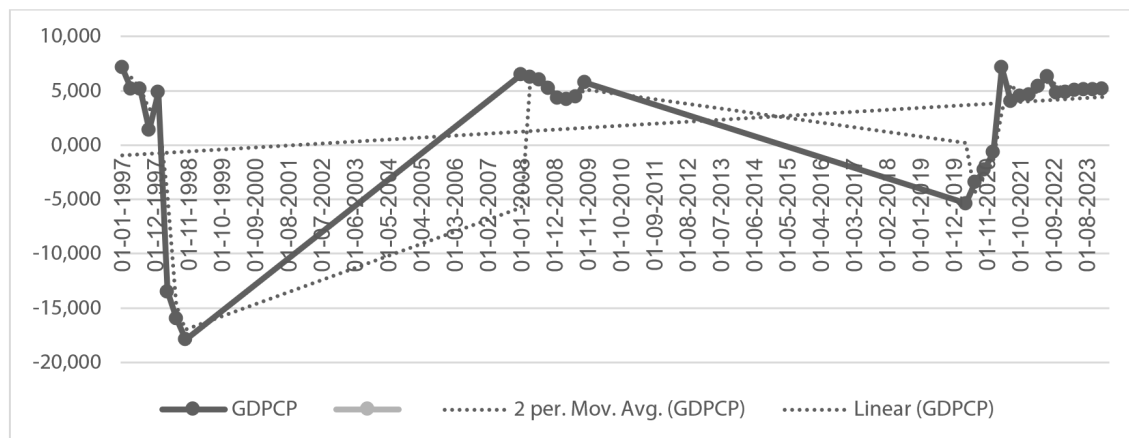
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INTRODUCTION

Indonesia's economic growth has experienced significant volatility over the past three decades, shaped by three major crises: the Asian Financial Crisis (1997–1998), the Global Financial Crisis (2008–2009), and the COVID-19 pandemic (2020–2023). These shocks disrupted trade flows, undermined currency stability, and exposed structural vulnerabilities within Indonesia's macroeconomic framework. In such episodes, government responses have typically focused on monetary measures aimed at stabilizing inflation and exchange rates (Desdiani et al., 2022; Hidhiir et al., 2024). As shown in Figure 1, real GDP growth contracted sharply by -5.365% in Q1 2020, reflecting widespread economic dislocations, including labor market contraction, trade disruptions, and productivity stagnation (Dutu, 2016; Ghannili & Choiri, 2024; Nugraha, 2020; Tinungki et al., 2022).

Despite its abundant natural resources and large population, Indonesia's recovery has remained uneven. Manufacturing output and investment have repeatedly been hindered by elevated global uncertainty (Claveria, 2022; Setyawan, 2020). Scholars continue to debate whether crises such as the COVID-19 pandemic catalyze long-term recovery or entrench structural stagnation (Silva & de Araújo, 2023). The International Monetary Fund (2024) emphasizes that economic uncertainty now encompasses not only inflation and growth volatility, but also geopolitical risk, technological disruption, and climate-related threats. In this regard, the World Uncertainty Index (WUI) has become a critical indicator for evaluating asymmetric global shocks to investment, inflation, exchange rates, and capital flows (Bush & López Noria, 2021; Demir & Danisman, 2021; Nguyen & Lee, 2021).

Figure 1. Economic Growth at Constant Prices in Indonesia During the Monetary, Global, and Pandemic Crises



Source: FRED (2024), Data Processed

Indonesia's economic resilience thus depends on effective coordination between external policy instruments and domestic macroeconomic management. The central bank plays a pivotal role in guiding monetary policy, often employing Dynamic Stochastic General Equilibrium (DSGE) models to evaluate inflation targeting and interest rate transmission (Mohamad et al., 2020; Zams, 2021). However, many existing studies are

limited in scope—either examining single crisis episodes, focusing narrowly on individual macroeconomic variables (Ghannili & Lucky, 2024; Sutarjo et al., 2021), or employing static models that fail to capture structural dynamics across time. Furthermore, few studies incorporate structural breaks or nonlinearities associated with crisis episodes, despite their relevance in shaping long-run economic outcomes. While some studies highlight the roles of trade and productivity (Van der Eng, 2010), others question their effectiveness under conditions of sustained volatility (Bonciani & Ricci, 2020; Thorbecke, 2023).

Many studies overlook how crises evolve. Hidthiir et al. (2024) found that while financial development boosts long-term growth in ASEAN countries, short-term stability needs comprehensive policies. Sutarjo et al. (2021) highlighted the long-term effects of exports, imports, interest rates, and exchange rates on Indonesia's growth from 1990 to 2029. Mohamad et al. (2020) found mixed effects of exchange rates on growth in several Asian countries during the 1997 crisis. Van der Eng (2010) finds that Indonesia's manufacturing sector had a negative impact on growth in specific periods, though gains were seen later, reflecting policy and institutional changes. TFP stabilized during major shocks, highlighting the role of stable monetary policy, as shown by Dutu (2016), who found that interest rate smoothing and exchange rate responsiveness enhance growth. Thorbecke (2023) notes that industrial and sectoral measures had little impact in mitigating the COVID-19 crisis. Similarly, Bonciani & Ricci (2020) highlight that global economic uncertainty, as measured by the World Uncertainty Index, severely hampers growth in 144 small and developing economies, particularly those in trade and monetary alliances.

This study fills a significant gap in the literature by examining how multiple crises and global economic uncertainty simultaneously shape Indonesia's economic performance over an extended period. Previous studies typically address isolated crisis events or fail to capture the structural shifts that accompany long-term volatility. By integrating structural break analysis and the World Uncertainty Index into the DV-ARDL framework, this study reveals how global uncertainty, rather than being solely a challenge, can act as a catalyst for resilient growth when met with credible domestic policy responses (Gonese et al., 2023; Handoyo et al., 2020; Hatmanu et al., 2020; Sunde, 2017; Ugurlu, 2024). The study also incorporates the World Uncertainty Index to account for the influence of global volatility explicitly. Specifically, this research aims to evaluate the asymmetric effects of key macroeconomic variables on growth during and after crisis periods and provide empirically grounded policy insights to strengthen Indonesia's economic resilience in the face of future shocks.

METHODS

This study uses quarterly time-series data from 1991-Q1 to 2024-Q1, sourced from the Federal Reserve Economic Data, focusing on Indonesia's real GDP (hereafter GDPCP or growth) as the dependent variable. The use of FRED data in this study is because the database provides greater accuracy in economic time series data obtained

from various sources. These time series include banking, business/fiscal, consumer price index, employment and population, exchange rate, gross domestic product, interest rate, monetary aggregates, producer price index, and others. Independent variables include the price value of goods and services measured through exports (hereafter EXP) and imports (hereafter IMP), productivity, as measured by total manufacturing output (hereafter PRO), interest rate policy represented by the overnight (<24 hours) benchmark interest rate (hereafter IR), the exchange rate measured by the real effective exchange rate (hereafter ER), economic globalization measured using the global uncertainty index (hereafter EG), and the state obligations measured by foreign debt (hereafter FD). Three dummy variables represent major crises: the Asian financial crisis (1997-Q1 to 1998-Q4), the global financial crisis (2008-Q1 to 2009-Q4), and the COVID-19 pandemic (2020-Q2 to 2023-Q1). Variable descriptions are detailed in Table 1.

Table 1. Description of Data and Data Sources

Variables	Description	Unit description	Sources
GDPCP	Economic growth at constant prices	Quarterly percentage	Statistika (2025)
EXP	The price value of goods and services measured through exports	Percentage of GDP	Statistika (2025)
IMP	The price value of goods and services measured through imports	Percentage of GDP	Statistika (2025)
PRO	Productivity, as measured by total manufacturing output	Percentage of GDP	Statistika (2025) and Federal reserve economic data
IR	Interest rate policy represented by the overnight (<24 hours) benchmark	Percentage	Statistika (2025)
EG	Economic globalization measured using the global uncertainty index	Global index	Statistika (2025) and Federal reserve economic data
ER	The exchange rate measured by the real effective exchange rate	Percentage of US\$	Federal reserve economic data
FD	The state obligations measured by foreign debt	Percentage of US\$	Federal reserve economic data
D1	Monetary Crisis (1997-Q1 to 1998-Q4)	0 did not experience a crisis and 1 experienced a crisis	Author compilation (dummy)
D2	Global Crisis (2008-Q1 to 2009-Q4)	0 did not experience a crisis and 1 experienced a crisis	Author compilation (dummy)
D3	Pandemic Crisis (2020-Q2 to 2023-Q1)	0 did not experience a crisis and 1 experienced a crisis	Author compilation (dummy)

Source: Author Compilation

This study applies the Dummy Variable–Autoregressive Distributed Lag model, a modified ARDL (Autoregressive Distributed Lag) approach, to assess the impacts of

the monetary crisis, global financial crisis, and COVID-19 pandemic on Indonesia's economy. The method is suitable for time-series analysis with mixed integration orders and allows for consistent estimation across crisis periods. It aligns with macroeconomic research using GDPCP as the dependent variable, as supported in time-series literature (Breitung & Salish, 2021). Moreover, ARDL captures dynamic effects before, during, and after each crisis period. The econometric form of the model is specified as follows:

Equation (1) short-term estimation:

$$\text{GDPCP}_t = \alpha_0 + \alpha_1 \text{EXP}_T + \alpha_2 \text{IMP}_T + \alpha_3 \text{PRO}_T + \alpha_4 \text{IR}_T + \alpha_5 \text{EG}_T + \alpha_6 \text{ER}_T + \alpha_7 \text{FD}_T + \alpha_8 \text{EXP} * \text{Crisis}_t + \alpha_9 \text{IMP} * \text{Crisis}_t + \alpha_{10} \text{IR} * \text{Crisis}_t + \alpha_{11} \text{D}_{n(t)} + \alpha_{12} \text{EC}_{t-1} + \epsilon_t \quad (1)$$

Equation (2) long-term estimation:

$$\Delta \text{GDPCP}_t = \beta_0 + \beta_1 \Delta(\text{EXP})_T + \beta_2 \Delta(\text{IMP})_T + \beta_3 \Delta(\text{PRO})_T + \beta_4 \Delta(\text{IR})_T + \beta_5 \Delta(\text{EG})_T + \beta_6 \Delta(\text{ER})_T + \beta_7 \Delta(\text{FD})_T + \beta_8 \Delta(\text{EXP} * \text{Crisis})_t + \beta_9 \Delta(\text{IMP} * \text{Crisis})_t + \beta_{10} \Delta(\text{IR} * \text{Crisis})_t + \beta_{11} \Delta(\text{D}_{n(t)}) + \epsilon_t \quad (2)$$

In Equations (1) and (2), EC is the error correction term, capturing the balance of shocks over time, while other abbreviations refer to Table 1.

The DV-ARDL model estimation follows several key stages. First, descriptive statistics, OLS regression, and heteroscedasticity tests are performed to examine the characteristics of each variable, assess their individual effects, and ensure the efficiency of the model's error term. Second, unit root tests are conducted to determine the stationarity of the data, whether at level (0) or first difference (1) (Sunde, 2017), including structural break analysis to ensure model reliability (Çamalan et al., 2025). Third, a cointegration bounds test assesses the joint significance of crisis variables at 1%, 5%, and 10% levels (Breitung & Salish, 2021). DV-ARDL then estimates short- and long-term crisis effects, with model stability confirmed through CUSUM and CUSUM-Q tests (Figures 2–4).

RESULTS AND DISCUSSION

Table 2 presents the descriptive statistics of all variables used in this study. The dependent variable, GDPCP, has a mean of 4.768, a median of 5.188, with a maximum of 10.74 and a minimum of -17.93. Among the independent variables, exchange rate has the lowest mean (0.195), while productivity has the highest (53.977). Foreign debt averages US\$22,492.565, reflecting the state's fiscal burden. The data shows a significance level below 1%, indicating the overall data has no similarity (stochastic). A total of 129 observations meets the requirement for time-series analysis. These findings align with prior research (Hidhiir et al., 2024; Mohamad et al., 2020; Sutarjo et al., 2021; Van der Eng, 2010).

Table 3 presents regression results from 1991-Q1 to 2024-Q1, showing the impact of crises on economic growth. The model is significant with an R-squared value of 0.651524, indicating a good fit and consistency. Production does not have an effect, while most other variables are significant. GDPCP impacts commodity imports and economic globalization, while foreign debt has a strongly negative impact on GDP. Exchange and interest rates have minimal impact on productivity and lack significant

correlation with growth. Global uncertainty and imports are key growth drivers, while exchange rates, interest rates, and monetary policies have a limited impact on sustained economic performance.

Table 2. Descriptive Analysis

	GDP	PCP	EXP	IMP	PRO	IR	EG	ER	FD	D1	D2	D3
Mean	4.768	22.181	16.749	53.977	10.708	0.198	0.195	3.594	0.06	0.06	0.09	
Median	5.188	20.309	16.392	-13.098	8	0.165	-0.069	3.771	0	0	0	
Maximum	10.744	48.833	28.619	5057.952	68.76	0.877	50.350	4.908	1	1	1	
Minimum	-17.929	14.320	0	-2711.992	3.5	0	-48.219	0	0	0	0	
Std. Dev.	4.058	6.241	3.534	689.494	8.839	0.165	7.440	1.095	0.239	0.239	0.287	
Skewness	-3.394	2.043	-0.832	4.635	3.830	1.397	0.140	-0.877	3.7	3.7	2.861	
Kurtosis	17.198	8.669	10.024	37.089	22.162	5.364	30.920	4.195	14.689	14.689	9.183	
Jarque-Bera	1372.486	270.652	288.739	6915.881	2359.984	74.257	4320.216	24.980	1060.612	1060.612	393.2	
Probability	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	
Sum	634.223	2950.041	2227.586	7178.965	1424.217	26.303	25.927	478.072	8	8	12	
Sum Sq. Dev.	2174.3	5140.6	1649	62753140	10313.5	3.597	7307.5	158.2	7.5	7.5	10.9	
Observations	133	133	133	133	133	133	133	133	133	133	133	

Source: Author Compilation

Table 3. Regression Results of the Crisis Effect on Growth

Variable	Indonesia's Growth During Crisis (Static)			
	Coefficient	Std. Error	t-statistic	Prob.
Constant	12.29648	1.386360	8.869360	0.0000 ^a
Export	-0.252787	0.056062	-4.509062	0.0000 ^a
Import	0.338819	0.085624	3.957063	0.0001 ^a
Productivity	0.000440	0.000322	1.366481	0.1743
Interest Rate	-0.259930	0.036832	-7.057204	0.0000 ^a
Economic Globalization	3.114855	1.471598	2.116647	0.0363 ^b
Exchange Rate	-0.071679	0.031427	-2.280813	0.0243 ^b
Foreign Debt	-1.352065	0.278778	-4.849972	0.0000 ^a
Economic Crisis	-2.745493	0.564155	-4.866561	0.0000 ^a
R-squared	0.651524			
F-statistic	28.97934			
Prob (F-statistic)	0.000000			

Note : Symbol ^{a,b, dan c} is the value of the significant level of 1%, 5%, and 10%.

Source: Author Compilation, FRED (2024)

Table 4 presents various heteroscedasticity tests to assess whether the residual variance in the regression model is constant. The tests include ARCH, White test, Breusch-Pagan

test, Harvey test, and Glejser test. The ARCH, Harvey, White, Breusch-Pagan and Glejser tests accept the alternative hypothesis (H_1), indicating potential heteroscedasticity. These results indicate that the regression model is affected by heteroscedasticity, although not consistently across all tests.

Table 4. Heteroscedasticity Test

	ARCH	White	Breusch-P	Harvey	Glejser
F-statistic	2.030496	1.232358	1.374296	0.337133	1.421439
Obs*R-squared	2.030020	84.05345	16.06341	4.342423	16.54485
Scaled explained SS		210.4695	40.22273	8.271924	23.39571
Prob. F(1,128)	0.1566				
Prob. F(77,53)		0.2110			
Prob. F(12,118)			0.1877	0.9807	0.1656
Prob. Chi-Square (1)	0.1542*				
Prob. Chi-Square (77)		0.2725*			
Prob. Chi-Square(12)			0.1883*	0.9764*	0.1675*

Notes: *The critical value is greater than 5
Source: Author Compilation

Table 5. Unit Root Test

Variables	Augmented Dickey-Fuller test (ADF)		Phillips-Perron test (PP)		Information
	Level	First Diff.	Level	First Diff.	
GDPCP	-4.364089 ^a		-3.230846 ^b		I(0)
EXP	-2.367199	-9.479852 ^a	-2.674416 ^c		I(1)
IMP	-4.219713 ^a		-3.193389 ^b		I(0)
PRO	-11.48424 ^a		-11.48518 ^a		I(0)
IR	-3.648597 ^a		-3.358865 ^b		I(0)
EG	-7.199698 ^a		-7.489305 ^a		I(0)
ER	-8.174290 ^a		-10.87866 ^a		I(0)
FD	-1.165113	-11.39559 ^a	-1.261215	-11.39559 ^a	I(1)
D1	-3.043954 ^b		-3.312543 ^b		I(0)
D2	-3.043954 ^b		-3.312543 ^b		I(0)
D3	-0.234720	-6.452996 ^a	-2.635767 ^c		I(1)

Notes: Symbol ^{a,b, dan c} is the value of the significant level of 1%, 5%, and 10%.
Source: Author Compilation

Table 5 shows that all variables—EXP, IMP, PRO, IR, EG, ER, FD, D1, D2, D3, and GDPCP—are non-stationary at level but become stationary at the first difference. These results justify the use of the ARDL model for both short-run and long-run

cointegration analysis, particularly when ADF and PP tests fail to confirm stationarity at level (I(0)) but confirm it at the first difference (I(1)). Thus, it is concluded that all variables meet the stationarity requirement and are suitable for further ARDL-based cointegration analysis.

Table 6 shows the results of unit root testing with two structural breaks at the lower (BTB) and upper (BTA) bounds. In model (I), GDP_{CP} remains stable between 1991-Q4 and 1999-Q3 ($t = -5.099$). In model (II), when the trend is influenced by the crisis, the stability shifts slightly to 1991-Q3 to 1998-Q4 ($t = -6.037$), reflecting the impact of the economic crisis. Productivity remains stable until 2009-Q4, while foreign debt shows stability at 2011-Q4. These results suggest that several variables—including GDP_{CP}, EXP, IMP, PRO, IR, EG, ER, and FD—undergo significant structural changes before, during, and after crises, beginning in 1991-Q1.

Table 6. Unit Root Test with Two Structural Breaks

Variables	Break point basic intercept (I)			Break point basic intercept and trend (II)		
	t-stats	BTB	BTA	t-stats	BTB	BTA
GDP _{CP}	-5.099366	1991Q4	1999Q3	-6.037504	1991Q3	1998Q4
EXP	-3.085121	1992Q1	2008Q2	-6.487571	1992Q2	1997Q3
IMP	-6.772725	1991Q1	1998Q1	-6.682381	1991Q4	2007Q4
PRO	-14.43551	1991Q2	2009Q4	-14.29234	1991Q2	2009Q4
IR	-6.755477	1991Q3	1998Q2	-8.274454	1993Q1	1999Q3
EG	-8.183207	1991Q2	2005Q1	-8.951782	1991Q2	2001Q3
ER	-12.38558	1991Q2	1998Q4	-12.84569	1991Q2	1998Q4
FD	-1.325642	1991Q3	2011Q4	-2.927510	1991Q3	2002Q1

Note: The test model shows the critical values in model (I) (-4.949, -4.443, -4.193) and in model (II) (-5.719, -5.176, -4.894) at 1%, 5%, and 10%, respectively. BTB (lower quarter limit) and BTA (upper quarter limit) are the first and second breaks. GDP_{CP}, EXP, IMP, PRO, IR, EG, ER, FD affected by the trend of economic crisis in 1991-Q1.

Source: Author Compilation

Table 7 outlines the optimal lag selection based on the Akaike Information Criterion (AIC) and Schwarz Criterion (SC). The AIC suggests the optimal lag at lag 8 (AIC-KP = 52.99847), while the SC identifies lag 2 as optimal across multiple models (AC-KM = 55.54666, KG = 56.31314, KP = 55.62366). These criteria help determine how much past economic activity (inertia) influences current growth. Thus, the SC model is preferred due to its lower inertia at lag 2, compared to the AIC model, which indicates higher inertia at lag 6.

Table 8 presents the cointegration test results using the bound test for the variables during the crisis periods. The F-statistic values are 21.29096 (monetary crisis), 14.60115 (global crisis), and 18.76307 (pandemic crisis), all of which are greater than the critical values of 1.5 at the 10% level, confirming a long-term relationship between them during each crisis. Therefore, the bound test results confirm the presence of a long-term relationship in the ARDL model.

Table 7. Lag Order of Economic Crisis using VAR (Vector Autoregression)

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-4094.153151200108	NA	2.30e+18	67.82071	68.02866	67.90517
1	-3231.894665249074	1581.995	5.69e+12	54.90735	56.98686*	55.75192*
2	-3134.659718397112	163.9333	4.44e+12	54.63900	58.59008	56.24369
3	-3043.589331736858	139.9925	3.96e+12*	54.47255	60.29519	56.83735
4	-2971.041869364821	100.7271	5.06e+12	54.61226	62.30646	57.73717
5	-2895.919075531219	93.12743	6.68e+12	54.70941	64.27517	58.59443
6	-2795.154976759749	109.9245*	6.40e+12	54.38273*	65.82005	59.02786
7	-2735.031099066479	56.64564	1.39e+13	54.72779	68.03667	60.13303
8	-2646.730157879596	70.05695	2.32e+13	54.60711	69.78756	60.77247

Note: *indicates lag order selected by the criterion
Source: Author Compilation

Table 8. Cointegration Test (Bound Test)

Dependent/ independent variables	F-statistic	10%		5%		1%		Explanation
		I(0)	I(1)	I(0)	I(1)	I(0)	I(1)	
Monetary crisis	21.29096	1.76	2.77	1.98	3.04	2.41	3.61	Accepted Ha
Global crisis	14.60115	1.76	2.77	1.98	3.04	2.41	3.61	Accepted Ha
Pandemic crisis	18.76307	1.76	2.77	1.98	3.04	2.41	3.61	Accepted Ha

Source: Author Compilation

Table 9 shows the long-term and short-term estimation results from ARDL. During the monetary crisis in exports and foreign debt have a significant negative impact on growth, while imports have a significant positive effect. During the global crisis in interest rates, exchange rate negatively affects growth, while economic globalization contributes positively. During the pandemic in interest rates, exports, exchange rates —all indirectly affected by the crisis — significantly boost growth. The model shows strong statistical significance, with an F-statistical probability of 0.000 (<1.5 and 10%) and R-square of 0.580263 (monetary crisis), 0.368377 (global crisis), and 0.460572 (pandemic), indicating fairly good explanatory power and fairly consistent variation across crises.

And, presents the short-term estimation results. During the monetary crisis in imports and foreign debt significantly and negatively affect growth. In the global crisis in imports and economic globalization has a significant positive impact on growth. In contrast, during the pandemic in interest rates and exchange rate again shows a significant negative effect, reinforcing its adverse influence across crisis periods. The R-squared values are 0.7503 (monetary crisis), 0.6089 (global crisis), and 0.6660 (pandemic), indicating strong model fit. Additionally, all models report a probability (F-statistic) of 0.000 < 1.5 and 10%, confirming the short-term significance of the variables and rejecting the null hypothesis (H_0).

Table 9. Stability of Long-Term and Short-Term Estimates

Variables	Monetary Crisis (I)		Global Crisis (II)		Pandemic Crisis (III)	
	Long Term	Short Term	Long Term	Short Term	Long Term	Short Term
GDPCP(-1)		0.0267		0.7999		0.7899
		-0.190447 ^b		-0.022965		-0.022234
EXP	0.1025	0.0282*	0.0383	0.0281	0.0244	0.0170
	0.194703	0.245126 ^b	-0.190023 ^b	-0.194387 ^b	-0.191808 ^b	-0.196072 ^b
IMP	0.4302	0.4288	0.5326	0.5320	0.5690	0.5685
	0.052460	0.062451	0.059446	0.060811	0.047899	0.048964
PRO	0.0411	0.1252*	0.5456	0.5437	0.7979	0.7983
	0.000533 ^b	0.000269	0.000121	0.000124	-4.26E-05	-4.36E-05
IR	0.0030	0.0028*	0.0000	0.0009*	0.0000	0.0003*
	-0.241963 ^a	-0.204818 ^a	-0.254274 ^a	-0.157505 ^a	-0.250759 ^a	-0.157714 ^a
EG	0.7897	0.7896	0.0100	0.0683*	0.0270	0.1595*
	0.115247	0.137195	4.483510 ^b	1.977029 ^c	3.671205 ^b	1.408058
ER	0.2332	0.2275	0.0043	0.0017	0.0012	0.0004
	-0.033052	-0.039347	-0.073878 ^a	-0.075574 ^a	-0.078138 ^a	-0.079876 ^a
FD	0.3676	0.3659	0.9007	0.9007	0.0047	0.0037
	-0.228582	-0.272115	-0.047129	-0.048211	1.890791 ^a	1.932831 ^a
EXP*Crisis	0.0003	0.0031*	0.9360	0.9361	0.9013	0.9013
	-1.346690 ^a	-1.304268 ^a	-0.039864	-0.040780	-0.072395	-0.074004
IMP*Crisis	0.0261	0.0202*	0.8977	0.8977	0.6476	0.6471
	1.074856 ^b	1.245570 ^b	0.080456	0.082304	0.321848	0.329004
IR*Crisis	0.0022	0.0806*	0.9176	0.9175	0.0099	0.0075
	0.349580 ^a	0.169837 ^c	-0.113699	-0.116310	-2.362706 ^a	-2.415238 ^a
Constant	0.5917		0.7576		0.9516	
	-0.062748		-0.051107		-0.009491	
CointEq		0.0000		0.0000		
		-1.190447		-1.022965		
R-squared	0.580263	0.750291	0.368377	0.608959	0.460572	0.666037
F-statistic	9.189190	21.29096	5.249011	14.60115	7.684348	18.76307
Prob(F-statistic)	0.000000		0.000000		0.000000	
Akaike info criterion	3.876457	3.708518	4.237483	4.069544	4.079699	3.911760
Schwarz criterion	4.271523	3.862155	4.544756	4.135388	4.386972	3.977605

Note: The critical level criteria ^a, ^b, and ^c are the percentages of 1%, 5%, and 10%. The independent variable is economic growth at constant prices. ARDL-crisis (I) (1,1,0,1,1,0,0,0,1,1,1), ARDL-crisis (II) (1,0,0,0,1,1,0,0,0,0,0), ARDL-crisis (III) (1,0,0,0,1,1,0,0,0,0,0). * p-values are incompatible

Figure 2. CUSUM and CUSUM-Q for coefficient stability of ARDL Monetary Crisis Model

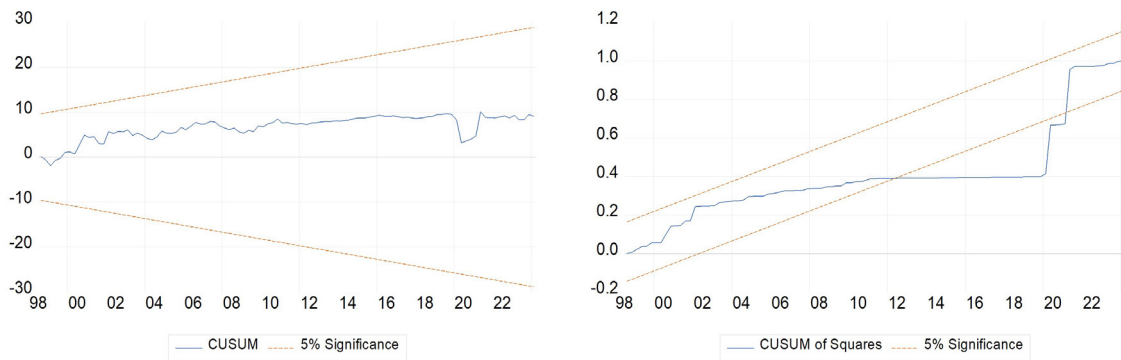
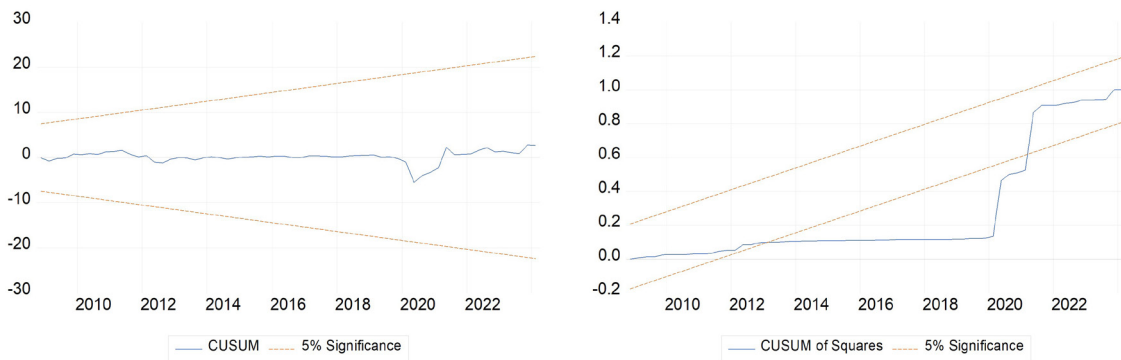
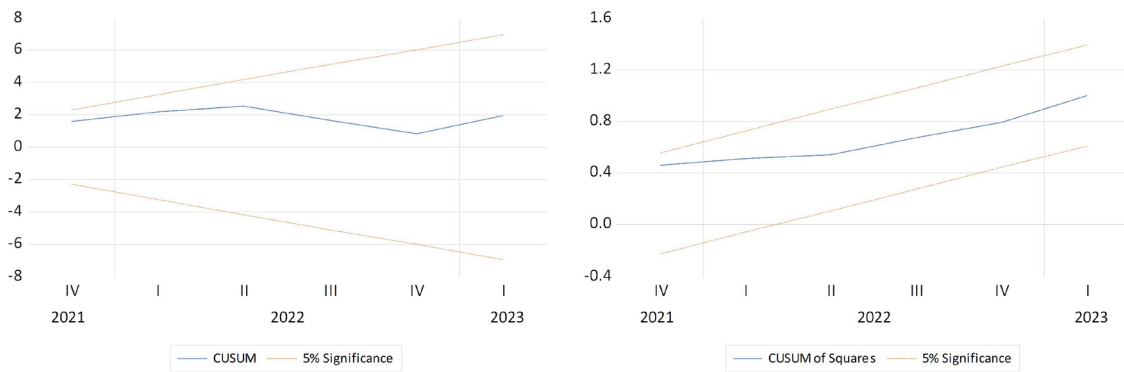


Figure 3. CUSUM and CUSUM-Q for coefficient stability of the ARDL Global Crisis Model



Figures 2 to 4 show CUSUM and CUSUM-Q test plots assessing ARDL model coefficient stability during different crises. In Figure 2 (monetary crisis), the CUSUM plot remains stable within the 5% significance bounds, but the CUSUM-Q plot shows growth variability shifts from 2011 to 2020. In Figure 3 (global crisis), the CUSUM plot shows slight deviations, with growth fluctuations from 2012 to 2020. Figure 4 (pandemic crisis) shows no major structural shocks, with both plots within confidence bounds. Overall, these results suggest that economic stability varied across crisis periods, with greater instability observed during the monetary and global crises than during the pandemic.

This study finds that trade, particularly exports, significantly influences Indonesia's economic growth at constant prices, both in the short and long term. However, unlike previous research by Ghazouani et al. (2020), Carrasco & Tovar-García (2021), Nasreen & Anwar (2014), and Were (2015), which identifies trade as a consistent engine of growth, our results suggest a more nuanced relationship. While exports and imports contribute positively in the short term, their long-run effects appear negative due to structural inefficiencies and elevated residual values. These findings underscore the limitations of Indonesia's trade infrastructure, exacerbated by institutional weaknesses and external shocks.

Figure 4. CUSUM and CUSUM-Q for coefficient stability of ARDL Pandemic Crisis Model

Rahman (2021) argues that trade benefits younger economies, but this study shows that such advantages diminish over time when structural rigidity persists. Our results highlight the urgent need for legal reform, improved export competitiveness, and policy coordination—supporting perspectives from Elfaki et al. (2021) and Nathaniel et al. (2021) regarding commodity governance and international cooperation.

Indonesia's manufacturing sector exhibits only marginal influence on GDP growth, particularly during times of crisis. Although short-term gains were observed during the monetary and global crises, these were not statistically significant. The long-term impact was negative, especially during the global crisis and the pandemic. These findings align with Van der Eng (2010) and Thorbecke (2023), who contend that manufacturing may offer temporary recovery benefits but lacks resilience under sustained shocks. In contrast to studies that emphasize the industrial sector's role in recovery, our analysis reveals a systemic weakness in Indonesia's manufacturing framework. This emphasizes the need for structural transformation through enhanced production quality, investment in human capital, and adaptive industrial policies (Aginta & Someya, 2022).

The study confirms that Indonesia's benchmark interest rate had a negative short-term effect during the 1997/1998 monetary crisis, but exerted a positive influence over the long term. This finding is consistent with Sutarjo et al. (2021), who noted the extreme volatility of Bank Indonesia Certificates—reaching 58.4%—and the resulting inflationary shock of approximately 70%. Such macroeconomic turmoil triggered loan defaults, business closures, and capital flight, amplified by weak monetary oversight and political instability. Bonciani & Ricci (2020) similarly note that during the global financial crisis, monetary policy struggled to stabilize financial cycles amid rising interest rates and exchange rate pressures. In contrast to previous studies, our findings illustrate the dual role of interest rates in crisis contexts: both as stabilizers and sources of volatility. This result underscores the need for context-sensitive monetary policy aligned with institutional and market realities.

In contrast to conventional expectations, this study finds that global uncertainty—measured by the Global Economic Uncertainty Index—had a positive impact on Indonesia's economic growth during crisis periods. This outcome supports the theoretical models proposed by Behera et al. (2023), Dai et al. (2021), and Fazelabdolabadi (2019), which suggest that uncertainty can incentivize reform-oriented and resilient economic behavior.

Céspedes et al. (2020) emphasize the role of public confidence in crisis management. Extending this view, our findings stress that policy credibility, institutional adaptability, and transparent communication are equally vital. Indonesia's ability to convert external shocks into momentum for investment and reform marks a unique contribution to the literature on growth under uncertainty.

This study finds minimal and inconsistent effects of the real effective exchange rate on GDP across crisis periods. During the pandemic, the long-run contribution was only 0.0291%. These findings diverge from Dutu (2016) and Sutarjo et al. (2021), who argue that exchange rate appreciation fosters growth. The discrepancy likely stems from structural factors: reliance on imported inputs, volatile export pricing, and underutilization of the local currency. While previous studies, such as those by Mohamad et al. (2020), highlight mixed impacts depending on the model used (OLS, REM, FEM), our study adds clarity by identifying the critical role of coordinated policy—particularly in currency pricing, fiscal incentives, and export diversification—in enhancing the growth potential of exchange rate adjustments.

Consistent with Azam et al. (2013), Cahyadin & Sarmidi (2019), and Triatmanto et al. (2023), our analysis confirms the negative impact of foreign debt on growth during monetary, global, and pandemic crises. Poorly managed external debt leads to depreciation, inflation, and reduced investor confidence, ultimately eroding economic stability. While Sudarma & Yasa (2021) and Bordo & Meissner (2009) note the conditional benefits of debt in supporting key sectors, our study underscores the primacy of governance. Transparent, targeted, and accountable debt strategies are essential for converting external financing into productive investment, especially in labor-intensive and social infrastructure sectors.

CONCLUSION

This study analyzes the impact of various economic factors on Indonesia's GDP from 1991-Q1 to 2024-Q1, using a Dummy Variable – Autoregressive Distributed Lag (ARDL) approach to determine the effects of the monetary, global, and pandemic crises. This study reveals that Indonesia's macroeconomic growth dynamics are shaped not only by traditional variables such as trade, interest rates, and exchange rates, but also by institutional adaptability and the capacity to respond to crisis-induced uncertainty. Contrary to mainstream literature, our findings suggest that the positive effects of trade and interest rates are often temporary and vulnerable to external shocks and governance inefficiencies. Meanwhile, manufacturing output and foreign debt contribute little—or

even negatively—to long-term growth when not aligned with structural reforms. Most notably, this study highlights a counterintuitive but critical insight: global economic uncertainty, when met with responsive and credible domestic policy, can act as a growth catalyst. This challenges conventional crisis narratives and introduces a new perspective—where resilience, not mere recovery, becomes the foundation of sustained economic progress.

This implication provides insight into the importance of policymakers to reframe trade policy for a value creation shift from commodity volume to value-added exports through industrial upgrading, legal reform, and investment in trade infrastructure. Revitalizing manufacturing with innovation is redirecting industrial policy towards technology, skilled labor, and crisis-resilient supply chains to restore long-term productivity. Refining monetary instruments for stability involves tailoring interest rate responses to crisis contexts and strengthening coordination between fiscal and monetary actors to protect growth. Institutionalizing crisis-responsive governance leverages uncertainty through agile policymaking—building anticipatory systems, transparent communication, and stakeholder trust. An anchor exchange rate strategy in domestic strength enhances domestic currency utility and reduces external vulnerability by fostering local input usage and currency-based trade. Aligning debt with strategic sectors ensures foreign borrowing supports high-impact areas like health, education, and infrastructure, with strict accountability and performance-based outcomes.

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Forecasting Indonesia's Unemployment Rate with Official Statistics and Big Data: A U-MIDAS Approach

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JEL Classification:

C55

E24

J64

Received: 10 October 2024

Revised: 25 May 2025

Accepted: 02 June 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: The current model is unable to forecast the unemployment rate utilizing varying periods of predictor variables. Furthermore, the use of official statistics and big data in previous studies to forecast Indonesia's unemployment rate has been limited.

Research Objectives: This study forecasts Indonesia's biannual unemployment rate (UR) by utilizing monthly Google Trends Index (GTI) data, quarterly Gross Domestic Product (GDP) data, and monthly inflation data.

Research Methods: The unrestricted mixed data sampling (U-MIDAS) model is applied to forecast Indonesia's UR using data from the second semester of 2006 to the first semester of 2024.

Empirical Results: This study finds that the best model for predicting UR is one that utilizes a combination of big data and official statistics. Using 34 GTI keywords relevant to job seekers' cultural and behavioral patterns in Indonesia, Indonesia's UR in February 2024 was 4.7%.

Implications: This study demonstrates that employing GTI and macroeconomic variables for forecasting unemployment enhances predictive accuracy compared to utilizing either variable independently.

Keywords:

U-MIDAS; unemployment rate; google trends index; big data

How to Cite:

Mustapa, R. M., & Wahyuni, R. N. T. (2025). Forecasting Indonesia's Unemployment Rate with Official Statistics & Big Data: A U-MIDAS Approach. *Etikonomi*, 24(2), 587 – 604. <https://doi.org/10.15408/etk.v24i2.41760>.

INTRODUCTION

The labor market has undergone significant changes since the introduction of the internet, transitioning from a print-centric economy to a more global digital landscape. The concurrent rise in labor demand within the digital domain is suggested by the transition of the labor supply system to digital platforms. LinkedIn and Indeed have emerged as prominent digital marketplaces that facilitate connections between employers and the majority of job seekers (Dillahun et al., 2021). Interaction on these digital platforms produces a big data source, characterized by rapid accessibility, high granularity, and low cost (Ghasemaghaei, 2021).

In contrast to conventional data sources, such as censuses, surveys, and administrative records, big data can reveal user behavior and interests that fluctuate over time and vary across geographical regions. The Google Trends Index (GTI), a significant data source, can be used to assess user interest (Afkham et al., 2021; D'Amuri & Marcucci, 2017). The value of the GTI will increase as a result of an increase in the number of job searches conducted by users, which will indicate a comparable increase in its prominence on Google. GTI has significantly altered the prognosis of various socio-economic indicators, including unemployment rates. Numerous studies have demonstrated its unique ability to predict unemployment. The results demonstrate that GTI's forecasting capabilities surpass those of conventional benchmark models. GTI has significantly improved the accuracy of forecasting by serving as a proxy for labor supply, quickly and accurately illustrating unemployment (Costa et al., 2024; Fondeur & Karamé, 2013; Mulero & Garcia-Hiernaux, 2022; Simionescu & Cifuentes-Faura, 2022).

Previous research in Indonesia has focused more on using a few GTI keywords to forecast unemployment. For example, Fajar et al. (2020) precisely forecasted the monthly unemployment rate utilizing the "layoffs" search trend on GTI. Research by Naccarato et al. (2018) also demonstrates that utilizing Google Trends has enhanced the accuracy of forecasting youth unemployment. Few studies still use more keywords to represent the broad patterns of the labor market. Furthermore, Widyarsi & Usman (2021) employed gross domestic product (GDP), inflation, and GTI. In addition to big data, official statistics, including GDP and inflation, can be used to forecast the unemployment rate (Davidescu et al., 2021). Okun's law asserts that economic contraction is indicative of high unemployment (Ball et al., 2017), as evidenced by the escalating unemployment rate during the COVID-19 pandemic, which was exacerbated by the lethargic global economy.

Additionally, the Phillips curve illustrates inflation as a macroeconomic indicator by analyzing trends in unemployment. This curve describes a potential trade-off between inflation and unemployment, where lower unemployment rates tend to be associated with higher inflation, and vice versa (Crump et al., 2024). Because official statistics are reported at different times (GDP growth every three months and inflation and GTI every month), data interpolation was used to combine the three variables (Widyarsi & Usman, 2021). While interpolation may provide a potential remedy, this approach neglects essential data patterns during brief economic intervals.

This study aims to forecast Indonesia's unemployment rate by combining official statistics and GTI while employing the Unrestricted-Mixed Data Sampling (U-MIDAS) model, which effectively handles predictors with differing data frequencies and eliminates the need for interpolation. High unemployment rates can have an impact on numerous aspects. Unemployed individuals relate to mental health issues and social exclusion (Pohlan, 2019). In addition, unemployment has a negative impact on food security (Haini et al., 2023), increases poverty (Ngubane et al., 2023), and increases criminality (Jawadi et al., 2021). For mitigating the negative impacts of increasing unemployment, the government needs to undertake unemployment forecasts in order to implement appropriate policies.

The MIDAS model has been utilized in prior studies to contrast it with alternative models, including the autoregressive (AR) model and the autoregressive integrated moving average with exogenous variables (ARIMAX) model (Smith, 2016; Tungtrakul et al., 2016). This model, however, has constraints in addressing variations in quantity and complexity due to its reliance on a nonlinear estimation approach (Tarsidin et al., 2018). This study introduces an innovative strategy that utilizes a more flexible MIDAS regression technique, known as the U-MIDAS model, to address these issues. The U-MIDAS model demonstrates greater flexibility than the MIDAS model in managing varying quantities of variables and complex dimensions, and it provides estimates more easily due to its use of Ordinary Least Squares (OLS) (Ghysels et al., 2016).

This study will present three new contributions to the field of unemployment forecasting. First, BPS-Statistics Indonesia publishes data on Indonesia's unemployment rate biannually. The unemployment rate, derived from surveys, is published three months after survey completion. The unemployment rate for the first semester is typically released in May, while the rate for the second semester is typically released in November. The prolonged publication delay is attributed not only to the duration of the survey implementation series and constrained expenses but also to significant changes required prior to data dissemination (Borup & Schütte, 2022). The utilization of GTI may address this issue, as it provides more current unemployment rate forecasts, given that GTI data is accessible monthly. Second, we utilize the U-MIDAS model to predict low-frequency data (unemployment data) released every six months by BPS-Statistics Indonesia, using high-frequency data (quarterly GDP, monthly inflation, and monthly GTI) without requiring data aggregation. This model preserves important high-frequency information that could be lost in standard aggregation methods. Third, this study uses more keywords (34) to build GTI compared to previous studies, such as Adu et al. (2023), Fajar et al. (2020), Naccarato et al. (2018), Simionescu and Cifuentes-Faura (2022), Smith (2016), Tarsidin et al. (2018), Tungtrakul et al. (2016), and Widyarsi and Usman (2021). Job seekers in Indonesia frequently employ these keywords on digital platforms such as Jobstreet, LinkedIn, and Fiverr.

METHODS

This study employs official statistical data, such as the biannual unemployment rate ($UR_{t,(SA)}$), quarterly GDP at constant prices ($GDP_{t,(Q)}$), and monthly consumer inflation ($inflation_{t,(M)}$) from BPS-Statistics Indonesia, as well as monthly GTI data from Google. In this study, $GTI_{t,(M)}$ denotes the principal component variable of the monthly GTI. Data from the second semester of 2006 to the first semester of 2024 is used because GTI data for Indonesia has been accessible since mid-2006. This period includes several significant macroeconomic phases—namely the 2008 global financial crisis, the COVID-19 pandemic, and the post-pandemic recovery—thus offering a thorough temporal framework to analyze fluctuations in labor market behavior and assess the predictive efficacy of job-search intensity on unemployment dynamics.

This paper's primary innovation is incorporating keywords that reflect the culture and behavior of job seekers in Indonesia, alongside the application of the U-MIDAS model to mitigate the constraints of utilizing variables with varying frequencies, thus improving the model's predictive efficacy relative to prior research. The efficacy of utilizing GTI data necessitates the careful selection of suitable keywords. The selection of GTI keywords will prioritize terms most commonly searched by job seekers due to their role as a labor supply (Vicente et al., 2015). We present an innovative approach, unprecedented in Indonesia, utilizing 34 keywords corresponding to job seekers' cultural and behavioral patterns: Pendaftaran CPNS, Lowongan BUMN, Interview Kerja, Fiverr, LinkedIn, Jobstreet, Curriculum Vitae, Resume, Cover Letter, Motivational Letter, CV, Pekerjaan Baru, Pekerjaan Sementara, Interview User, Kesempatan Kerja, Wawancara Kerja, Karir, Pekerjaan Paruh Waktu, Pekerjaan Gaji Tinggi, Outsourcing, Bursa Kerja, Rekrutmen, Lamaran Pekerjaan, Cara Mencari Kerja, Cari Uang, Cari Kerja, Pengusaha, Wirausaha, Wiraswasta, Pekerjaan Online, Bisnis, Lowongan Kerja, Peluang Usaha, dan Lowongan Pekerjaan. The determination of the number of principal components is based on the requirement that the cumulative variance explained by the principal components must reach at least 75 percent.

The U-MIDAS model is a regression technique that addresses frequency discrepancies between response and predictor variables without requiring aggregating predictor variables. In this study, the response variable is a low-frequency variable (UR), and high-frequency predictor variables (GDP , $inflation$, GTI) and their lags elucidate the response variable. The U-MIDAS model employs a straightforward polynomial lag computed by OLS.

Prior to modeling, the data series in time series analysis must demonstrate stationarity. A stationarity evaluation on all variables utilizes the Augmented Dickey-Fuller (ADF) test. It includes both trend and intercept components in Equation 1. We can infer that the variable (Y) is stationary when δ is less than 0.

$$\Delta Y_t = c_0 + \beta_0 T + \delta Y_{t-1} + \sum_{k=1}^h \beta_k \Delta Y_{t-k} + \varepsilon_t \quad (1)$$

ΔY_t is first difference ($Y_t - Y_{t-1}$), T indicates the trend, and k is the number of lag terms. Subsequent to performing the stationarity test, the following phase constructs three U-MIDAS models. This study employs Eviews data processing software to construct the

three proposed research models. Equation 2 delineates a formula that employs official statistical data (official statistics model). Equation 3 delineates a formula that incorporates GTI data (big data model). Finally, Equation 4 employs a combination of official statistical data and GTI data (combination model). The developed models are as follows:

$$UR_{t,(SA)} = a_1 + \sum_{p=1}^s \gamma_p GDP_{t-(p-1),(Q)} + \sum_{q=1}^v \omega_{inflasi_q} inflation_{t-(q-1),(M)} + \varepsilon_{1t} \quad (2)$$

$$UR_{t,(SA)} = a_2 + \sum_{q=1}^v \omega_{1q} GTI_{1t-(q-1),(M)} + \sum_{q=1}^v \omega_{2q} GTI_{2t-(q-1),(M)} + \sum_{q=1}^v \omega_{3q} GTI_{3t-(q-1),(M)} + \dots + \sum_{q=1}^v \omega_{zq} GTI_{zt-(q-1),(M)} + \varepsilon_{2t} \quad (3)$$

$$UR_{t,(SA)} = a_3 + \sum_{p=1}^s \gamma_p GDP_{t-(p-1),(Q)} + \sum_{q=1}^v \omega_{inflasi_q} inflation_{t-(q-1),(M)} + \sum_{q=1}^v \omega_{1q} GTI_{1t-(q-1),(M)} + \sum_{q=1}^v \omega_{2q} GTI_{2t-(q-1),(M)} + \sum_{q=1}^v \omega_{3q} GTI_{3t-(q-1),(M)} + \dots + \sum_{q=1}^v \omega_{zq} GTI_{zt-(q-1),(M)} + \varepsilon_{3t} \quad (4)$$

where z is the number of the principal component variables of the monthly GTI.

The optimal model selection is conducted in phases to guarantee that the selected model is the most parsimonious while exhibiting superior unemployment prediction capabilities. The initial phase is choosing the model with the most optimal lag for Equation 2. The methodology entails parameter estimation with a minimum lag value of one and a maximum lag value of eleven. The maximum lag for each method will vary among model situations, determined by the predictor variables and the number of observations linked to each variable. The model with the best lag is determined by assessing the highest Adjusted R-square in conjunction with the lowest values of the Akaike Information Criterion (AIC), Schwarz Criterion (SC), and Hannan-Quinn (HQ) Criterion. The model with the selected optimal lag must satisfy the conditions of normality, homoscedasticity, and non-autocorrelation, as it is estimated using OLS. A model with the optimal lag for Equation 2 will be derived from the initial stage. The identical procedure is employed to construct a model with the optimal lag for Equations 3 and 4.

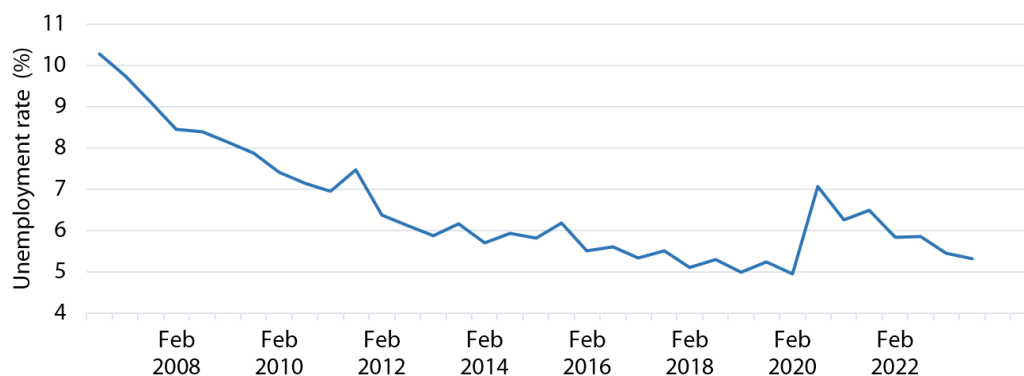
RESULTS AND DISCUSSION

This section elucidates the correlation between unemployment conditions and the economy in Indonesia over time, as well as how GTI data exemplifies unemployment patterns. Figure 1 demonstrates a decline in the unemployment trend in Indonesia from 2006 to 2023. The consistent decline in unemployment occurred from 2006 to 2012. This decline suggests the ongoing stability of the labor market, despite global economic uncertainty stemming from the 2008 financial crisis and rising commodity prices. Variations in the unemployment rate occurred between the first semester of 2012 and the second semester of 2020, due to the prolonged business cycle and the ongoing surge in commodity prices. Consequently, the decline in the unemployment rate was less significant than in previous years. The increase in the unemployment rate during the COVID-19 pandemic was most pronounced, as shown in Figure 1, reflecting the

economic downturn in Indonesia resulting from measures such as reduced working hours, extensive social restrictions, and layoffs. The unemployment rate declined to 1.84 percent in the second semester of 2022 and remained at that level until the end of 2023.

Figure 2 depicts an upward trend in GDP from 2006 to 2023. The persistent upward trend of GDP signifies annual economic growth. Nonetheless, economic contraction also transpired. The COVID-19 pandemic, which impacted economic conditions, led to a deceleration of Indonesia's economy after a period of sustained expansion. Following the most severe contraction in 2020, the economy exhibited improvement, as demonstrated by the rise in GDP from 2021 to 2023.

Figure 1. Indonesia's Unemployment Rate in the First Semester of 2006 – the Second Semester of 2023

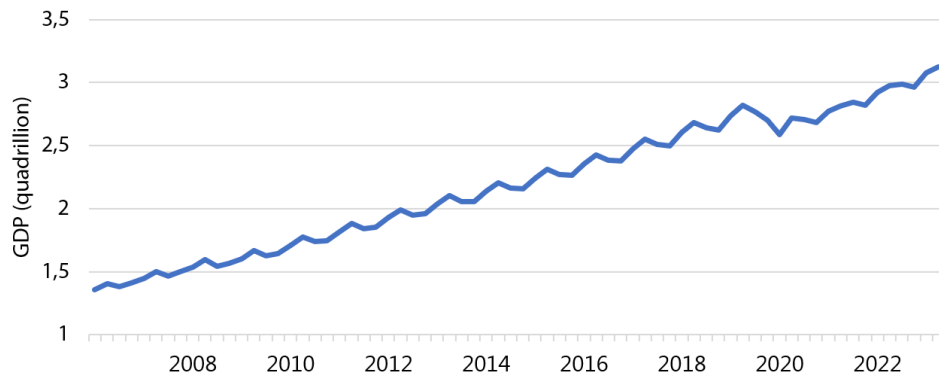


Source: BPS-Statistics Indonesia

The month-to-month inflation trend in Indonesia from 2006 to 2023 remains stable at 0.30 percent. Figure 3, however, indicates that elevated inflation transpired in June 2008. The rising inflation that year was a result of the global financial crisis. Kang et al. (2020) elucidate that escalating commodity and energy prices triggered the inflation surge in 2008, resulting from the global financial crisis. The peak inflation rate during the study period was recorded in September 2013, at 3.29 percent. The primary factor driving this inflation was the escalation of food prices, which was additionally influenced by the surge in fuel prices. Conversely, Indonesia encountered deflation of 0.09 percent in February 2015, primarily attributed to a decline in the food expenditure category, which typically sees an increase.

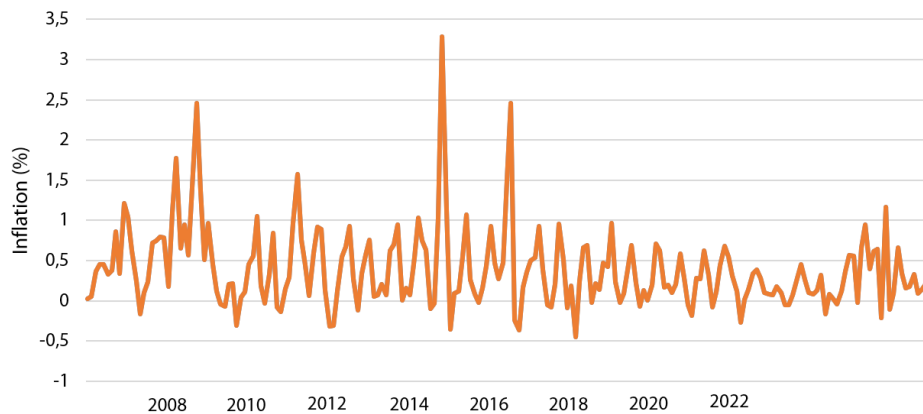
The primary issue in forecasting with GTI data is the appropriate selection of keywords. This study presents originality by employing 34 distinct keywords to reflect the dynamic patterns of labor behavior. Figure 4 illustrates a significant correlation among various keywords. LinkedIn exhibits a strong correlation with job vacancies, as it is one of the most widely used platforms for job searching. The principal component analysis reduced the 34 GTI datasets to satisfy the assumption of independence. With a criterion of a minimum cumulative variance of 75% (Mathai et al., 2022), we identified three principal components of GTI.

Figure 2. Indonesia's GDP in the Third Quarter of 2006 – the Fourth Quarter of 2023



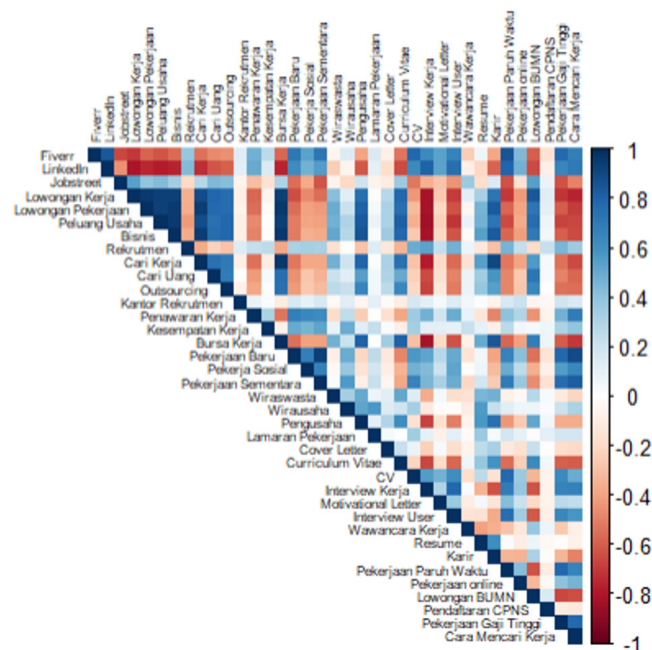
Source: BPS-Statistics Indonesia

Figure 3. Monthly Inflation in Indonesia from 2006-2023



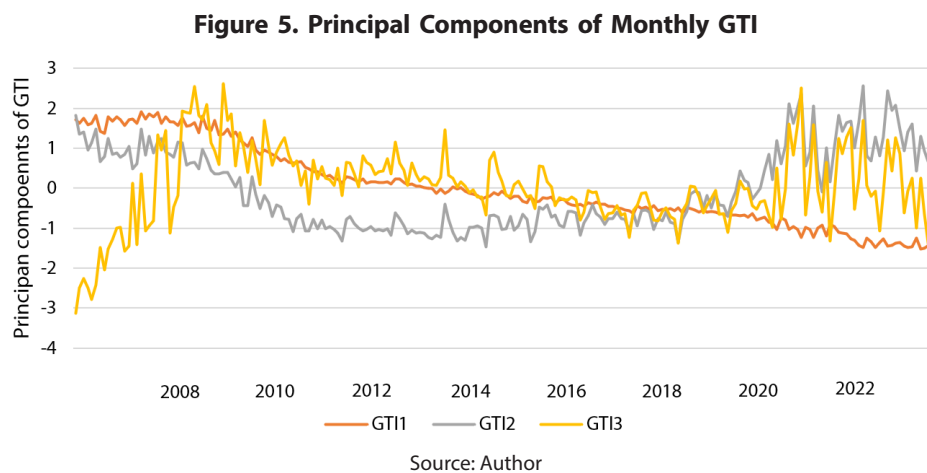
Source: BPS-Statistics Indonesia

Figure 4. Correlation Matrix between GTI Keywords



Source: Author

The patterns of the three principal components of GTI illustrated in Figure 5 demonstrate notable variations. It indicates a transformation in worker behavior about job searches on online platforms. The varying patterns evident in the three main GTI component graphs indicate that the keywords included in the GTI predictor have consistently featured prominent concepts over time, thereby preserving their usefulness for modeling purposes.



The next step involves preliminarily identifying relationships among the variables to ensure the accuracy of variable selection. We implemented adjustments for all variables because the initial detection method, which employs Pearson correlation, fails to consider the frequency differences among the variables. The adjustment entailed utilizing partial data for the correlation calculation: utilization of GDP data from the first and third quarters; utilization of inflation data from February and August; utilization of the average data of the principal GTI components over six months in the first and second semesters; and utilization of unemployment rate data from the first and second semesters. The use of GDP and inflation data during that period is attributable to the collection of unemployment rate data from the same timeframe. The application of a six-month average for GTI data is supported by a study examining the duration of job searches in Indonesia over six months (Zatzaha et al., 2020).

Table 1. Pearson Correlation between Variables

Variable	Correlation	Statistics	<i>p-value</i>
GDP	-0.904***	-7.426	0.000
inflation	0.417*	2.639	0.013
GTI1	0.845***	9.079	0.000
GTI2	0.396**	2.478	0.018
GTI3	-0.136	-0.788	0.436

Note: (***) significant at 1%, **) significant at 5%, *) significant at 10%
Source: Author

Table 1 shows the Pearson correlation between variables. A higher value of Pearson correlation indicates a stronger relationship between two variables (Johnson & Bhattacharyya, 2019). Table 1 reveals a negative correlation between the GDP variable, which acts as an indicator of economic growth, and the unemployment rate, highlighting a significant relationship between these two factors. The results indicate the existence of Okun's law in Indonesia, supported by recent literature. This finding indicates a correlation between economic growth and the expansion of job opportunities in the formal sector. As a result, the decrease in the number of informal workers who are vulnerable to unemployment is likely to lead to a reduction in the unemployment rate.

In Indonesia, there is a significant correlation between inflation and the unemployment rate, which diverges from the expectations set by the Phillips curve theory. This situation can occur when a country demonstrates relatively low inflation due to policies designed to manage prices, which typically support job creation more effectively. The inflation rate suggests that maintaining price stability may lead to increased job opportunities. The evidence indicates that maintaining low and stable inflation is crucial for creating more job opportunities.

However, the three principal components of the GTI demonstrate differing correlations. This outcome is defensible, as the differences in terminology used can elucidate the relationships among the variables in accordance with the existing literature (Widyarsi & Usman, 2021). The modeling process can proceed efficiently even when predictor variables show a weak correlation with the unemployment rate. The exclusion of unnecessary variables is not obligatory, as these variables could signal economic shifts.

U-MIDAS modeling begins by performing a stationarity test on all variables by applying the ADF test. After analyzing the pre- and post-pandemic periods, it is clear that the GDP variance exhibits fluctuations over time, which requires the application of a natural logarithm transformation.

Table 2. Stationarity Test

Variable	At Level	First Difference	Stationarity Level
UR	-2.666	-8.919***	First difference
Ln GDP	-1.626	-3.498**	First difference
inflation	-10.824***	-	Level
GTI1	-1.224	-19.512***	First difference
GTI2	-1.625	-3.572**	First difference
GTI3	-3.558**	-	Level

Note: (***) significant at 1%, (**) significant at 5%, (*) significant at 10%
Source: Author

Table 2 indicates that the stationary variables exist at varying levels. The subsequent step is to determine the best lag for each model. According to the testing criteria, the ideal lags for the official statistics, big data, and combination model are three, five, and five, respectively. The subsequent stage involves identifying the optimal prediction model. Table 3 presents a detailed comparison of the three models and their corresponding selection criteria.

Table 3. Selection Criteria for The Best Prediction Model

Model	Adjusted R-Square	AIC	SC	HQ
Official statistics	0.761	0.381	0.695	0.488
Big data	0.284	1.604	2.322	1.848
Combination	0.873	-0.390	0.790	0.007

Source: Author

The adjusted R-squared value for the official statistics model (Equation 2) stands at 0.761. The analysis indicates that the predictor variables in the combined model account for 76.13 percent of the variation in unemployment rate changes. In contrast, the remaining variation is attributed to factors not included in the model. In the big data model (Equation 3), the adjusted R-squared value is 0.284, indicating that the predictor variables included in the model can account for 28.40% of the variation in unemployment rate changes. In contrast, the remaining variation is attributed to other factors not encompassed by the model. The adjusted R-squared value for the combined model (Equation 4) is 0.873, indicating that 87.30% of the variation in unemployment rate changes can be accounted for by the predictor variables in this model. The subsequent step involves evaluating the assumptions of the three best models.

Table 4. Normality Assumption Test

Model	Statistical Value	Critical Value	<i>p-value</i>	Decision
Official statistics	0,549	5,991	0,760	Failed to Reject H_0
Big data	0,760	5,991	0,684	Failed to Reject H_0
Combination	0,114	5,991	0,945	Failed to Reject H_0

Source: Author

Table 4 indicates that the three models satisfy the normality assumption. It also demonstrates that statistical values for the official statistics model, big data, and their combination are less than the crucial value, with a *p-value* exceeding 0.05. Consequently, it may be concluded that the model's error is normally distributed with a mean of zero and constant variance.

Table 5 indicates that the non-autocorrelation assumption for the three models is satisfied. Table 5 illustrates that the computed statistic values for each latency are inferior to their critical thresholds and exhibit p-values over 0.05. Upon examining the computed statistics, all models exhibit values below the critical threshold and p-values exceeding 0.05. Consequently, it can be inferred that the errors are independent or not serially associated.

Table 5. Non-autocorrelation Assumption Test

Model	Statistical Value	Critical Value	<i>p-value</i>	Decision
Official statistics	5,944	18,307	0,989	Failed to Reject H_0
Big data	10,767	18,307	0,824	Failed to Reject H_0
Combination	17,429	18,307	0,358	Failed to Reject H_0

Source: Author

Table 6 indicates that the three models satisfy the homoscedasticity assumption. Upon examining the computed statistics, all models exhibit values below the crucial threshold and p-values exceeding 0.05. Consequently, it can be concluded that the error variance remains constant, thereby satisfying the assumption of homoscedasticity.

Table 6. Homoscedasticity Assumption Test

Model	Statistical Value	Critical Value	<i>p-value</i>	Decision
Official statistics	14,024	26,296	0,597	Failed to Reject H_0
Big data	8,628	26,296	0,928	Failed to Reject H_0
Combination	14,330	26,296	0,574	Failed to Reject H_0

Source: Author

Table 3 indicates that the optimal method is the combined model, as evidenced by its superior Adjusted R-squared value and the lowest AIC, SC, and HQ metrics. In the current analysis, the official statistics model is more effective than the big data model. The constraint of GTI, functioning solely as a proxy for labor supply, remains inadequate for generating a reasonably accurate forecast. The findings align with the study by Ormerod et al. (2014), indicating that incorporating GTI did not significantly enhance the model's accuracy. These findings could be attributed to a constraint of GTI, which remains affected by the social conditions prevalent in the region and the temporal context of the study. When extensive searches are conducted during a period of heightened interest in a particular topic, the resulting forecasts may demonstrate low accuracy, as evidenced by the findings of Google Flu Trends (Ormerod et al., 2014).

Table 7. Best Prediction Model

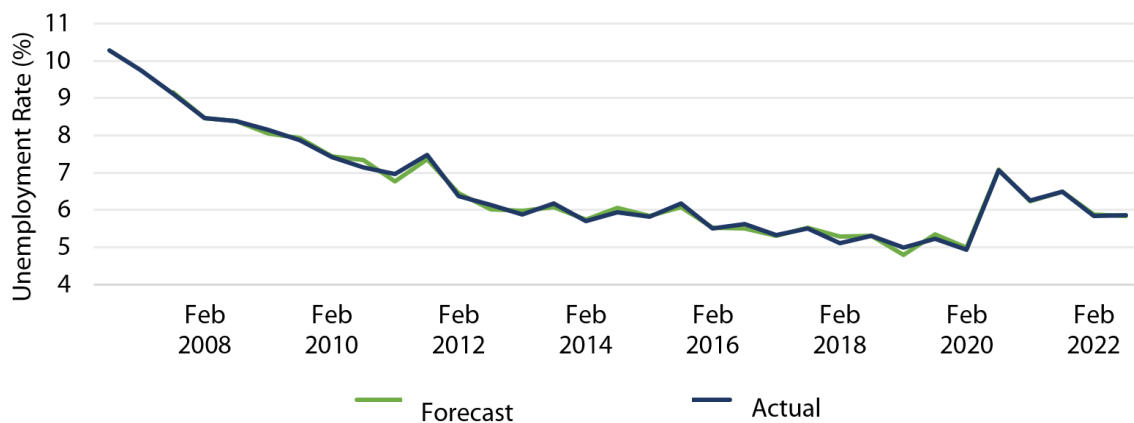
Variable	Coefficient	Std. Error	T-statistics	Prob.
Variable: D(ln GDP) Lags: 5				
Lag 1	-7.695	12.877	-0.598	0.569
Lag 2	-22.362***	4.397	-5.085	0.001
Lag 3	-33.464**	10.524	-3.180	0.016
Lag 4	-16.469**	5.676	-2.902	0.023
Lag 5	7.782	9.342	0.833	0.432
Variable: Inflation Lags: 5				
Lag 1	0.536	0.301	1.778	0.119
Lag 2	-0.070	0.142	-0.495	0.636
Lag 3	0.505	0.311	1.624	0.148
Lag 4	-0.301	0.438	-0.688	0.513
Lag 5	0.272	0.248	1.094	0.310
Variable: D(GTI1) Lags: 5				
Lag 1	-4.368*	2.249	-1.942	0.093
Lag 2	-4.435**	1.375	-3.226	0.014
Lag 3	-5.354**	1.597	-3.353	0.012
Lag 4	-3.824**	1.449	-2.640	0.033
Lag 5	-0.358	1.279	-0.280	0.788
Variable: D(GTI2) Lags: 5				
Lag 1	-0.768	0.407	-1.888	0.101
Lag 2	-0.691	0.574	-1.204	0.268
Lag 3	-1.365**	0.441	-3.095	0.017
Lag 4	-1.200**	0.465	-2.583	0.036
Lag 5	-0.412	0.327	-1.261	0.248
Variable: GTI3 Lags: 5				
Lag 1	0.343	0.229	1.496	0.178
Lag 2	-0.457	0.269	-1.696	0.134
Lag 3	0.084	0.227	0.369	0.723
Lag 4	-0.446*	0.216	-2.061	0.078
Lag 5	-0.462	0.248	-1.857	0.106

Note: ***) significant at 1%, **) significant at 5%, *) significant at 10%

Source: Author

The integration of GTI variables with macroeconomic indicators is considered to yield more accurate forecasts. The findings align with the research conducted by Smith (2016), which demonstrated that the MIDAS model, utilizing survey data predictor variables alongside GTI, was more effective in forecasting the unemployment rate in the UK. The involvement of the GTI, characterized by its real-time and high-frequency nature, effectively captures patterns of unemployment fluctuations that survey indicators, which exhibit a lag, fail to detect. Table 7 presents the outcomes of the optimal prediction model.

Figure 6. Line Graphs of Forecasted and Actual Unemployment Rate for Best Model



Source: Author

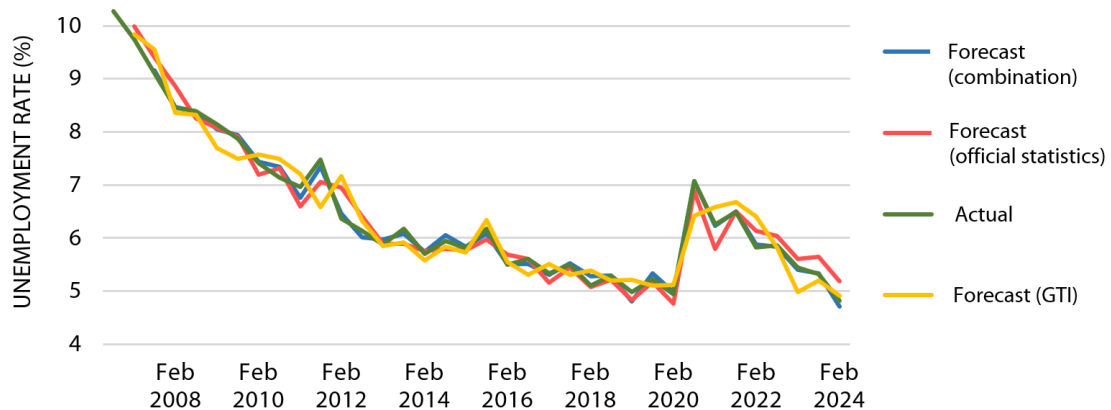
The forecast results for the unemployment rate in February 2024 are illustrated in Figure 6, utilizing the best model. The image analysis indicates that the projected unemployment rate for Indonesia in February 2024, utilizing the combined model, is 4.7 percent. At this point, the precise value stands at 4.82 percent. Both values have shown a decline compared to the previous period (August 2023) and the same month in the prior year (February 2023), indicating a positive trend in Indonesia's unemployment situation. The value has approached the Sustainable Development Goals (SDGs) target for the unemployment rate of 4.6 percent for 2024. The forecasting results demonstrate a high level of accuracy, evidenced by the negligible discrepancies between actual data and forecast outcomes over the observed period. The best model successfully identified the rise in the unemployment rate in 2020.

Figure 6 indicates that unemployment forecasting using a mix of macroeconomic indicators and GTI is most suitable for implementation in Indonesia. This outcome aligns with the findings of Gayaker & Türe (2025), which demonstrated that integrating macroeconomic indicator variables with GTI enhances forecasting accuracy relative to utilizing a single indicator alone. The amalgamation of the two variables integrates the adaptability of labor market behavior signals with the consistency of economic indicators, yielding more dependable forecasts. Incorporating varied

keywords has improved the model's prediction efficacy relative to conventional models alone.

Based on Figure 7, forecasting using macroeconomic indicators tends to underestimate the actual values during various intervals, particularly from August 2016 to February 2021. The extended duration of underestimating is likely due to the inconsistencies in economic swings that impacted the precision of the unemployment rate trend throughout that era. Economic shocks can diminish the precision of projections for unemployment derived from economic data. The GTI technique produced excessively optimistic expectations after COVID-19, particularly from February 2021 to February 2022, whereas it underestimated projections from February 2013 to February 2015. The overestimate during this period is consistent with research conducted by Dilmaghani (2018), which suggests that social incentives can influence the stability of predicting GTI in specific groups and time frames. For instance, atypical variations in GTI occurred during the COVID-19 era, characterized by a surge in layoff narratives, which led to the keyword "unemployment" gaining significant traction, even among individuals not actively seeking employment. Consequently, misleading popularity emerged due to insufficient control within the model.

Figure 7. Line Graphs of Forecasted and Actual Unemployment Rate for All Model



Source: Author

The forecasting results from the combination model closely align with the unemployment rate. The absence of control variables that accurately represent the economic conditions in the GTI data has been tackled by integrating economic indicators derived from surveys with the GTI data. The U-MIDAS model, incorporating macroeconomic indicator predictor variables and GTI, demonstrates superior performance in forecasting the unemployment rate for February 2024 compared to its benchmark model.

CONCLUSION

The results of this study demonstrate that the U-MIDAS model, which integrates official statistics and big data, more precisely forecasts Indonesia's unemployment rate than either using big data or official statistics alone. The optimal model predicted an unemployment rate of 4.7 percent in February 2024, which was 0.12 percentage points lower than the actual data released by BPS-Statistics Indonesia. The use of a broader spectrum of keywords and alignment with Indonesian culture has demonstrated enhanced model performance. Therefore, to enhance the accuracy of the prediction results, additional studies can incorporate keywords that job seekers in Indonesia frequently use to create GTI.

This study presents a strategy for the government to implement more rapid and precise policies regarding unemployment in Indonesia. BPS-Statistics Indonesia currently releases official unemployment statistics biannually, with a dissemination delay of three months following the survey. The U-MIDAS model enables policymakers to swiftly estimate Indonesia's unemployment rate, even on a monthly basis, by utilizing a combination of GTI data and official statistics. When the estimation value suggests a rise in the unemployment rate, the government may enact relevant policies to mitigate unemployment, such as instituting tax incentives to promote job creation, investing in education and vocational training to align worker skills with market demands, and initiating labor-intensive public works programs.

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Nexus between Governance and Sustainable Development in Developing Countries: A Simultaneous Approach

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JEL Classification:

F63

O16

Q01

Received: 06 May 2024

Revised: 13 May 2025

Accepted: 25 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: The present research contributes a novel task in examining the simultaneous relationship between governance and sustainable development (SD), aiming to capture the endogenous relationship between these two concepts.

Research Objectives: This study examines the relationship between governance and sustainable development in 59 developing countries, utilizing annual data from 2006 to 2022.

Research Methods: The study employs panel Generalized Methods of Moment (GMM) and panel three-stage least squares (3SLS) techniques by using STATA 17. Data for this study is extracted from the World Development Indicators (WDI), International Financial Statistics, and World Governance Indicators.

Empirical Results: The findings indicate that governance, tax-to-GDP ratio, and financial development are positively related to SD. Moreover, SD also has a positive impact on governance in developing countries. Control variables, including the misery index and population, are negatively related to governance.

Implications: The study offers policy recommendations to enhance transparency and government quality, which are integrated into the development process to reduce social disparities, mitigate environmental challenges, foster economic growth, and ensure the well-being of citizens.

Keywords:

financial development; governance; sustainable development; developing countries; panel GMM; panel 3SLS.

How to Cite:

Siddiq, A., Danish, M. H., & Ashfaq, M. (2025). Nexus Between Governance and Sustainable Development in Developing Countries: A Simultaneous Approach. *Etikonomi*, 24(2), 605 – 622. <https://doi.org/10.15408/etk.v24i2.45368>.

INTRODUCTION

The concept of sustainable development aims to fulfil the needs of today's generation without compromising the ability of future generations to meet their own needs (Duran et al., 2015). The structure of the SDGs focuses on achieving harmony and prosperity for every individual by 2030, through the eradication of hunger and protection of the environment. The SDGs aim to ensure that lower income and social disparities, as well as a sustainable environment, are taken into account during the economic growth process. In this manner, sustainable development ensures a prosperous and healthy environment for living for current and future generations (UN, 2023). Sustainability refers to the reliability or stability, whereas "development" indicates a change or a process. The definition of "sustainable development" refers to balanced growth and evolution, indicating that the present is better than the past and the future will be better than the present. In this context, environmental management policies, social progress, and balanced growth are considered essential for attaining sustainable development (Frolova et al., 2019).

Good governance was first proposed by the World Bank in 1989, which includes six indicators for evaluating the framework of good governance. International organizations have also supported these indicators, including voice and accountability, government effectiveness, political stability, regulatory quality, control of corruption, and the rule of law (Huang & Ho, 2017). In recent years, global organizations such as the World Bank, the League of Nations, the OECD, the IMF, and the Asia-Pacific Economic Cooperation Forum have placed a greater emphasis on governance. An adequate governance structure is crucial for enhancing the country's competitiveness and improving an individual's living standard. Therefore, the connection between development and governance has become a key area of attention worldwide, particularly in developing countries, aimed at promoting reforms and reducing poverty (Grindle, 2004).

A governance system that is open and accountable is crucial for sustainable development (SD). The public has access to data, information, and processes that enable informed decision-making through transparency. Empirically, good governance has a more substantial impact due to its emphasis on accountability, transparency, and balanced strategies for economic growth (Thanh et al., 2020). Trustworthy institutions with transparent oversight procedures and clear objectives are crucial for implementing SD plans. Control of corruption and political stability are essential for achieving economic growth. In addition, political stability will increase the opportunities for funds transfer and provide a better environment for the inflow of investment in countries. Consequently, the absence of violence and terrorism indicators, which are measured as good governance, is also important for achieving growth (Odugbesan et al., 2021).

Two decades of discussion about governance and sustainable development in academia have seen significant progress, although there remains a lack of studies focused on how they interact, especially within developing countries. Many researchers have focused on one aspect at a time, and as a result, have not adequately studied the interplay between governance and development. The objective is to add clarity by examining the

relationship between governance quality and sustainable development, and how they interact with one another. The present research is important and interesting because it examines the relationship between governance and sustainable development in parallel. This study examines the two-way relationship between improvements in governance and overall sustainability, providing a clearer understanding of both. This perspective is particularly critical in developing countries, which often have weak institutions, low state capacity, and urgent development challenges that must be addressed simultaneously.

The impact of governance on sustainable development is consistent at both the micro and macro levels. A review of empirical studies reveals a complex picture, with different scholars examining the relationships between governance and growth, corruption and growth, and environmental sustainability. According to previous research, corruption harms SD (Mugellini, 2019; Hope Sr., 2023). While few studies revealed the role of governance in attaining SDGs (Gündoğdu & Aytekin, 2022; Irtysheva et al, 2022; Liu & Alden, 2022; Lyulyov et al., 2024), few studies reported the role of governance in attaining environmental sustainability (Ikenga et al., 2022; Elander, 2022; Raper et al., 2022; Safdar et al., 2022; Shu et al., 2023; Balsalobre et al., 2023). However, these studies have considered a very narrow scope of governance and SD.

The present research portrays that good governance can mitigate corruption and misuse of public funds, which eventually contributes to SD. This research is significant for readers and policymakers to guarantee accountability, address economic and social disparities, mitigate environmental challenges, encourage economic growth, and ensure the well-being of citizens. Policymakers will achieve a better understanding after analysis of this research of how the governance framework impacts SD outcomes and finds which aspects of governance are more important for encouraging sustainable growth as well. Furthermore, our empirical findings help inform the formulation of appropriate policies related to identifying specific governance structure weaknesses, such as higher corruption, lower transparency, and a weak institutional framework, which are obstacles to desirable growth and development in developing economies.

Our research provides contributions in two ways. First, previous studies have examined the separate impacts of governance and corruption on growth and environmental sustainability; however, little consideration has been given to their mutual interaction, particularly in the developing world. This study fills this gap by using six combined indicators for the governance index and a sustainable development index that measures both the HDI and Ecological Impact Index in the context of developing countries. Second, a vast empirical literature applying combined modelling methods to study the dynamic interactions between governance and sustainable development outcomes does not exist. This paper offers novelty by employing a simultaneous equation modelling technique that can help analyze the mutual causality and support the response between governance and SD more rigorously. The novelty of this study lies not only in its interdependency but also in its focus on developing countries, where sustainability imperatives and governance problems are intricately intertwined.

By filling this gap, this research helps advance the discussion among researchers. This study employs simultaneous modelling to examine the impact of government quality on sustainable development in developing countries. In this way, we understand the implications of governance and SD over the years.

METHODS

This study aims to estimate the relationship between governance and sustainable development for a panel of 59 developing countries from 2006 to 2022, resulting in a sample of 1003 observations. To achieve the primary objective of the research, the dynamic panel data estimation process, specifically the panel GMM method, was employed by examining the existing literature for this purpose. The dynamic panel data requires $N > 25$ and $T < 25$ as the first assumption. The second assumption for endorsing this model is that a fixed effect should be present in the model. The final and utmost imperative assumption for the application of dynamic panel data is the presence of a lagged value of the dependent variable, serial correlation, along with group-wise heteroscedasticity. The purpose of selecting dynamic panel data and panel GMM estimation methods is that, based on these assumptions, an endogeneity problem exists, which is addressed by Adekunle (2021) and Asongu & Odhiambo (2021), as in the above equation, where the lagged dependent variable is included as the explanatory variable in the model is known as a dynamic panel data model. The dependent variable becomes an explanatory variable with a lag value. This type of model is usually expressed in the form of this equation:

$$Y_{it} = \delta Y_{it-1} + \beta X_{it} + \mu_{it} \quad (1)$$

Where Y_{it} , dependent variable δY_{it-1} , lagged value of a dependent variable βX_{it} , Explanatory variables. The dynamic panel data model has two types: firstly, the autoregressive panel data model indicates that the model contains only the lagged dependent variable as the explanatory variable. Arellano and Bond (1991) introduced the Different GMM techniques of dynamic panel assessment to resolve the issues in auto-regressive models, such as endogeneity and autocorrelation. Meanwhile, the lagged values of independent variables used as instrumental variables, determined by the first differences, are known as the Difference GMM approach. The autoregressive panel data model is shown as:

$$Y_{it} = \delta Y_{it-1} + \beta X_{it} + \mu_{it} \quad (2)$$

When the difference equation and the level equation are analyzed as one system together, it is called System GMM. Hansen (1982) introduced the System GMM technique to resolve the problems in distributed lagged models, such as endogeneity, autocorrelation, and heteroscedasticity. Meanwhile, the lagged values of independent variables used as independent variables are known as the distributed lagged model. The distributed lag model is shown as:

$$Y_{it} = \delta Y_{it-1} + \beta X_{it} + \beta X_{it-1} + \mu_{it} \quad (3)$$

Since the estimation method of the Two-Step System GMM is used in our equation. Primarily, the panel data set is balanced, and $N > T$. Furthermore, the System GMM technique is used for the reason that the endogeneity and autocorrelation problems exist in the model. The study also used the Arellano and Bond test to solve the problems of serial correlation. Lastly, the instrument overidentification is checked by the Sargan test.

The simultaneous Equations are also assessed using 3SLS followed by Zellner, (1992) and Murshed & Mredula, (2018). One of the assumptions of the OLS estimation approach is undermined by heteroscedasticity in the data. Conversely, the 3SLS technique supposes that the error terms within each equation are both homoscedastic and serially uncorrelated, regardless of whether structural error terms may be associated with the simultaneous equations. It is essentially a kind of Instrumental Variables (IV) estimate where correlations between various equations, including unobserved error factors, are enabled. By taking these correlations into account, equation-by-equation regression becomes effective.

Table 1. Variables and Measurement

Symbol	Variables	Definitions	Sources
SD	Sustainable development	The sustainable development index consists of the average and expected years of school, life expectancy at birth, GNI per capita 2011 PPP\$, CO2 emissions tons, and material footprint. On a scale between 0 and 100.	Hickel (2020)
GOV	Governance	The Governance Index includes accountability, regulatory quality, political stability, government effectiveness, control of corruption, and rule of law. The index is calculated by a weighted average formula. The index values fell in a range from -2.5 to 2.5.	World Governance Indicators (WGI)
PS	Public Spending	Includes government expenditure and is measured as a percentage of GDP.	IMF
TAX	Tax Revenue	Tax revenue is measured as a ratio of GDP.	WDI
FD	Financial Development	The financial development is comprised of two components: the financial institution index and the financial market index. This is an index scale between the value of 0 to 1.	IMF
GFCF	Gross Fixed Capital Formation	Capital formation is annually measured as a percentage of growth.	WDI
MI	Misery Index	The misery index is calculated as the sum of unemployment and inflation rates. This is an index that goes from 0 to indefinite.	WDI
TRADE	Trade Openness	Trade openness is generally measured through the ratio of exports + imports and divided by gross domestic product. Export, import, and GDP data are taken in constant 2015 prices, stated in USD.	WDI
POP	Population	Population, total includes the actual classification of population, which includes everyone who lives there, regardless of citizenship or legal status.	WDI

The 3SLS methodology evaluates all coefficients quickly, in contrast to the 2SLS method with a set of simultaneous equations, which calculates the slope variables of each equation separately. 3SLS also provides reliable parameter estimation in cases when equations are interdependent. We have utilized the two simultaneous equations to establish the nexus between governance and sustainable development in developing countries. The regression models are as follows:

$$SD_{it} = \alpha_0 + \alpha_1 GOV_{it} + \alpha_2 PS_{it} + \alpha_3 TAX_{it} + \alpha_4 FD_{it} + \alpha_5 GFCF_{it} + \mu_{1it} \quad (4)$$

$$GOV_{it} = \beta_0 + \beta_1 SD_{it} + \beta_2 MI_{it} + \beta_3 TRADE_{it} + \beta_4 LnPOP_{it} + \mu_{2it} \quad (5)$$

where ‘it’ denotes entities and periods, ‘t’ is the time which is used in this research (2006 from 2022, and ‘i’ indicates the cross-sectional aspects of the data (the 59 developing countries)).

Subsequently, the static panel model provides robust and reliable results by using fixed and random effects. Both models mitigate and control unobserved heterogeneity omit variable partiality and check the applicability of random and fixed effects models through the Hausman test. Moreover, the static effect estimators are biased because the lagged value of the dependent variable is affected by its current value. In summary, the article contributes noteworthy perspectives on the nexus of governance and sustainable development in developing countries with the help of the above-mentioned appropriate techniques.

The governance index developed by Kaufmann & Kraay (2024) is in line with Pahlevi (2017) and Roy (2021). However, the governance index calculation in our paper is different from Kaufmann & Kraay (2024), Pahlevi (2017), and Roy (2021) in that we used a weighted average formula. All indicators of good governance are classified into two groups developed by the World Bank, the first characterized by weak governance, with an estimation value of -2.5. On the other hand, strong governance specifies a 2.5 estimation value. The weighted average formula is as follows:

$$I = (1/6 * \text{Voice and Accountability}) + (1/6 * \text{Political Stability}) + (1/6 * \text{Government Effectiveness}) + (1/6 * \text{Regulatory Quality}) + (1/6 * \text{Rule of Law}) + (1/6 * \text{Control of Corruption}) \quad (6)$$

where I indicate the index.

The sustainable development index was constructed by Hickel (2020), which includes five indicators: education, life expectancy, income, CO2 emissions, and material footprint. The sustainable development index has been measured as the human development index as well as the ecological efficiency index. The all-variable list is presented in Table 1.

RESULTS AND DISCUSSION

The main findings indicate that the relationship between governance and sustainable development in developing countries is significant and positive, suggesting that a good governance structure provides transparent and accountable policies, which are crucial

for achieving sustainable development. Sustainable development enhances governance structures through economic stability and effective resource management, thereby promoting sustainable development. This section presents the descriptive statistics (Table 2), correlation (Table 3), and panel GMM outcomes of both models (Table 4). The findings of the 3SLS are presented in Table 5. The results of FE and RE are presented in Table 6.

Descriptive statistics of the analysis are presented in Table 2, which specifies that the 'SD' mean is 0.662 with a standard deviation (Std.D) of 0.113. The maximum and minimum values of SD are 0.85 and 0.367, respectively. The GOV mean is -0.454 with a Std.D of 0.469. The minimum and the maximum values of GOV are -2.02 and 0.683, respectively. The PS average is 25.8 with a Std.D of 9.59. The PS maximum value is 66.4, and 8.21 is the minimum value. Additionally, the TAX average is 15.5 with a Std.D of 6.02. The tax maximum and minimum values are 39.9 and 3.48, respectively. The perceived FD average is 0.230 with a Std.D of 0.136. The FD maximum and minimum values are 0.732 and 0.037, respectively. The GFCF mean is 6.29 with a Std.D of 19.0. The maximum and minimum GFCF are 231.9 and -84.8, respectively. The mean is 14.1 with a standard deviation of 11.2. The maximum and the minimum values are 183.8 and -1.79, respectively. The TRADE average is 0.701 with a Std.D of 0.306. The maximum is 1.90, and the minimum value is .193. The LnPOP mean value is 16.5 with a Std.D of 1.51. The maximum and minimum values are 21.0 and 12.5, respectively.

Table 2. Descriptive Statistics

Variables	Mean	Std. Deviation	Min.	Max.
SD	0.66	0.11	0.37	0.85
GOV	-0.45	0.47	-2.02	0.68
PS	25.89	9.60	8.22	66.44
TAX	15.57	6.03	3.49	39.99
FD	0.23	0.14	0.04	0.73
GFCF	6.29	19.09	-84.88	231.93
MI	14.11	11.23	-1.80	183.84
TRADE	0.70	0.31	0.19	1.90
LnPOP	16.58	1.51	12.57	21.07

The correlation analysis among variables is shown in Table 3. The findings indicate that governance and financial development have a low positive correlation with sustainable development. In contrast, public spending, tax revenue, the misery index, and trade openness also have negligible positive associations with sustainable development. The gross fixed capital formation and population have a negligible negative association with sustainable development from 2006 to 2022 for developing economies.

Table 3. Correlation Matrix

	(SD)	(GOV)	(PS)	(TAX)	(FD)	(GFCF)	(MI)	(TRADE)	(LnPOP)
SD	1.0000								
GOV	0.4593	1.0000							
PS	0.2640	0.2768	1.0000						
TAX	0.1012	0.2480	0.6317	1.0000					
FD	0.4051	0.4885	0.2742	0.1239	1.0000				
GFCF	-0.1595	-0.1264	-0.1121	-0.0636	-0.1333	1.0000			
MI	0.0332	-0.0852	0.0899	0.1041	0.0918	-0.1253	1.0000		
TRADE	0.1821	0.3093	0.3933	0.3912	0.1559	-0.0135	-0.0168	1.0000	
LnPOP	-0.0964	-0.2015	-0.2536	-0.3741	0.3347	0.0098	-0.0440	-0.4177	1.0000

Results of the two-step system GMM for models 1 and 2 are presented in Table 4. The main findings of this section are a two-way relationship between core variables, such as governance and sustainable development. However, sustainable development and governance are used as explanatory variables with a lag value in both models. The first model results indicate that governance has a significant and positive impact on sustainable development, suggesting that governments that invest in education, infrastructure, and innovation support sustainable technologies, such as renewable energy production. This result supports the concept of economic sustainability and a sustainable environment in society, aligning with previous studies, such as Massey (2022) and Gündoğdu & Aytekin (2022). The results of tax revenue have a positive impact on sustainable development, indicating that tax revenue can support governments in financing environmental protection and sustainable programs. This condition includes financial support for hydropower, solar, and wind power projects, as well as support for environmental conservation and laws and acts that prevent environmental pollution, and the management of natural resources. These results have been found in previous related studies, such as Gurdal et al. (2021).

Furthermore, financial development has a positive impact on sustainable development, as it enables families to make investments in health and education, leading to social returns and human capital development. Human capital is capable of generating new ideas, developing new knowledge, and adding to the industry's knowledge base. Thus, human capital is a vital factor that determines a positive, sustainable development and an increase in well-being. These results align with Nguyen et al. (2022). Gross fixed capital formation has an insignificant impact on sustainable development, indicating that investments in automobile financing, such as electric buses, public transportation, metro lines, and bike lanes, contribute to environmental sustainability. These results are similar with Maune et al. (2023). Moreover, public spending is significantly and negatively associated with sustainable development, indicating that while public spending is important for development, it also increases public debt, diverting funds from essential expenditures on infrastructure, education, and health to service the debt. These results are similar to Hamadu (2024).

The second model results indicate that sustainable development has a positive association with governance, which indicates that sustainable development concerns the protection of the environment, social justice, and economic stability, enabling the development of better governance structures that are responsive to society and more efficient. The results of trade openness have a positive association with governance, indicating that trade requires improvements in the regulatory environment, transparency, and bureaucratic efficiency, which reduces the probability of corruption and increases accountability. These results are similar to those of Effiong et al. (2023).

Table 4. Empirical Results for Sustainable Development and Governance

Variables	(SD) GMM	(GOV) GMM
SD		0.16240*** (0.000)
GOV	0.00984*** (0.000)	
PS	-0.00044*** (0.000)	
TAX	0.00052** (0.034)	
FD	0.02744*** (0.001)	
GFCF	0.00003 (0.176)	
MI		-0.00124*** (0.000)
TRADE		0.05209** (0.014)
LnPOP		-0.02685*** (0.000)
Constant	0.07108*** (0.000)	0.27316** (0.027)
Observation	885	885
Number of ids	59	59
Wald Chi2	1.3406***	0.39035 ***
Sargan test (Prob)	19.38 (0.250)	75.99 (0.126)
AR (2)	1.14 (0.253)	-0.03 (0.975)

*** indicates 'p<0.01'; ** indicates 'p<0.05' and * indicates 'p<0.1'.

The misery index has a negative association with governance, indicating that in developing countries where governance structures are already relatively weak, increasing misery leads to governance challenges such as corruption, organizational incompetence, and poor decision-making. The results of this study align with a previous study by Majeed

(2014), who found a negative impact of inflation and unemployment on governance. Furthermore, population size has a negative association with governance in developing countries, indicating that population growth exacerbates unemployment and poverty problems when job creation fails to keep pace. High unemployment often leads to social unrest, increased crime rates, and political instability.

Both models indicate that the Wald-chi2 value is significant, suggesting that both models provide a good fit and that the parameters differ significantly from their expected values. The Sargan test chi-square value is not significant, specifying that overidentifying restrictions are valid. To conclude, both models exhibit the absence of autocorrelation, with insignificant auto-regressive (AR) values.

Table 5 presents the 3SLS findings for both models. The simultaneous model indicates that sustainable development and governance are treated as endogenous variables in this analysis. The first model shows the impact of governance on sustainable development in developing countries. The outcomes demonstrate that governance has a positive impact on sustainable development. Due to good governance, the use of available resources is well-monitored, leading to better-quality development, including the eradication of poverty and inequality, as well as improvements in environmental issues. Effective governance that promotes accountability and fosters political stability alongside the rule of law is crucial for implementing sustainable environmental policies. For instance, sound government frameworks can promote sustainable policies on environmental aspects, improve the provision of public services, encourage economic growth, and support the development of underprivileged societies. Moreover, good governance promotes the engagement of people with their leaders, as well as giving them a voice in their governance; hence, sustainable development will be of higher quality. These results align with previous studies, such as Massey (2022), which investigated the positive impact of adequate governance and public administration on achieving sustainable development. Gündoğdu & Aytekin (2022) reported that governance indicators, such as democracy, the rule of law, and regulatory quality, have a positive effect on sustainable development.

Public spending has an insignificant impact on sustainable development. Through government expenditure on the health and education sectors, people will be empowered, resulting in improved human capital and lower poverty levels. A skilled workforce is capable of generating new ideas, developing new knowledge, and contributing to the industry's knowledge base. Thus, human capital is a vital factor that determines positive, sustainable development and an increase in well-being, securing funding for organizations and programs involved in enforcing environmental laws and regulations, environmental conservation, pollution prevention, and ecosystem recovery. The protection of the environment plays a crucial role in achieving environmental sustainability. The positive association between public spending and sustainable development was also found by Cristóbal et al. (2021), who identified a positive role of public spending in achieving 17 SDGs in upper-middle-income countries.

Table 5. Empirical results of 3SLS

Equation	Obs.	Parms	RMSE	R ²	Chi2	p
SDI	1003	5	.10047	0.2118	614.88	0.0000
GOV	1003	4	.52702	-0.2604	390.85	0.0000
Variables			(SD) 3SLS			(GOV) 3SLS
SD						4.8086*** (0.000)
GOV			0.14210*** (0.000)			
PS			0.00019 (0.273)			
TAX			-0.00023 (0.416)			
FD			0.13172*** (0.000)			
GFCF			-0.00013** (0.032)			
MI						-0.00211*** (0.003)
TRADE						0.02197 (0.293)
LnPOP						-0.03814*** (0.000)
Constant			0.69576*** (0.000)			-2.9913*** (0.000)
Observation			1003			1003
R-squared			0.2118			-0.2604

*** indicates 'p<0.01', ** indicates 'p<0.05' and * indicates 'p<0.1'.

In contrast, tax revenue has an insignificant impact on sustainable development. Raising tax revenue levels may have adverse effects on sustainable development in developing countries if it is not well-managed. High taxes have adverse effects on small businesses and low-income individuals, potentially depressing entrepreneurship and economic growth. This condition can lead to increased unemployment and poverty, ultimately destabilizing social sustainability. Additionally, when increased revenue is spent inefficiently, it is often lost through corruption or allocated to unproductive sectors. It does not enhance public services, including education, health services, and infrastructure, which are vital for long-term development. In this manner, an increase in tax revenue that can potentially finance development can undermine sustainability if it suppresses economic activity and is not appropriately reinvested. These findings are compatible with previous studies, such as Abd Hakim et al. (2022), who reported that

direct and indirect tax deters growth in developing countries due to weak institutional performance.

The finding that financial development is positively related to sustainable development and a sound financial system enhances the ability of sources of finance for individuals, small businesses, and large businesses to invest in sustainable activities, such as renewable energy and other green technologies. Financial independence is also achieved by empowering excluded individuals through the provision of banking services, savings, and micro-financial credit facilities, thereby enhancing the welfare of these individuals and the broader community. Furthermore, it enables shaping external stakeholder environments, such as financial markets, as a source of foreign direct investment and as agents that can mobilize domestic savings and invest in activities aligned with achieving sustainable development. These results align with Nguyen et al. (2022), which found a positive relationship between financial development and economic growth in emerging markets.

However, the impact of GFCF is negative on sustainable development. In developing countries, large-scale construction projects, such as roadways, buildings, and industries, can have a negative impact on the environment through deforestation. However, building and reconstructing roads within forests, wetlands, and ecosystems can lead to water pollution, reduce biodiversity, and have permanent detrimental effects on the environment. All these impacts will weaken the environmental dimension of sustainability. In contrast, Maune et al. (2023) noticed a positive relationship between capital formation and economic growth. This finding suggests that investments in automobile financing, such as electric buses, public transportation, metro lines, and bike lanes, will contribute to environmental sustainability. Furthermore, green transportation reduces pollution, lowers carbon emissions, and enhances the well-being of urban communities. The resilience of the transport system also enhances access to employment opportunities and services, leading to social progress and economic growth.

The results of the governance model are presented in this section. Sustainable development has a positive impact on governance. Sustainable development plays a crucial role in enhancing governance in developing countries by increasing transparency, eradicating unfair disparities, enhancing institutional capacity, and promoting long-term planning and sustainable development. Sustainable development concerns, including the protection of the environment, social justice, and economic stability, facilitate the development of better governance structures that are responsive to society and more efficient. Efficient incorporation of sustainability into national development activities enables developing countries to construct enhanced governance frameworks for sustainable development that would promote peace, sustainable economic development, and human development. There is a positive relationship between HDI and governance quality. If education levels increase, individuals become more aware of their rights, understand how their government functions, and comprehend how politics works.

This paper indicates that the misery index is negatively associated with governance. In developing countries where governance structures are already relatively weak, increasing misery helps to bring governance challenges, such as corruption, organizational incompetence, and poor decision-making, to light. For example, in countries like Senegal, a high misery index is an indication of the nation's economic difficulty and is associated with a high level of corruption, as well as the misappropriation and misuse of funds intended for the provision of health and education services. Furthermore, high inflation diminishes real wages, thus reducing purchasing power, and increases unemployment, which in turn decreases political stability and exacerbates poverty and disparity. This can result in more protests, strikes, and civil unrest, and lower the government's credibility and power. However, these results are similar to those of Effiong et al. (2023), who reported that inadequate governance and weak quality of institutions increase the economic pain.

Table 6. Empirical Results of RE and FE.

Variables	(SD) RE	(GOV) FE
SD		1.3624*** (0.000)
GOV	0.03545*** (0.000)	
PS	0.00116*** (0.000)	
TAX	-0.00072** (0.081)	
FD	0.16874*** (0.000)	
GFCF	-0.00007 (0.102)	
MI		-0.00301*** (0.000)
TRADE		-0.04021 (0.285)
LnPOP		-0.21693*** (0.000)
Constant	0.62095*** (0.000)	2.3101*** (0.007)
R-squared	0.1138	0.0990
Wald-Chi2/F-Stat	139.53***	25.83***
Hausman value		13.22**

*** indicates 'p<0.01', ** indicates 'p<0.05' and * indicates 'p<0.1'.

Trade openness has an insignificant impact on governance. When countries open to trade, they enter into contact with international organizations as well as foreign investors. This interaction provides them with the best governance practices

to change inefficient or corrupt institutions. Furthermore, trade openness requires improvements in the implementing institutions, such as property rights, legal bodies, and regulatory agencies, as well as combating corruption to ensure investor and market stability. However, trade openness puts external pressure on the nation to reform those institutions that facilitate economic activities. Where institutions are strong enough to enhance fair trade, settle disputes, and enforce contracts to support better governance, there is less corruption. These outcomes align with a previous study by Majeed (2014), which reported that trade openness policies mitigate corruption in countries.

Ultimately, the population is negatively correlated with governance. Population growth exacerbates the problems of unemployment and poverty when job creation fails to keep pace with it. High unemployment leads to social unrest, increased crime rates, and political instability. Furthermore, in developing countries, population growth increases the overload of public services. For this reason, shortages of necessities can occur, including housing, transportation, health services, and education. However, an increasing population puts pressure on governments, which often results in increasing economic inequality and lower governance quality. These results have been found in previous related studies, which have also found that a population boom lowers government efficiency and countries' well-being.

The Fixed Effect (FE) and Random Effect (RE) are used to evaluate the robustness of the results presented in Table 6. The Chi-square value at the 1% level of significance in the Hausman test proves that it is suitable for fixed effects estimation. The FE is suitable for the governance model because the evidence indicates that the P-value is significant at the 1% level. The Hausman test value is modest in the sustainable development model. Consequently, the RE approach is suitable for this model.

CONCLUSION

Our analysis results in two main findings. First, an adequate governance structure is important for sustainable development. A transparent, accountable, and well-controlled government helps a country achieve its development aims. Effective government laws in developing countries mean they are likely to do what is best for society, the economy, and the environment. Second, the analysis shows that sustainable development plays a positive role in guiding the governance process. Enhancing HD indicators, such as education, health, and income, encourages citizens to participate more actively and feel safer, which in turn creates a better and more trustworthy government.

Furthermore, our empirical findings may help formulate appropriate policies for the developing economy's government and policymakers. One of the primary policy implications of the nexus between governance and sustainable development in developing countries is the urgent need to build institutional capacity and foster transparent and accountable systems of governance. Good governance is crucial in ensuring that public resources, including tax revenues, are efficiently and equitably

directed to priority development areas such as education, health, infrastructure, and environmental protection. Second, poor governance has been known to lead to corruption, ineffective management, and the poor delivery of public services, which in turn lower economic growth and social trust — both of which are fundamental pillars of sustainable development. Policymakers must therefore focus on reforms that strengthen the rule of law and fiscal transparency, as well as establish effective mechanisms for citizen participation and oversight. Third, the development strategies pursued by countries would be more resilient and effective if good governance principles were incorporated into these strategies and allowed for adjusting short-term political goals to long-term sustainability-related objectives.

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Multidimensional Poverty in Indonesia: The Role of Economic, Social, Educational, and Political Factors

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JEL Classification:

I32

E24

G21

Received: 29 January 2025

Revised: 04 May 2025

Accepted: 21 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study advances the field by employing a comprehensive, multidimensional framework that examines the synergistic interactions between economic, social, educational, and political factors. This study also provides a more nuanced and evidence-based perspective on poverty dynamics, moving beyond the oversimplified, single-dimensional analyses that have dominated prior scholarship.

Research Objectives: This study aims to examine the impact of educational participation, crime rates, unemployment, access to Islamic financing, and the democracy index on poverty levels in Indonesia.

Research Methods: Panel data from 2015 to 2022 is examined using a fixed effects model to identify the key determinants of poverty.

Empirical Results: The findings indicate that higher net enrolment rates and increased access to Islamic financing significantly contribute to poverty reduction, while rising crime rates and unemployment are associated with increased poverty levels. Interestingly, the democracy index shows no statistically significant effect on poverty during the examined period.

Implications: The findings have significant policy relevance, emphasizing the need to enhance access to quality education, promote job creation, and expand Islamic financing as an inclusive economic tool.

Keywords:

Poverty, education, crime, unemployment, Islamic financing, democracy

How to Cite:

Rama, A., Putri, Poppy S., Mynbayeva, E. (2025). Multidimensional Poverty in Indonesia: The Role of Economic, Social, Educational, and Political Factors. *Etikonomi*, 24(2), 623 – 634. <https://doi.org/10.15408/etk.v24i2.44640>.

INTRODUCTION

Poverty remains a significant challenge in Indonesia, the world's fourth most populous country, with a population of 275.77 million as of 2022. The core issue is not the population size, but the lack of human capital development – particularly in education and access to economic opportunities – which deepens poverty (Hatta & Sarkawi, 2011). According to the Central Bureau of Statistics (BPS, 2022), poverty levels in Indonesia declined from 2015 to 2019 but spiked in 2020 due to the COVID-19 pandemic, which severely impacted the economy. However, poverty levels began to decrease again in 2021 and 2022 as the economy recovered.

Poverty is a complex and multidimensional social issue (Abdu & Delamonica, 2018; Ferreira & Lugo, 2013) that extends beyond income deficiencies to encompass various aspects of life, including access to education, healthcare, employment, and social and political participation. Therefore, to understand and effectively address poverty, a comprehensive approach is needed, considering various factors including economic, educational, social, and political dimensions. The economic dimension, for example, includes unemployment and access to financial resources; the educational dimension focuses on community involvement in the education system; the social dimension involves factors such as crime and inequality; while the political dimension relates to the role of public policy and democratic stability in poverty alleviation (Alkire & Foster, 2011; Sen, 2014). By employing this multidimensional approach, poverty analysis can provide a more comprehensive picture, leading to more effective strategies for addressing this issue.

Addressing poverty requires a focus on the quality of human resources, a crucial factor in alleviating it. Education plays a vital role in enhancing human capital, as it is widely regarded as a key driver of economic growth, improving welfare, and reducing poverty (Hofmarcher, 2021; Spada et al., 2023). A standard indicator used to assess the success of human resource development is the participation rate of the population at various educational levels. It is generally expected that higher levels of educational participation correlate with improved human resource quality. Ladd (2012) shows a strong and significant relationship between education and poverty, while Hofmarcher (2021) finds that education has a negative and significant impact on poverty. Improved access to education offers greater opportunities for communities to enhance their welfare.

Social factors, in addition to education, play a significant role in perpetuating poverty. Poverty often leads to negative consequences, one of which is an increase in crime, as individuals struggling to make ends meet face difficulties in maintaining stable social lives (Todaro & Smith, 2009). Shifts in societal values such as materialism and hedonism can foster negative behaviours like crime, which in turn exacerbate poverty (Huang et al., 2004). High crime rates not only hinder economic growth but also worsen poverty directly by disrupting income sources and depleting resources. Violent crimes, in particular, increase financial instability, pushing vulnerable families further into poverty and diminishing the positive effects of economic growth (Adekoya & Razak, 2016; Raj & Kalluru, 2023).

Unemployment is a significant social factor contributing to poverty. A high unemployment rate signals a failure in a country's development, as it reflects an imbalance between the labour force and available job opportunities. Unemployment is positively and significantly correlated with poverty, primarily because it reduces income, thereby lowering individual welfare. McClelland (2000) empirically confirms that the impacts of unemployment on families include poverty and hardship, strained relationships, poorer health (although the causal relationships are not always clear), and housing stress. As unemployment rises, the productivity of the population decreases, making it harder for individuals to meet their basic needs. This inability to fulfil basic needs further exacerbates poverty levels. Recent studies by Aderounmu et al. (2021) and Meo et al. (2023) have also highlighted the negative impact of unemployment on poverty in Nigeria and Pakistan, underscoring the need for policies that address unemployment to alleviate poverty.

Islamic bank financing has demonstrated a positive impact on poverty reduction by improving access to financial resources for marginalized communities. Several empirical studies have highlighted the significant role of Islamic finance in supporting small and medium-sized enterprises (SMEs), which are key drivers of job creation and economic growth in developing countries. For instance, Amijaya et al. (2023) find that Islamic financing significantly reduces poverty by increasing the financial inclusion of low-income populations, enabling them to invest in businesses and improve their livelihoods. Similarly, Martiana and Rahmanto (2021) emphasize that Islamic microfinance institutions provide essential capital to the poor, promoting entrepreneurial activities that create jobs and enhance community welfare. Moreover, Islamic banks' focus on asset-backed financing and risk-sharing mechanisms aligns with poverty reduction goals by ensuring that funds are used for productive and sustainable purposes.

The implementation of democratic governance offers significant benefits, particularly in optimizing national resource allocation and reducing poverty (Fambeu, 2021). Amartya Sen, a Nobel Laureate in Economics, emphasizes that poverty in several Asian and African countries stems from the failure to implement democracy effectively (Fan, 2023). Although democracy may not have a direct impact on economic growth, it contributes indirectly by fostering human capital development, enhancing economic stability, and promoting individual freedoms (Doucouliagos & Ulubaşoğlu, 2008). In line with this, Tavares and Wacziarg (2001) find that democratic institutions tend to respond to the needs of the poor by expanding access to education and reducing income inequality. However, these gains often come at the cost of lower physical capital accumulation. Despite their advantages, democratic systems still face challenges such as weak transparency, limited public participation, and ineffective poverty-reduction policies, all of which can limit their overall impact.

Based on the background outlined, this study aims to identify the root causes of poverty using a multidimensional approach. Utilizing panel data from all provinces in Indonesia from 2015 to 2022, the research investigates key economic, social, educational, and political factors that contribute to poverty in the country.

This study makes three key contributions that address critical gaps in poverty literature. *First*, while existing studies often adopt a unidimensional economic approach (e.g., D'Attoma & Matteucci, 2024; Dong et al., 2021), this research advances a multidimensional poverty framework by integrating economic, social, political, and educational dimensions to reveal their interconnected dynamics. By doing so, it challenges reductionist poverty models and offers a more holistic understanding of deprivation—particularly relevant in developing economies where institutional and social structures mediate economic outcomes. *Second*, much of the current empirical evidence on poverty stems from Western or industrialized contexts (e.g., Ayoo, 2022; Liu et al., 2021), leaving a gap in understanding how political governance and social systems shape poverty in emerging economies. This study fills that void by focusing on Indonesia, demonstrating how political stability, crime rates, and educational access interact uniquely in shaping poverty trajectories—a contribution critical for policymakers in similar developing settings. *Third*, while Islamic finance has often been studied in isolation (e.g., Liu et al., 2021), this research empirically links it to poverty alleviation within a broader institutional framework, showing how its ethical and inclusive mechanisms—such as risk-sharing and prohibitions on exploitative practices—enhance financial inclusion and microenterprise growth. This study bridges a theoretical gap between Islamic economics and development studies, offering actionable insights for leveraging faith-based finance in poverty reduction strategies.

METHODS

To understand the complexity of poverty's underlying causes, this study examines economic, social, educational, and political factors that may influence poverty levels. The research relies on secondary data obtained from the Indonesian Central Bureau of Statistics and reports from the Financial Services Authority, for the period from 2015 to 2022. The dataset is structured as a panel, combining time-series data from 2015 to 2022 with cross-sectional data from 31 provinces in Indonesia. Restricting the analysis to the 2015–2022 period ensures methodological consistency by avoiding biases arising from changes in data collection protocols. This timeframe also aligns with the availability of high-frequency, province-level panel data (31 provinces over 8 years), which offers an optimal balance between temporal depth and spatial coverage.

The primary dependent variable, poverty, is measured as the number of people living below the poverty line. Education is represented by the pure participation rate, which refers to the percentage of the school-aged population currently attending school at the appropriate educational level. It is calculated as the ratio of students of official school age who are enrolled in school to the total population of school-aged individuals. The crime rate and unemployment rate represent social factors. The crime rate reflects the level of vulnerability to criminal activity in a specific region during a particular time, while the unemployment rate refers to the labor force that is not employed but is actively seeking employment or preparing to start a new business.

The Economic factor is captured through the volume of Islamic bank financing allocated to small and medium enterprises (SMEs). The Political factor is represented by Indonesia's Democracy Index, a composite index compiled by the Indonesian Central Bureau of Statistics. This index encompasses various variables, including freedom of expression, the right to vote and be elected, and the effectiveness of local government bureaucracy.

This study employs a panel regression model to analyse the multidimensional factors influencing poverty in the Indonesian context. The baseline model for this study is specified as follows:

$$Y_{it} = \beta_0 + \beta_1 \log X_{1it} + \beta_2 \log X_{2it} + \beta_3 \log X_{3it} + \beta_4 \log X_{4it} + \beta_5 \log X_{5it} + \epsilon_{it} \quad (1)$$

In this model, Y_{it} represents the dependent variable, which measures poverty for province i at time t . The independent variables $\log X_{1it}$, $\log X_{2it}$, $\log X_{3it}$, $\log X_{4it}$, and $\log X_{5it}$ are the logarithmic transformations of key factors representing education (school participation: X_1); social factors (crime: X_2 ; unemployment: X_3); and economic (Islamic bank financing: X_4); and political (democracy index: X_5) factors, respectively. The parameter β_0 denotes the intercept, while β_1 , β_2 , β_3 , β_4 , and β_5 are the coefficients associated with the respective independent variables. Finally, ϵ_{it} is the error term, capturing unobserved factors that may influence poverty but are not included in the model. This specification enables a robust examination of how these multidimensional factors collectively impact poverty levels across provinces over time.

RESULTS AND DISCUSSION

Table 1 reports the results of the panel regression model using the Fixed Effect Model (FEM). The panel regression results offer valuable insights into the factors that influence poverty across various regions in Indonesia. The analysis includes the impact of various economic, social, educational, and political factors, with all variables presented in their logarithmic forms.

The coefficient for School Participation (X_1) is -0.017967, with a statistically significant p-value of 0.0002, indicating a negative and significant relationship between education participation and poverty levels. Specifically, a 1% increase in school participation is associated with an approximate 0.018% reduction in poverty, holding other factors constant. Although the effect size is modest, the negative direction underscores the vital role of education in alleviating poverty. Higher levels of education equip individuals with the skills, knowledge, and qualifications necessary for better employment opportunities, which can lead to increased income, enhanced socio-economic mobility, and a reduced risk of falling into or remaining in poverty.

Furthermore, education not only strengthens individual capacities but also contributes to long-term economic development by fostering a more skilled and productive workforce (Chevalier et al., 2004). These findings are consistent with previous research, such as Arsani et al. (2020), which confirms the significant inverse relationship between education

and poverty in Indonesia. In this context, improving access to quality education emerges as a strategic and sustainable approach to breaking the cycle of poverty, especially in developing countries like Indonesia.

Table 1. Panel Regression Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	6.419175	0.947749	6.773073	0.0000
School participation (X1)	-0.017967	0.014237	-0.138176	0.0002
Crime (X2)	0.026843	0.033573	0.799558	0.0149
Unemployment (X3)	0.010681	0.017190	-0.621359	0.0000
Islamic bank financing (X4)	-0.021601	0.029625	-0.087793	0.0001
Democracy index (X5)	-0.023048	0.004169	-1.210795	0.4351
<i>Fixed Effects (Cross)</i>				
ACEH	-0.672220			
BALI	-0.840864			
BANTEN	0.546063			
BENGKULU	-0.360450			
JAKARTA	-0.023963			
GORONTALO	-0.829626			
JAMBI	-0.455894			
WEST JAVA	1.900235			
CENTRA JAVA	1.929413			
EAST JAVA	2.274090			
WEST KALIMANTAN	-0.017639			
SOUTH KALIMANTAN	-0.819064			
CENTRAL KALIMANTAN	-1.119391			
EAST KALIMANTAN	-0.623233			
BANGKA BELITUNG	-1.824510			
RIAU ISLAND	-1.140094			
LAMPUNG	0.859888			
MALUKU	-0.280531			
NORTH MALUKU	-1.668573			
WEST NUSA TENGGARA	0.342783			
EAST NUSA TENGGARA	0.896362			
WEST PAPUA	-0.744365			
RIAU	0.140801			
SOUTH SULAWESI	0.540836			
CENTRAL SULAWESI	-0.078440			
SOUTHEAST SULAWESI	-0.339454			
NORTH SULAWESI	-0.793701			
WEST SUMATERA	-0.233808			
SOUTH SUMATERA	0.893677			
NORTH SUMATERA	1.081653			
YOGYAKARTA	0.115579			

The coefficient for Crime (X2) is 0.026843, indicating a positive relationship between crime rates and poverty levels. Specifically, a 1% increase in the crime rate is associated with an approximate 0.027% increase in poverty, holding other variables constant. This finding suggests that regions with higher crime rates tend to experience greater levels of poverty. The positive association may be explained by the economic disruption caused by crime, which can undermine business activity, discourage investment, and slow economic growth (Detotto & Otranto, 2010). High crime rates often deter potential investors and employers, leading to reduced job opportunities and increased unemployment—key drivers of poverty.

Additionally, crime imposes indirect costs on both individuals and businesses, such as increased spending on security and reduced consumer confidence, further exacerbating economic hardship (Carboni & Detotto, 2016). These results are consistent with Mehlum et al. (2005), who highlight the detrimental impact of crime on economic performance and poverty. Therefore, reducing crime is a strategic component of poverty alleviation efforts, particularly in vulnerable regions.

Unemployment (X3) has a positive coefficient of 0.010681, indicating a strong relationship with poverty. Specifically, a 1% increase in the unemployment rate is associated with an approximate 0.011% increase in poverty, controlling for other variables. This result highlights the crucial role of employment in alleviating poverty. As unemployment rises, individuals lose access to a steady income, making it increasingly difficult for them to meet their basic needs and maintain economic stability. Prolonged joblessness not only affects personal well-being but also contributes to a broader decline in household consumption and productivity, thereby intensifying poverty at the community level (de Graaf-Zijl & Nolan, 2011). These findings are consistent with DeFina (2004), who finds a significant positive relationship between unemployment and poverty. The evidence underscores the importance of effective labor market policies and job creation strategies as crucial components of poverty alleviation efforts.

The coefficient for Islamic Bank Financing (X4) is -0.021601, indicating a negative relationship with poverty. A 1% increase in Islamic bank financing is associated with an approximate 0.022% decrease in poverty, holding other factors constant. This result suggests that greater access to Islamic financing, particularly for small and medium-sized enterprises (SMEs), contributes significantly to poverty reduction. By providing Sharia-compliant financial products that avoid excessive interest and promote risk-sharing, Islamic banks support productive economic activities, especially among underserved populations (Lebdaoui & Wild, 2016; M. Anwar et al., 2020). Financing for SMEs plays a vital role in generating employment and stimulating income growth, particularly in low-income communities. This finding is consistent with Parewangi & Iskandar (2020), who demonstrate the significant poverty-reducing impact of Islamic financial services. Expanding the outreach of Islamic banking to include marginalized groups and enhancing financing for micro and small enterprises can further promote inclusive growth, serving as an effective strategy for alleviating poverty.

The coefficient for the Democracy Index (X5) is -0.023048; however, with a p-value of 0.4351, the result is not statistically significant. While the negative sign suggests a potential inverse relationship between democracy and poverty, the lack of significance implies that, in this model, the level of democracy does not have a measurable impact on poverty outcomes. This result aligns with findings by Ross (2006), who argues that the relationship between democracy and poverty reduction is complex and often inconclusive. Democratic governance alone does not guarantee improved welfare for the poor, especially in the absence of strong institutions and inclusive policies. Structural challenges such as corruption, weak legal frameworks, and inadequate public service delivery can limit the effectiveness of democratic systems in addressing poverty. Moreover, as highlighted by Harber (2002) and Kapstein and Converse (2008), the exclusion of marginalized groups from meaningful political participation further diminishes democracy's potential to drive pro-poor change. These findings underscore the need for not only democratic governance but also targeted, well-implemented policies and institutional reforms to ensure that democratic ideals translate into concrete improvements for impoverished populations.

The fixed effects for the regions reflect the unique characteristics of each province that affect poverty levels, while controlling for other factors. For instance, regions such as West Java and Central Java exhibit high fixed effects, with coefficients of 1.900235 and 1.929413, respectively, indicating that these provinces have higher poverty levels compared to the baseline region. In contrast, provinces such as Bali and Aceh exhibit lower poverty levels, with fixed effect coefficients of -0.840864 and -0.672220, respectively. Additionally, West Papua and North Maluku have negative coefficients of -0.744365 and -1.668573, respectively, indicating that these regions also experience lower poverty levels compared to the reference province. The regional fixed effects highlight the extent of regional disparities in poverty, demonstrating that geographic and contextual factors have a significant impact on poverty outcomes across Indonesia.

Overall, the analysis highlights how education, crime, unemployment, Islamic financing, political, and regional factors interact to determine poverty levels in Indonesia. The findings suggest that while some factors, such as education and Islamic financing, help reduce poverty, others, like crime and unemployment, contribute to its increase. Additionally, regional differences play a crucial role in shaping the overall poverty landscape.

Table 2. The Chow Test

Redundant Fixed Effects Tests			
Pool: POOL01			
Test cross-section fixed effects			
Effects Test	Statistic	d.f.	Prob.
Cross-section F	65.851248	(30,212)	0.0000
Cross-section Chi-square	578.818474	30	0.0000

This study employs panel regression, combining cross-sectional and time-series data, to determine the most suitable estimation model: the Common Effect Model (CEM), the Fixed Effect Model (FEM), or the Random Effect Model (REM). The Chow test is used to determine whether to choose between CEM and FEM. If the cross-section F probability is below 5% (0.05), FEM is selected; otherwise, CEM is preferred.

Table 3. The Hausman Test

Correlated Random Effects - Hausman Test			
Pool: POOL01			
Test cross-section random effects			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	30.177791	5	0.0000

Based on the results shown in Table 2, the Chow test indicates that the p-value is 0.00, which is less than the significance level of 0.05. This result confirms that the appropriate model for this analysis is the Fixed Effect Model (FEM). To determine the best model between the Fixed Effect Model (FEM) and the Random Effect Model (REM), the Hausman test is used. If the p-value is less than 0.05, the Fixed Effect Model is chosen. If it is greater than 0.05, the Random Effect Model is preferred.

Based on the Hausman test output in Table 3, the p-value is 0.00, which is less than 0.05. This indicates that the selected model is the Fixed Effect Model (FEM). Therefore, it can be concluded that H0 is rejected and H1 is accepted. Since the Fixed Effect Model (FEM) is chosen, the Lagrange Multiplier (LM) test is not required.

CONCLUSION

This study examines the multifaceted factors that contribute to poverty, particularly within the Indonesian context. The empirical findings confirm that education has a statistically significant negative relationship with poverty, indicating that higher education levels enhance individual capabilities and productivity, thereby contributing to poverty reduction. In contrast, crime rates show a statistically significant positive relationship with poverty, suggesting that higher crime rates hinder economic growth, reduce investment, and limit employment opportunities, thereby exacerbating poverty. Unemployment is also found to have a significant positive effect on poverty, highlighting that rising unemployment increases poverty by reducing household income and preventing individuals from escaping the poverty cycle. Furthermore, the study confirms that the availability of Islamic financing for SMEs plays a crucial role in poverty reduction by supporting business expansion, increasing production, and generating employment. However, the relationship between democracy and poverty, although negative, is not statistically significant, indicating that democracy alone does not directly impact poverty levels unless supported by strong institutions and effective policy implementation.

The findings of this study have several important policy implications for effectively combating poverty. *First*, increasing access to quality education, particularly for disadvantaged groups, should be a top priority to boost human capital and productivity. This can be achieved through targeted scholarships, vocational training programs, and adult education initiatives. *Second*, addressing crime through enhanced law enforcement and proactive crime prevention measures is critical for fostering economic stability and growth. *Third*, policies aimed at reducing unemployment—such as job creation programs, skills training, and support for entrepreneurship—must be implemented to mitigate poverty. *Fourth*, expanding access to Islamic financing for SMEs is also crucial for driving business expansion, job creation, and poverty reduction, particularly in rural and underserved areas. *Finally*, strengthening democratic institutions by promoting transparency, reducing corruption, and ensuring the rule of law will improve the effectiveness of poverty-reduction policies, empowering marginalized communities to participate in the policymaking process and fostering inclusive economic development.

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Exploring the Regional Multidimensional Poverty Pattern in Indonesia: Does Climate Matter?

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JEL Classification:

I32

O10

Q54

Received: 16 June 2024

Revised: 19 May 2025

Accepted: 27 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study develops a comprehensive regional measure of poverty using the capability approach to understand the pattern of multidimensional poverty in Indonesia.

Research Objectives: This study has two objectives: first, to construct and examine multidimensional poverty levels in 33 Indonesian provinces from 2010 to 2020; and second, to investigate the association between climate variables and the Multidimensional Poverty Index (MPI).

Research Methods: The MPI is measured through equal weighting of 20 indicators. A pooled ordinary least squares regression was used to study the relationship between the climate variables and MPI.

Empirical Results: The findings indicate that most provinces have experienced a decrease in poverty over the past decade. However, significant inequality persists among provinces, particularly in the eastern regions of Indonesia. Further analysis reveals that temperatures exceeding 25.25 °C may lead to an increase in the MPI, while precipitation exceeding 9.5 mm/day is associated with a decrease in the MPI.

Implications: This study underscores the importance of incorporating climate change concerns, specifically increasing temperatures and unpredictable precipitation, into poverty reduction strategies and highlights the need for region-specific policies to address the multifaceted nature of poverty in Indonesia effectively.

Keywords:

multidimensional poverty index; temperature; precipitation; capability approach; pooled OLS regression

How to Cite:

Pratiwi, I. E., & Joshi, N. P. (2025). Exploring the Regional Multidimensional Poverty Pattern in Indonesia: Does Climate Matter? *Etikonomi*, 24(2), 635 – 652. <https://doi.org/10.15408/etk.v24i2.39523>.

INTRODUCTION

The topic of the interrelation between poverty and climate change has received increased attention in academic research and has been a fascinating topic to discuss. Existing empirical evidence indicates a vicious cycle between climate change and poverty, in which poverty exacerbates the suffering of disadvantaged groups due to climate change. Research regarding the linkage between climate change and poverty has been continuously conducted by focusing on two main aspects: the economic impact of climate change at the household level (Li et al., 2024; Schleyppen et al., 2024; Etwire, 2024; Yagaso et al., 2024; Otrachshenko et al., 2024; Amare & Balana, 2023), and at the aggregate level (Gill et al., 2024; Demirhan & Bayraktar, 2025; Roy, 2024; Yuan et al., 2024; Huynh & Hoang, 2024). For instance, Sinha et al. (2022) confirm the positive link between poverty and vulnerability to climate change, whereby regions with high levels of poverty are also highly vulnerable to climate change, and vice versa. Sebukeera et al. (2023) suggest that climate variability has a significant impact on the likelihood of a household falling into poverty in Uganda.

On the other hand, a study by Mahjoubi and Mkaddem (2024), which utilized national-level data and spatial model analysis, suggests that climate change, precipitation, and temperature have both direct and indirect effects on poverty. Dang et al. (2023) identify the impact of high temperatures on poverty and inequality using subnational data analysis. Their findings suggest that both hotter and colder temperatures are associated with higher poverty rates and inequality.

Ogbeide-Osaretin et al. (2022) conducted a study using secondary data from 1980 to 2020 to explore the relationship between climate change, poverty, and inequality in Nigeria. The study concludes that there is a U-shaped relationship between temperature and inequality. Specifically, temperature has a significant negative impact on the Gini ratio, while the square of temperature has a positive effect on the Gini ratio. These findings indicate that as temperatures rise due to climate change, income inequality initially decreases because the effects are felt similarly across all income levels. However, as temperatures continue to rise, the poor become increasingly exposed and unable to afford measures to mitigate the impact, which affects their income sources and widens the income inequality gap.

Barbier and Orchard (2017) investigated whether the spatial distribution of rural populations in 2000 affected changes in poverty rates from 2000 to 2012 in 83 developing countries. The study found no direct evidence that climate change itself changes poverty levels. However, climate change indirectly affects poverty by altering the effectiveness of economic growth in reducing poverty. Therefore, while promoting economic growth is often the most effective means, it is not sufficient on its own to address the challenges faced by large rural populations living in less favorable and remote agricultural areas vulnerable to climate change. Meanwhile, Islam and Winkel (2017) suggest that reducing inequality could help contain the adverse effects of climate change and mitigate climate change itself, while Markkanen and Anger-Kraavi (2019) underline that well-designed

and carefully implemented climate change mitigation policies could potentially provide opportunities to address gender, health, and economic inequalities.

To estimate the relationship between climate change and poverty, most researchers have developed poverty measurements using monetary indicators such as assets and income as proxies for poverty. Meanwhile, non-monetary metrics of poverty have received little attention in the climate change literature. Estimates relying only on monetary indicators can be misleading (Hallegatte et al., 2020) and may fail to reflect the distributional impacts of climate change on poverty. Under these circumstances, this approach may disproportionately obscure the impacts on specific regions and hinder the development of effective mitigation policies by governments (Hallegatte et al., 2018).

It is undeniable that there is no superior approach to measuring poverty and inequality compared to others to date. The Gini coefficient is a very popular and commonly used measure to gauge inequality. However, some other methods are also commonly used to measure inequality, such as the Theil Index and the Coefficient of Variation (Allison, 1978), as well as the Williamson coefficient (Williamson, 1965). So far, the distribution of income has been widely used as an indicator for identifying inequality. However, measuring inequality should not only consider one aspect, because it may also be linked to many aspects of an individual's life (Quadrado et al., 2001). Inequality should encompass all socio-economic aspects of livelihood and well-being, including health, education, technology, communication, and infrastructure (Alkire & Foster, 2011). Adopting a single indicator, such as the Gross Domestic Product (GDP) per capita, may also lead to an ambiguous interpretation, as the same indicator is often used to study a country's economic growth or development. It is believed that relying solely on economic performance indicators is insufficient to calculate development or well-being accurately. As stated by Sen (1980), although it may be valuable to identify inequality based on income data, the income indicator cannot fully capture an individual's well-being due to its simplicity. Therefore, numerous multidimensional indices have recently been developed, acknowledging the value of pondering multiple aspects of life.

Generally, GDP has been the most widely used indicator of regional inequality in Indonesia. Although many studies have aimed to develop new indices that capture the socio-economic dimensions of inequality, there is a limited body of research and empirical evidence specific to Indonesia. Most previous studies (Akita & Miyata, 2018; Tadjoeeddin et al., 2016; Tadjoeeddin & Chowdhury, 2019) have relied on GDP to understand inequalities between regions, provinces, and even districts in Indonesia. However, as previously mentioned, GDP per capita provides an ambiguous result and is insufficient for measuring development across multiple aspects of human well-being. Therefore, it is crucial to develop and explore alternative indices and measurements that take into account the multidimensional aspects of human development, in order to gain a more comprehensive and "realistic" understanding of regional disparities in Indonesia over time.

This study aims to achieve the following two objectives: better to understand poverty and its interrelationship with climate change. First, it constructs and examines

the level of multidimensional poverty in 33 provinces in Indonesia from 2010 to 2020. Second, it examines the relationship between climate change and multidimensional poverty in Indonesia. This research remains highly relevant and interesting to discuss because climate change and poverty are two of the most pressing global challenges of our time, specifically in the context of developing countries, such as Indonesia, with complex and evolving interactions. Both remain important global agendas as Sustainable Development Goals (SDGs), specifically SDGs #1 and 13. As previously explained, numerous studies have investigated the relationship between climate change and poverty. However, most have relied heavily on income and assets to measure poverty. This study, in contrast, examines critical non-monetary dimensions, including health, education, economics, and housing. What sets this study apart is its comprehensive integration of both monetary and non-monetary metrics to assess poverty, providing a more holistic view of how climate change exacerbates poverty in a broader sense. The novelty of this research lies in its innovative framework, which links climate variables to MPI, offering policymakers a more nuanced understanding of the distributional effects of climate change on poverty. By doing so, this study not only fills a significant gap in the literature but also provides actionable insights for designing targeted and equitable climate mitigation and adaptation policies.

This study makes a significant contribution to the existing literature in four key ways. First, it addresses a gap by proposing an alternative approach to examining regional multidimensional poverty, moving beyond GDP per capita through the capability approach outlined by Sen (1980). Second, the study explores the link between poverty and climate change. Given that Indonesia ranks among the top three countries in terms of natural hazard risk, this research could provide insights into how to reduce poverty while mitigating the risks associated with climate change. Third, the case study focuses on Indonesia, an archipelagic and heterogeneous country, making it particularly relevant for policymaking, as it takes into account regional characteristics, such as demographics and geographic conditions. Finally, the study utilizes large, recent, nationally representative secondary data to analyze multidimensional poverty in the country.

METHODS

In order to examine multidimensional poverty in Indonesia, this study identifies four domains of human capabilities. The data collected from the National Bureau of Statistics of Indonesia (BPS) encompassed 33 provinces. Due to some indicators having missing values in certain years, only data from 2010 to 2020 were used. Meanwhile, the historical climate data from 2010 to 2020 collected based on the weather station in each province in Indonesia were aggregated at the provincial level. Overall, 186 stations were distributed around the Indonesian region, and the geographic location of each station (latitude and longitude) is used to identify the weather from the NASA POWER source. Considering that one province may have more than two stations, the climate was then aggregated by using an area-weighted average, as shown in the following formula.

$$X_{i,t}^{temp} = \frac{\sum_{s=1}^N temp_{i,s} \cdot a_{i,s}}{\sum_{s=1}^N a_{i,s}}$$

and

$$X_{i,t}^{prec} = \frac{\sum_{s=1}^N prec_{i,s} \cdot a_{i,s}}{\sum_{s=1}^N a_{i,s}} \quad (1)$$

where $X_{i,t}^{temp}$ and $X_{i,t}^{prec}$ are the temperature and precipitation area-weighted average temperature in province i at year t , $temp_{i,s}$ the temperature of a particular meteorological station s in province i , N is the number of stations over the province i , $a_{i,s}$ is the area of Thiessen polygon of station s in province i . The area (m²) of Thiessen polygon in each station is measured using QGIS software.

As previously explained, the data used for measuring multidimensional poverty in Indonesia were obtained from the National Bureau of Statistics of Indonesia, covering 33 provinces over the period 2010–2020. Since the data contains variables with different formats or units and cannot be aggregated directly, the min-max normalization method is then implemented. The formula is presented in Equation (2) and Equation (3). In detail, Equation (2) is applied when the indicator used to construct the MPI has a positive impact. Meanwhile, Equation (3) is calculated when the indicator negatively affects the level of multidimensional poverty. Equations (2) and (3) are as follows:

$$x_{ijt} = \frac{k_{ijt} - x_{jmax}}{x_{jmax} - x_{jmin}} \quad (2)$$

$$x_{ijt} = \frac{x_{jmax} - k_{ijt}}{x_{jmax} - x_{jmin}} \quad (3)$$

Where,

x_{ijt} is the normalized value of the j^{th} indicator in i province on year t ,

k_{ijt} is the actual value of the j -th indicator in i province on year t ,

x_{jmax} is the maximum value of the j -th indicator.

For the purpose of measuring the MPI of each province, this study employs an equal-weight approach to calculate the composite index of each dimension. This approach has been applied in constructing the household's MPI and various studies. Considering that each dimension and indicator used in this study are equally crucial, four dimensions are given equal weight ($1/4 = 0.25$ of each dimension). Each indicator within its dimension is also given equal weight. It is worth noting that some indicators may have some missing data for some years. In this case, this study follows the assumption that there may not be a sudden change from one year to the following one, so it can be undertaken by counting the previously available year (Parente, 2019). Table 1 shows the list of MPI dimensions and their weights.

The calculation of the MPI is then aggregated by using additive aggregation through the following formula:

$$MPI_{it} = \sum_{j=1}^m w_j x_{ijt} \quad (4)$$

Where,

MPI_{it} is the multidimensional poverty index of i province on year t ,

w_j is the weight of the j -th indicator,

x_{ijt} is the normalized value of the j -th indicator in i province on year t .

To understand how climate change affects multidimensional poverty in Indonesia, a pooled ordinary least squares regression is conducted to investigate the impact. The model is as follows:

$$MPI_{it} = \beta_0 + \beta_1 TEMP_{it} + \beta_2 PREC_{it} + \beta_3 Region_{it} + \beta_4 Lat_{it} + \beta_5 Long_{it} + \beta_6 Lat_{it} * Long_{it} + \varepsilon_{it} \quad (5)$$

where MPI_{it} refers to the multidimensional poverty index of province i in year t , $TEMP_{it}$ and $PREC_{it}$ are the independent variables of climate change, which indicate the temperature and precipitation in province i at year t . $Region_{it}$ serves as a control variable representing the regions of west, central, and east. Lat_{it} and $Long_{it}$ are the latitude and longitude of province i in year t . The addition of $Region_{it}$, Lat_{it} and $Long_{it}$ are to control the regional heterogeneity. β_{1-6} 's are the regression coefficients and ε_{it} is the error term. Furthermore, Equation (6) is used to estimate the non-linear effect of temperature and precipitation. Previous studies (Burke et al., 2015; Henseler and Schumacher, 2019) found that the effect of temperature on economic growth is non-linear. The model is as follows:

$$MPI_{it} = \beta_0 + \beta_1 TEMP_{it} + \beta_2 TEMP_{it}^2 + \beta_3 PREC_{it} + \beta_4 PREC_{it}^2 + \beta_5 Region_{it} + \beta_6 Lat_{it} + \beta_7 Long_{it} + \beta_8 Lat_{it} * Long_{it} + \varepsilon_{it} \quad (6)$$

Table 1. Dimension and Weights of MPI

Dimensions of Capabilities (weights)	Indicators (weights)	Unit of Measurement
Life and health (1/4)	Life expectancy rate (1/24)	Life expectancy at birth in year
	Malaria incidence (1/24)	Malaria incidence per 1000 people
	Prevalence of crime (1/24)	Risk of citizens become crime victims per 100000 people
	Completion of crime rate (1/24)	Percentage completion crime
	Death from natural disasters (1/24)	Number of deaths due to natural disasters
Education and learning (1/4)	Literacy rate (1/20)	Percentage of literate people aged 15 years and over
	School participation rate (1/20)	School participation rate (7-12 years) (in percentage)
		School participation rate (13-15 years) (in percentage)
	Internet used rate (1/20)	Percentage of households ever accessing the internet in the last 3 months
	Ownership of computer (1/20)	Percentage of households owns computer
	Phone ownership (1/20)	Percentage of households owns fixed line telephone

Dimensions of Capabilities (weights)	Indicators (weights)	Unit of Measurement
Economic (1/4)	Per capita income (1/20)	Regional Gross Domestic Products (RGDP) by expenditure
	Unemployment rate (1/20)	Unemployment rate (in percentage)
	Gini ratio (1/20)	Gini ratio
	Poverty rate (1/20)	Percentage of poor population
	Foreign Direct Investment (FDI) (1/20)	FDI realization (in million US\$)
Housing (1/4)	Dwelling ownership status of own (1/16)	Percentage of households owns dwellings
	Improved sanitation (1/16)	Percentage of households who have access to improved sanitation
	Improved drinking water (1/16)	Percentage of households who have access to improved drinking water
	Access to electricity (source of lighting) (1/16)	Percentage of households with lighting source of state electricity

RESULT AND DISCUSSION

The descriptive statistics of the Multidimensional Poverty Index (MPI) scores for 33 provinces in Indonesia from 2010 to 2020 are presented in Table 2. The data show that, overall, Indonesia has experienced a reduction in multidimensional poverty over the past decade. The average MPI in 2010 was 0.513, with the maximum and minimum scores being 0.649 and 0.395, respectively. By 2020, the average MPI had gradually decreased to 0.368, with the maximum and minimum scores being 0.587 and 0.247, respectively.

Table 2. Descriptive Statistics of MPI

Year	Mean	Min	Max.	Std. Deviation
2010	0.513	0.395	0.649	0.054
2011	0.488	0.316	0.682	0.072
2012	0.464	0.294	0.657	0.070
2013	0.454	0.313	0.619	0.067
2014	0.445	0.278	0.609	0.070
2015	0.439	0.313	0.614	0.067
2016	0.421	0.272	0.673	0.070
2017	0.408	0.252	0.610	0.066
2018	0.396	0.255	0.581	0.061
2019	0.371	0.247	0.588	0.062
2020	0.368	0.247	0.587	0.060

Source: Authors' calculations

The trend of MPI for each province from 2010 to 2020 is illustrated in Figure 1 a-k. As shown in Figures 1a through k, all provinces in Indonesia have reduced their MPI. These results indicate that all dimensions and indicators used to construct

the MPI—including life and health, education and learning, economic conditions, and housing—have improved from 2010 to 2020. Based on the estimates, the most significant dimension for reducing the MPI in Indonesia is life and health, particularly the indicators related to deaths from natural disasters and malaria incidence. Another highly contributing dimension is housing, specifically access to electricity and improved drinking water.

These findings align with previous studies. For example, Wink Junior et al. (2024) found that floods may increase the likelihood of people falling into poverty. Meanwhile, Yang et al. (2024) concluded that reducing malaria prevalence in households has a causal effect on increased wealth, and that increased wealth, in turn, contributes to further reductions in malaria prevalence. Similarly, Handayani et al. (2024) suggested that expanding access to stable electricity has a significant impact on poverty alleviation. Additionally, Ladi et al. (2021) found that water availability plays a critical role in shaping human development in Iran.

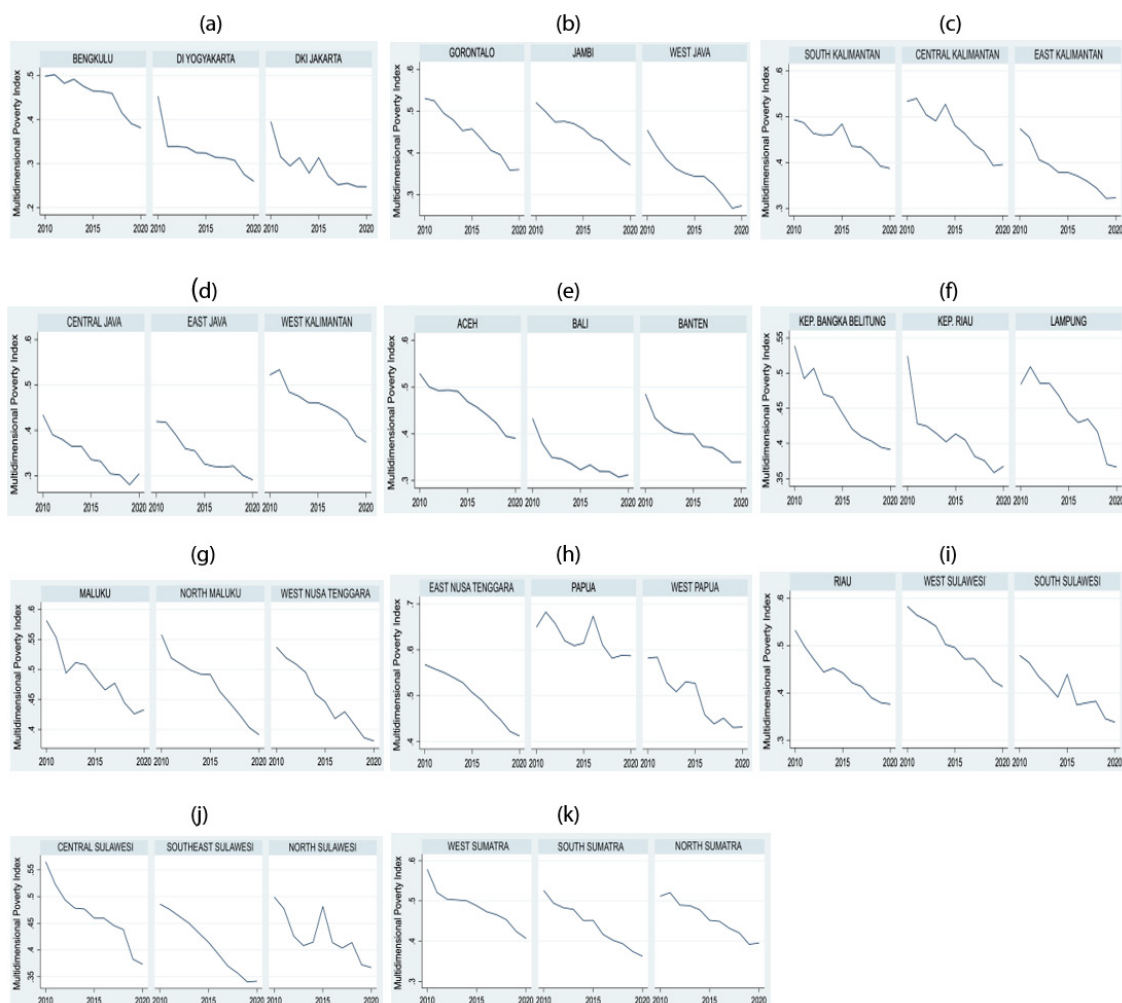
In 2010, around 14 provinces had MPI scores below 0.5, indicating lower levels of multidimensional poverty compared to the other 19 provinces. DKI Jakarta had the lowest MPI in 2010 (0.395), which decreased to 0.247 in 2020 (Figure 1). The observed reduction of approximately 37.48% in DKI Jakarta's MPI signifies a notable decline in multidimensional poverty (Figure 1a). This improvement can be attributed to several key factors, including enhanced access to healthcare, education, economic growth, and infrastructure development. Specifically, in the health and life dimension, DKI Jakarta has experienced an increase in life expectancy and a reduction in malaria incidence. According to Diwyarthi et al. (2023), improved accessibility to healthcare facilities is strongly associated with higher life expectancy and a better overall quality of life. In 2023, life expectancy in DKI Jakarta reached 73 years, the second highest among Indonesia's provinces (BPS, 2025). Moreover, since 2023, DKI Jakarta has been one of the five provinces in Indonesia to achieve malaria-free status (Jakarta Health Service, 2023).

As the economic powerhouse of Indonesia, DKI Jakarta has exhibited robust economic growth, with the economy expanding by 4.93% in the third quarter of 2024 compared to the same period in 2023 (BPS Jakarta, 2025). The city has also made significant investments in infrastructure development, including transportation networks, housing, and access to clean water, all of which are likely to have contributed to improvements in the overall quality of life. Novitasari et al. (2020) argue that infrastructure development—such as the expansion of roads, the establishment of additional hospitals, and improvements in waste management—has had a positive and significant impact on DKI Jakarta's GDP. Furthermore, improvements in sanitation and the expansion of junior high schools have likely contributed to enhanced living standards, as reflected in the region's rising Human Development Index.

A significant reduction in the MPI is also observed in other provinces, including DI Yogyakarta, West Java, and East Java (Figure 1a, b, and d). West Java, for instance, reduced its MPI from 0.455 in 2010 to 0.273 in 2020, representing a substantial decline of approximately 40% (Figure 1b). Similar to DKI Jakarta, this reduction suggests considerable improvements in key dimensions of poverty, particularly in the health and

life dimension, as well as the economic dimension. This finding aligns with O'Donnell (2024), who argues that poor health is a significant contributor to poverty, with income loss due to illness or disability being a more significant factor in driving poverty. In the cases of DI Yogyakarta and East Java, both provinces achieved MPI scores below 0.3 by 2020 (Figure 1a), indicating a notable reduction in poverty levels. This can be primarily attributed to advancements in the health and life dimensions, as well as improvements in the housing dimension. These findings are consistent with Sunde (2024), who emphasized that poverty is predominantly driven by the lack of basic services, including limited access to healthcare and inadequate sanitation.

Figure 1. The Pattern of The Multidimensional Poverty Index of Each Province in Indonesia During the Period of 2010-2020



Furthermore, the notable improvements in the education and learning dimension have made a significant contribution to poverty reduction in DI Yogyakarta. In contrast, the rapid economic growth in East Java has been a crucial factor in fostering poverty reduction within the province. Spada et al. (2023) and Hofmarcher et al. (2021) highlight that increasing education can have a large impact on reducing poverty. Meanwhile,

Balasubramanian et al. (2023) found that a 10% increase in GDP is associated with a reduction in multidimensional poverty of approximately 5%.

Table 3. Linear and non-linear association of climate change with MPI

Variable	Linear effect	Non-linear effect
Temperature	-0.013*** (0.002)	-0.202*** (0.078)
Temperature ²		0.004** (0.001)
Precipitation	0.004** (0.001)	0.019*** (0.007)
Precipitation ²		-0.001*** (0.005)
Region (Central)	0.042*** (0.011)	0.078*** (0.012)
Region (East)	0.154*** (0.018)	0.144*** (0.018)
Lat	-0.058*** (0.017)	-0.079*** (0.017)
Lat ²		-0.001** (0.000)
Long	-0.003*** (0.000)	-0.051*** (0.008)
Long ²		0.000*** (0.000)
Lat x Long	0.000*** (0.000)	0.000*** (0.000)
Constant term	1.129*** (0.110)	6.840*** (1.013)
Number of Observation	363	363
R-Squared	0.440	0.526
F-Statistics	39.90***	35.50***

Notes: Standard errors in parentheses. ****p*-value < 0.01

Despite the overall reduction in MPI, a substantial gap has become apparent between the provinces. In 2015, three provinces in the eastern region of Indonesia—East Nusa Tenggara (NTT), West Papua, and Papua—still had high MPI scores above 0.5 (Figure 1h). Papua Province, in particular, did not show substantial improvement, continuing to experience high multidimensional poverty in 2018 and 2020. The possible explanation can be attributed to several factors, including a very high incidence of malaria and a high prevalence of crime. Additionally, Papua Province continues to have lower rates of literacy, lower school participation, lower regional income, poorer sanitation, and limited access to electricity.

In addition to these results, sensitivity and robustness tests were conducted to determine whether the MPI changes substantially if specific indicators are omitted and to verify the stability of the MPI. For this analysis, an alternative MPI was estimated using only four indicators: life expectancy at birth, school participation rate (7–12 years), school participation rate (13–15 years), and regional gross domestic product (RGDP). The results confirmed similar findings, as both the MPI and the alternative MPI used for the robustness test were found to be strongly correlated. The correlation coefficient of 0.849 indicates that the estimated MPI is robust.

The estimation results of climate change, represented by temperature and precipitation, on multidimensional poverty, using pooled ordinary least squares and Equation (5), are presented in Table 3. In general, all the independent variables are significant at a 1% significance level. The results indicate that higher temperatures are associated with a reduction in multidimensional poverty, as indicated by the negative coefficient of the temperature variable. On the other hand, an increased level of precipitation could positively contribute to the rising multidimensional poverty. In this case, a 1 mm/day increase in precipitation may be associated with a 0.004-point rise in MPI. In terms of region, the results reveal that provinces located in the East and Central regions of Indonesia tend to have higher MPI compared to provinces located in the West region.

Table 4 presents the estimation results regarding the non-linear relationship between climate change and multidimensional poverty. The results indicate a non-linear relationship between climate change and multidimensional poverty. Specifically, it is observed that temperature is associated with the MPI in a U-shaped manner, while precipitation impacts MPI in an inverted U-shaped manner. The findings suggest that at lower temperature levels, an increase in temperature results in a significant reduction in multidimensional poverty.

However, this effect changes after a specific threshold temperature is reached. Beyond this point, further increases in temperature lead to an increase in multidimensional poverty. The regression analysis identifies this turning point at approximately 25.25°C. The impact of higher temperatures above this turning point on multidimensional poverty can be attributed to several factors, including reduced agricultural productivity, exacerbated health conditions, decreased labor productivity, increased energy costs, water scarcity, and extreme events such as droughts. Several previous studies, such as Saeed et al. (2022), have revealed that increased heat stress due to high temperatures can reduce workers' productivity and, in turn, lead to higher poverty rates.

On the other hand, this study reveals that higher levels of precipitation contribute to an increase in multidimensional poverty up to an optimal level. Beyond this optimal level, further increases in precipitation result in a reduction in the MPI. The turning point for precipitation is identified as 9.5 mm/day. These results imply that while higher precipitation can exacerbate poverty up to 9.5 mm/day, beyond this threshold, increased precipitation may help reduce poverty. The impact of precipitation on multidimensional poverty may be related to the occurrence of extreme events, such as flooding and sea level

rise, which are associated with high levels of precipitation. However, at specific points, increased precipitation improves water availability, which is essential for agriculture and drinking water supplies. Matsumoto et al. (2021) suggest that although regional GDP generally decreases due to climate change, some areas may experience an increase in GDP because of their comparative advantage.

Table 5 presents the estimation results for each indicator considered in the construction of the MPI, as shown in Table 1. In total, 19 indicators are used for the MPI calculation. However, the indicator of deaths from natural disasters is excluded from the estimation due to limited data availability. The results reveal several key findings.

First, the analysis indicates that temperature and precipitation exhibit distinct effects on the indicators of MPI, confirming the presence of a non-linear relationship with multidimensional poverty. Specifically, temperature generally demonstrates a U-shaped relationship with economic dimensions, including RGDP, unemployment rate, and FDI, as well as dwelling ownership. This pattern suggests that an initial increase in temperature reduces these indicators, but beyond a certain threshold, further increases result in improvements.

Conversely, temperature exhibits an inverted U-shaped relationship with life and health dimensions, including life expectancy rates and malaria incidence, as well as education dimensions (literacy rates, school participation rates, internet usage, computer ownership), the Gini ratio, improved sanitation, improved drinking water, and access to electricity. This result implies that an initial rise in temperature leads to increases in these indicators up to a certain point, after which further increases in temperature result in declines.

Third, while the effects of temperature are observed across all MPI indicators, the impact of precipitation is not uniformly distributed, particularly concerning its influence on the life and health dimension and the economic dimension. The analysis reveals that precipitation has an inverted U-shaped effect on the poverty rate, indicating that initial increases in precipitation improve these economic indicators until a certain optimal level is reached, beyond which further increases lead to deterioration. Meanwhile, precipitation shows a significant U-shaped relationship with most indicators in the education and learning dimension.

As a tropical country, Indonesia typically experiences an average minimum temperature of 22.8°C and a maximum of 30.2°C (World Bank, 2021). While the country may be able to adapt to temperature increases within this range, temperatures exceeding these typical levels can pose significant risks to human health, daily activities, and the environment. Prolonged heat beyond the usual range can exacerbate heat stress, which, in turn, affects labour productivity (Dasgupta et al., 2021; Liu et al., 2021) and public health, potentially leading to an increase in heat-related illnesses and even fatalities. Similarly, Roy (2024) suggests that an increase in the annual average temperature would lead to a decline in life expectancy at birth. Furthermore, the temperature rise will interact with the rainfall cycle, contributing to a further decline in life expectancy.

Table 5. Impact of Climate Change on MPI Indicators

Variable	Temperature	Temperature ²	Precipitation	Precipitation ²
Life and Health				
Life expectancy rate	0.817*** (0.188)	-0.016*** (0.003)	-0.022 (0.001)	0.003** (0.001)
Malaria incidence	0.345*** (0.115)	-0.007*** (0.002)	-0.010 (0.010)	0.000 (0.000)
Prevalence of crime	-0.016 (0.230)	0.000 (0.004)	-0.022 (0.021)	0.002 (0.002)
Completion of crime	0.123 (0.213)	-0.002 (0.004)	-0.009 (0.019)	0.001 (0.001)
Education and Learning				
Literacy rate	1.360*** (0.129)	-0.026*** (0.002)	-0.003 (0.012)	-0.000 (0.000)
School participation rate (7-12 years)	0.985*** (0.098)	-0.018*** (0.002)	-0.012 (0.009)	0.000 (0.000)
School participation rate (13-15 years)	1.342*** (0.192)	-0.025*** (0.004)	-0.055*** (0.017)	0.003*** (0.001)
Internet used rate	0.687** (0.342)	-0.012* (0.007)	-0.063** (0.031)	0.005** (0.002)
Ownership of computer	1.150*** (0.265)	-0.021*** (0.005)	-0.043* (0.042)	0.003* (0.002)
Phone ownership	0.171*** (0.182)	-0.003 (0.003)	-0.027 (0.016)	0.003** (0.001)
Economic				
Regional Growth Domestic Product	-0.409* (0.228)	0.008* (0.004)	0.028 (0.021)	-0.001 (0.001)
Unemployment rate	-0.587** (0.227)	0.011** (0.004)	-0.043** (0.021)	0.002*** (0.001)
Gini ratio	0.029** (0.215)	-0.000** (0.004)	0.017 (0.019)	-0.000 (0.001)
Poverty rate	0.007 (0.177)	-0.000 (0.003)	0.055*** (0.016)	-0.003*** (0.001)
FDI	-1.215*** (0.206)	0.023*** (0.003)	0.034* (0.019)	-0.002 (0.001)
Housing				
Dwelling ownership	-1.272*** (0.242)	0.025*** (0.005)	0.033 (0.016)	-0.002* (0.002)
Improved sanitation	0.552** (0.242)	-0.010** (0.005)	-0.087*** (0.022)	0.005*** (0.001)
Improved drinking water	0.611** (0.259)	-0.011** (0.005)	-0.076*** (0.024)	0.005*** (0.002)
Access to electricity	0.685*** (0.189)	-0.013*** (0.004)	-0.077*** (0.017)	0.005*** (0.001)

Note: ****p-value* < 0.01, ***p-value* < 0.05, **p-value* < 0.1, standard errors in parenthesis

Additionally, although Indonesia is highly vulnerable to natural disasters such as flooding, certain regions frequently experience droughts due to a lack of precipitation. This condition may impact water availability for agricultural, drinking, and sanitation purposes. In areas dependent on rain-fed agriculture, insufficient precipitation can lead to crop failures, severely impacting food production and availability. The decline in agricultural productivity not only threatens food security but also exacerbates poverty levels, as many rural communities rely on agriculture for their livelihoods.

The findings of this study underscore the multifaceted and complex relationship between climate change and multidimensional poverty in Indonesia. However, the impacts largely depend on the local context, the effectiveness of management strategies, and the ability to adapt to and cope with these challenges. For instance, in regions that rely heavily on agriculture, such as Papua and West Papua provinces, extreme temperature increases and droughts may reduce labour productivity, thereby lowering agricultural output and income. On the other hand, regions with stronger adaptive capacities—such as improved infrastructure in the western region of Indonesia—may experience less severe consequences from climate change.

CONCLUSION

This paper develops an alternative measurement of multidimensional poverty using the capability approach and explores the relationship between climate change and multidimensional poverty in Indonesia, utilizing secondary data from 33 provinces between 2010 and 2020. The findings show a general reduction in poverty across most provinces over the past decade. In 2010, approximately 57 percent of the provinces had high poverty levels, with MPI scores above 0.5. By 2020, almost all provinces had reduced their poverty levels below 0.5, except for Papua, which showed minimal improvement. The robustness of the MPI estimates for each province was confirmed.

Additionally, this study incorporated historical temperature and precipitation data for each province from 2010 to 2020 to assess their relationship with the MPI. The results reveal a significant non-linear relationship between temperature and precipitation, as well as multidimensional poverty. Temperature is associated with the MPI in a U-shaped manner, while precipitation is in an inverted U-shape.

Based on these findings, the government should focus on adaptation strategies tailored to regional conditions. Integrating multidimensional poverty measures into climate change policies is essential to address not only economic but also health, education, and housing dimensions of poverty. Investing in climate-resilient infrastructure and improving access to essential services will help reduce climate-induced disparities, thereby lowering the MPI. Promoting early warning systems and climate education will help reduce climate-induced losses, thereby decreasing the MPI in regions relying on natural resource-based livelihoods, such as agriculture and forestry, particularly in Papua and West Papua, where temperature is expected to increase while precipitation becomes increasingly unpredictable due to climate change.

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The Role of Economic and Social Safety Nets in Extreme Poverty in Indonesia

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JEL Classification:

I32

P46

Q01

Received: 14 May 2024

Revised: 20 April 2025

Accepted: 02 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study focused on addressing the goal of reducing extreme poverty (EP) to 0% by 2024 in Indonesia, an objective that has been underexplored in global literature.

Research Objectives: This study examined convergence in EP across Indonesia and analyzed the impact of economic as well as social variables on poverty reduction.

Research Methods: Panel data from 34 Indonesian provinces (2017–2022) were analyzed using Generalized Method of Moments (GMM) and K-means Cluster analysis for regional classification.

Empirical Results: The results showed that provinces in Indonesia were reducing EP at an annual rate of 1.19%, with a half-life of 1.6 years. This process signified that the country was on a path to achieve near-zero EP by 2024. Major socioeconomic drivers identified during the study included employment expansion and investments in education. Moreover, K-means Cluster analysis identified Cluster 1 (Central Sulawesi, North Maluku, Papua) with the highest EP rate of 1.52%, showing critical geographic disparities.

Implications: The Government should adopt a multilevel strategic framework prioritizing regions with the highest poverty rates. Job creation and better access to education played a crucial role. Additionally, Indonesia's success could serve as a model for sustainable EP eradication in developing nations.

Keywords:

extrem poverty reduction; socioeconomic factors; system GMM; K-means cluster analysis

How to Cite:

Setyadi, S., Indriyani, L., & Widiastuti, A. (2025). The Role of Economic and Social Safety Nets in extreme poverty in Indonesia. *Etikonomi*, 24(2), 653 – 672. <https://doi.org/10.15408/etk.v24i2.38851>.

INTRODUCTION

The eradication of extreme poverty (EP) is a critical global agenda under Sustainable Development Goals (SDGs), aimed to be achieved by 2030 (United Nations, 2015). EP is a condition where the welfare of a population is lower than that of the international line (US\$1.90 PPP). This issue has severe long-term consequences, particularly for the poorest communities worldwide. Data from 2018 showed that approximately 670 million people lived on less than \$1.90 per day (Manuel et al., 2020). A study by Fox et al. (2015) explained that 5.3% of the global population, or roughly 16.5 million individuals, were classified as extremely poor in 2011. Alston (2018), United Nations Special Rapporteur on EP and human rights, documented that 18.5 million Americans lived in acute poverty. More importantly, the World Bank estimates that 680 million people will remain in EP by 2030, an increase of 250 million compared to pre-pandemic projections (Manuel et al., 2020). These trends indicate that EP remains a significant global challenge despite concerted mitigation efforts.

Brady (2019) categorized the leading causes of poverty into three primary frameworks. Firstly, behavioral theory postulates that poverty stems from individual behaviors shaped by societal incentives and cultural norms. Secondly, structural theory describes poverty as an outcome of inequitable economic and social systems that constrain individual agency. Thirdly, political theory asserts that power dynamics and institutions play a major role in shaping poverty-related policies and influencing how individual behavior affects poverty outcomes.

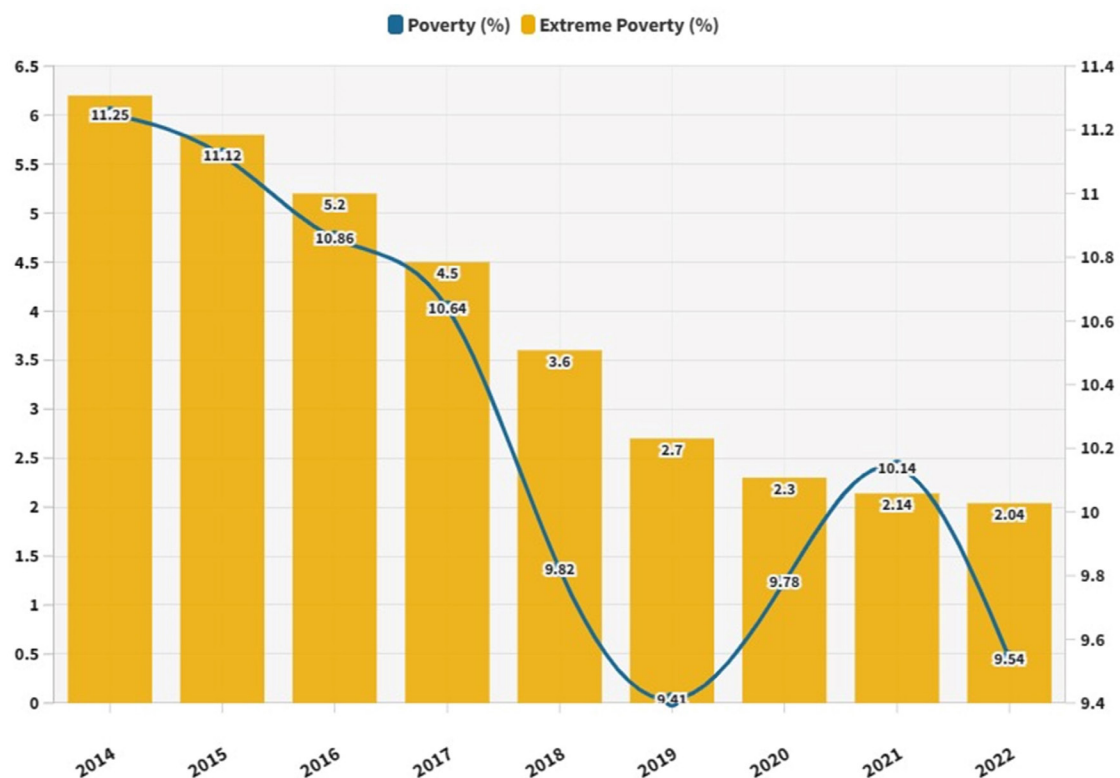
Indonesia aims to eliminate EP by 2024 through Presidential Instruction of the Republic of Indonesia No. 4/2022, as a nation committed to achieving the SDGs. Despite the steady decline of the poverty rate from 6.2% in 2014 to 2.04% in 2022, the COVID-19 pandemic has significantly slowed this progress (see Figure 1). Moreover, the most vulnerable groups in this kind of situation include individuals trapped in chronic poverty due to structural barriers, such as limited access to economic resources, education, and information.

Poverty is a multidimensional phenomenon caused by a lack of income or access to productive resources, and it is also closely connected to the assurance of survival, including the social status of communities within a broader context (UNDP, 2022). According to Cournane et al. (2015) and Chokkanathan and Mohanty (2017), one of the significant challenges faced by many developing countries is the disparity in social and economic status. To alleviate poverty, factors such as infrastructure, human resource development, access to employment, mobility, social representation, and social networks need to be improved (Anyanwu, 2017). As a result, studies have extensively examined the impacts of poverty and economic development. For instance, Hotez (2021) demonstrated that poverty would persist and have long-term consequences due to the COVID-19 pandemic. Hummel et al. (2015) explained that the increasing number of households falling into EP posed a burden on sustainable development.

Despite the extensive research on EP, several gaps remain in the existing literature. Previous studies have focused on the impact of economic growth on poverty, producing

contradictory results. Some studies have shown that economic growth can significantly reduce EP (Labidi et al., 2023; Anser et al., 2020; Anyanwu, 2017). However, investigation by Doe and Smith (2023) signified that economic growth in some developing countries did not automatically reduce poverty levels. This study found that factors such as income inequality, institutional quality, and resource distribution play a crucial role in determining how economic growth contributes to poverty reduction. The unequal distribution of economic gains diminished the significance of economic growth in reducing EP (Bolarinwa et al., 2021). Diverging from prior studies that assumed a direct link between economic growth and poverty reduction, this study systematically integrates income distribution, institutional quality, and redistributive policies as mediating mechanisms. Even though the relationship between economic growth and EP reduction has been widely explored, there is still a gap in understanding how the distribution of the growth benefits influences its effectiveness. Moreover, most studies tend to assume that economic growth automatically reduces poverty, often neglecting factors such as income inequality, access to resources, and redistributive policies.

Figure 1. Percentage of poverty and extreme poverty in Indonesia, 2014–2022 Source: Central Bureau of Statistics



Source: Central Bureau of Statistics

Studies on the role of social assistance and welfare programs in reducing EP have also produced inconsistent results, as Doe et al. (2023) found that social assistance significantly impacted poverty reduction. Additionally, allocating more healthcare resources

to low-income groups enables the poor to benefit more than higher-income groups (Anser et al., 2020). Some reviews suggest that while social assistance can improve the well-being of recipients, its long-term impact on poverty reduction is often limited, particularly without complementary programs such as improved access to education and employment (Banerjee et al., 2017; Hidrobo et al., 2018; Baird et al., 2018). These gaps highlight the need for further research on the contextual factors that influence the effectiveness of social assistance, including governance, transparency, and community engagement. Beside that, Saha and Qin (2023) conclude that financial inclusion has a negative association with extreme poverty in developing countries but not in high-income countries.

EP convergence is a process in which EP levels across regions or countries tend to approach a more balanced level over time. Previous studies have primarily examined the convergence of economic factors, including Gross Domestic Product (GDP) and income inequality, while EP convergence, particularly in regional contexts such as Indonesia, has rarely been explored. Diverging from prior studies that focused on macroeconomic convergence (e.g., GDP), this research pioneers the examination of EP convergence at the subnational level, employing advanced econometric techniques and spatial clustering, to capture Indonesia's unique regional disparities. The process creates a significant gap in the literature, showing the importance of understanding the dynamics of EP across regions to formulate more effective policies. Therefore, this study aims to address the gap by offering several novel contributions. Firstly, the investigation employs the Generalized Method of Moments (GMM) regression analysis, utilizing both first-difference and system GMM methods to model EP. This method allows studies to include lagged EP as an explanatory variable, capturing the dynamic nature of inequality and poverty. The method also addresses endogeneity issues commonly found in panel data models, producing more accurate and consistent estimates. Secondly, this study explores the concept of EP convergence, which has been rarely examined in previous literature. By analyzing EP convergence across regions in Indonesia, the analysis aims to understand the effectiveness of government efforts in reducing EP and achieving regional balance. The investigation also examines the impact of economic and social variables on EP convergence, providing a more comprehensive understanding of the factors influencing its reduction. Thirdly, this study employs K-Means Cluster analysis to group Indonesian provinces based on shared characteristics of EP. The method enables the identification of specific patterns of EP in each cluster, assisting the government in formulating more targeted policies. Consequently, this study makes a theoretical contribution to understanding the dynamics of EP and also provides practical recommendations for the government to accelerate the eradication of EP in the country.

METHODS

The data used in this study were sourced from the National Acceleration Program for Extreme Poverty Eradication, the Central Bureau of Statistics, and the Ministry of Finance. The dataset comprised panel data, cross-sectional data (34 provinces), and time-series data (2017–2022). Typically, this data enabled strong analysis of EP dynamics and

its determining factors over time. In the context of this study, the dependent variable in the analysis was EP, measured as the percentage of individuals with expenditures below the EP line (PPP-adjusted < US\$1.9 per day). Meanwhile, the independent variables were categorized into two groups: economic and social variables. Economic variables included economic growth (Growth), income inequality (Gini Index), and employment opportunity rate (Employment_Oppportunity). On the other hand, social variables comprised social assistance (Social_Costs), welfare (Welfare_Cost), healthcare (Health_Cost), and education expenditure (Education_Cost).

Table 1. Definition of Variables Used in the Analysis

Variable	Definition	Source
Dependent Variable		
Extreme_Poverty	Extreme Poor People (%): Individuals whose expenditures were beneath EP line, defined as purchasing power parity (PPP) less than US\$ 1.9 per day.	National Acceleration Program for Extreme Poverty Eradication, Coordinating Ministry for Human Development and Cultural Affairs
Independent Variable Economic		
Growth	Economic Growth (%): The total goods and services produced by a region over a specific period.	Central Bureau of Statistics
Gini	Income Inequality (Index): An indicator measuring disparities in income distribution among individuals or groups in a society.	Central Bureau of Statistics
Employment_Oppportunity	Employment Opportunity Level (%): The percentage of the working population compared to the total labor force.	Central Bureau of Statistics
Independent Variable Social		
Social_Costs	Social Assistance Spending (%): Government expenditures on direct assistance to vulnerable groups, including cash transfers, goods, or services.	Ministry of Finance
Welfare_Cost	Welfare Spending (%): Government expenditures on various programs and initiatives aimed at improving community welfare, including empowerment programs, job training, and infrastructure development.	Ministry of Finance
Health_Cost	Health Spending (%): Government expenditures on healthcare services for vulnerable or low-income groups.	Ministry of Finance
Education_Cost	Education Spending (%): Government expenditures to support access to and quality of education, particularly for children and adolescents from low-income families, including scholarships and school subsidies.	Ministry of Finance

Source: Calculation of Author

The analytical model was adapted from Manuel et al. (2020), as follows:

$$Extreme_Poverty = f(Economic, Social) \quad (1)$$

Where economic and social variables were analyzed to identify the determinants of EP. The definitions and data sources for each variable were shown in Table 1.

The dynamic panel data analysis method was used to estimate the convergence model using the GMM method. This method was selected due to the presence of a lagged dependent variable, namely EP, as an independent variable in the model specification. Endogeneity issues developed from dynamic relationships, leading to biased and inconsistent estimators when the model was analyzed using static panel data methods. Therefore, the model in this study was estimated using the dynamic panel data method with the GMM model, following the theory of Arellano and Bond with the first differences (FD-GMM) model. Since the GMM estimator in first differences has been criticized in the literature, system GMM (Sys-GMM) estimation proposes a theory that Blundell and Bond used as a system of equations estimated in first differences. Consequently, the evaluation of the dynamic panel data model using the system GMM model ensured unbiased, consistent, and valid criteria. To examine the impact of economic and social variables on EP, a GMM model was specified in Equation 2 as follows:

$$\begin{aligned} Extreme_Poverty_{it} - Extreme_Poverty_{it-1} = & \beta_0 + \beta_1 Extreme_Poverty_{it-1} + \beta_2 Growth_{it} + \\ & \beta_3 Gini_{it} + \beta_4 Employment_Opportunity_{it} + \beta_5 Social_Costs_{it} + \beta_6 Welfare_Costs_{it} + \\ & \beta_7 Health_Costs_{it} + \beta_8 Education_Costs_{it} + u_{it} \end{aligned} \quad (2)$$

Where $Extreme_Poverty = EP$, $Growth = Economic\ growth$, $Gini = Income\ inequality$, $Employment_Opportunity = Employment\ opportunity\ level$, $Social_Coast = Social\ assistance\ spending$, $Welfare_Coast = Welfare\ spending$, $Health_Coast = Health\ spending$, $Education_Coast = Education\ spending$, $\beta = Vector\ of\ predictor\ variable\ coefficients$, $t = Year$, $i = Province$, and $u = Error\ term$.

The behavior and characteristics of regions were examined to test the convergence hypothesis in empirical studies on β -convergence analysis. Previous studies on convergence had widely used both static and dynamic analyses to validate the hypotheses, leading to the conclusion that convergence studies were divided into two methods. These methods included σ -convergence (static analysis) and β -convergence (dynamic analysis), which predominantly applied GMM models. More importantly, convergence hypothesis generated significant interest, leading to extensive literature examining income convergence both in and across countries. To test the hypothesis of EP convergence in Indonesia, this study used a parametric method using β -convergence equation as follows:

$$Y_{it} = \frac{1}{T} \ln \left(\frac{Y_{it}}{Y_{it-1}} \right) = \frac{1}{T} \left[\left(\ln(Y_{it}) - \ln(Y_{it-1}) \right) \right] \quad (3)$$

Y_{it} in Equation 3 was subsequently used as dependent variable in Equation 4, as follows.

$$Y_{i,t} = \alpha - \beta \ln Y_{i,t-1} + \gamma X_{i,t-1} + u_{i,t-1} \quad (4)$$

$$-\beta = (1 - e^{-\lambda}) \text{ atau } e^{-\lambda} = 1 + \beta \quad (5)$$

Where, Y = dependent variable, X = explanatory variable, T = total number of observation periods, t = year, i = province, e = natural logarithm, and u = error term. The convergence process was observed when the coefficient of β was less than 1. Additionally, the speed of convergence, represented as λ , was derived from Equation 6. The speed estimated the rate at which EP approached a steady state. Moreover, half-life test in Equation 7 showed the time required to achieve steady-state condition of EP convergence or the time needed to reach half of EP convergence, expressed as τ .

$$\lambda = -\frac{\ln(\beta_1)}{T} \quad (6)$$

$$\tau = \frac{-\ln(0.5)}{-\ln(\beta_1)/T} = \frac{\ln(2)}{\lambda} \quad (7)$$

Where, λ = speed of convergence of EP, β_1 = coefficient of the lag of EP, T = total number of observation periods, and τ = half-life of convergence.

Subsequent analysis was conducted using K-Means Cluster method to identify provincial groupings based on similar characteristics (Jollyta et al., 2019). In this cluster analysis, provinces were grouped based on dimensions of EP, providing insights into EP in provinces in the same cluster and enabling comparisons in different cluster. Following the discussion, the clustering was defined by the following equation.

$$d(x_i, c_j) = \sqrt{\sum_{m=1}^n (x_{im} - c_{jm})^2} \quad (8)$$

Where x_i = feature vector of i-th data point, c_j = centroid vector of cluster j and n = number of features (dimensions of EP). This clustering method showed the highest and lowest levels of EP across 34 provinces of Indonesia, concerning government efforts to accelerate reduction of the poverty. Using K-Means Cluster method, the 34 provinces were grouped into three cluster, namely high, medium, and low.

RESULTS AND DISCUSSION

Table 2 shows the sample means for the variables used in this study. Generally, EP in several provinces remained high, signifying that the reduction of EP across regions had not been evenly achieved. Table 2 presents the sample means for economic indicators, including Gross Regional Domestic Product (GRDP), income inequality, and employment opportunities. Table 2 presents the social indicators, including social costs, welfare, health, and educational assistance.

Table 3 shows the results of bivariate analysis using GMM applied to social and economic indicators in combating EP across 34 provinces in Indonesia. In this Table, GMM estimation was conducted using two model methods, namely First Difference GMM (FD-GMM) and System GMM. During the analysis, tests were performed using the Sargan and Arellano-Bond tests to ensure the validity and consistency of the models

used to determine the best model. The results of these tests for both models are shown in Table 3, providing comprehensive information on the selection of the best model.

Table 2. Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Extreme_Poverty	204	5.5705	5.8109	0.03	37.0009
Growth	204	4.8008	5.3517	-15.74	43.58
lnGini	204	-1.0562	0.1147	-1.4439	-0.8209
lnEmployment_Opportunity	204	4.5513	0.0188	4.4892	4.5914
lnSocial_Cost	204	-1.1082	1.0319	-3.7161	1.9897
lnWelfare_Cost	204	4.0117	0.1053	3.6068	4.2912
lnHealth_Cost	204	2.6187	0.1751	2.0649	3.1542
lnEducation_Cost	204	3.1758	0.2528	2.0819	3.7576

Source: Calculation of Author

The FD-GMM model yielded a Sargan test statistic of 15.489, indicating that the FD-GMM estimator utilized invalid instruments. Moreover, Arellano-Bond test results for the FD-GMM model showed significance for AR(1) with a test statistic of -2.7469 and AR(2) of 2.0983. These results showed that the FD-GMM estimator was inconsistent, and further testing was conducted using the System GMM model. This inconsistency likely stems from the FD-GMM's inability to address persistent poverty dynamics, as lagged EP levels in rapidly changing economies like Indonesia may violate the assumption of weak exogeneity. The Arellano-Bond test for the System GMM model indicated that the AR(1) test statistic was significant at -1.6345, whereas the AR(2) test statistic was insignificant at 1.3278. This outcome showed that the System GMM estimator was consistent during the analysis. The System GMM superiority stems from its ability to incorporate both lagged levels and differences, thereby mitigating biases from unobserved heterogeneity—a critical advantage in analyzing dynamic poverty trends. The Sargan test result was insignificant, with a test statistic of 13.68982, indicating that the System GMM estimator was valid. The process concluded that the System GMM model was both valid and consistent. Therefore, the results of the dynamic panel data regression model specification test showed that the System GMM model was the best choice.

Convergence model results provided insights into several factors influencing the convergence of EP in Indonesia. Interventions aiming at these factors were necessary to accelerate the convergence process. These interventions focused more on regions with higher levels of EP to expedite the reduction of EP, accelerating the convergence process. The coefficient of the lagged EP variable, being less than one, indicated that the convergence process was linked to poverty reduction. Moreover, the outcome showed that the combined effect of social and economic factors accelerated the reduction of EP by 7.15% over six years, or 1.19% annually, with a measurable half-life of convergence.

This value implied that achieving a 0% EP would take approximately 9.69% of the required effort, or around 1.6 years.

The Sys-GMM estimation model in conditional β -convergence analysis was the best aggregate model for explaining the impact of economic and social factors on EP convergence in Indonesia. The coefficient of the economic growth variable (Growth) in the aggregate model was 0.022. Statistically, this result showed that the variable had a significant positive effect on accelerating the process of EP convergence in the country. However, this counterintuitive finding (where growth impedes EP reduction) mirrors Indonesia's uneven development pattern, characterized by urban-centric growth that widens rural-urban gaps. This process indicated that a 1% increase in economic growth slowed the convergence of EP reduction by 0.022% (*ceteris paribus*). Additionally, these results showed that economic growth accompanied by high and uneven income inequality, as well as structural disparities, delayed the process of EP reduction in Indonesia. This result aligns with Kuznets' inverted-U hypothesis, which posits that initial growth phases deepen inequality before eventually leading to redistribution, a stage that Indonesia has yet to fully navigate.

Table 3. Results of β -Convergence Model Estimation

Parameter	Dep. Var = EP	
	<i>First-differences GMM</i>	<i>System GMM</i>
Constant	-7.358 (0.214)	110.214* (0.017)
Extreme_Poverty _{t-1}	0.995*** (0.000)	0.958*** (0.000)
Growth	0.003 (0.234)	0.022* (0.016)
lnGini	-0.925 (0.084)	-13.009*** (0.000)
lnEmployment_Opportunity	1.084 (0.405)	-26.241** (0.010)
lnSocial_Costs	0.048 (0.249)	-0.213 (0.209)
lnWelfare_Cost	-0.145 (0.377)	-0.589 (0.274)
lnHealth_Cost	0.006 (0.920)	0.707* (0.046)
lnEducation_Cost	0.033 (0.536)	-1.8719634*** (0.000)
Implied λ	8.35	7.15
Half-life	8.30	9.69
Sargan Test	15.48874 (0.0168)	13.68982 (0.1876)
Arellano-Bond Test for AR(1)	-2.7469 (0.0060)	-1.6345 (0.021)
for AR(2)	2.0983 (0.0359)	1.3278 (0.1843)

Information: * p<0.05; ** p<0.01; *** p<0.001
Source: Author's Calculation

In underdeveloped countries, convergence of EP alleviation was reduced due to rapid national economic growth that widened the gap between urban and rural regions. This result supported the panel data analysis of 50 countries conducted by Garcia and Lopez (2023). Specifically, the study showed that GDP per capita growth significantly reduced the speed of poverty convergence, as the benefits of growth were intense among high-income groups. For Indonesia, resource-driven growth (e.g., palm oil, mining) disproportionately benefits corporations rather than impoverished communities, perpetuating spatial inequality. Santoso and Putri (2022) found that without redistributive policy interventions, economic growth delayed the convergence due to wealth accumulation among the elite. Aside from this, growth dependent on extractive sectors was negatively correlated with EP reduction due to limited job creation and unequal income distribution (Chen & Kim, 2023). Observations showed that economic growth alone was insufficient to reduce EP, except when supported by policies promoting equity and inclusivity.

This highlights the need to integrate pro-poor fiscal policies, such as land reform and progressive taxation, into growth strategies. This result implied that economic growth slowed the process of EP reduction convergence without appropriate policy interventions, particularly in countries with high income inequality, such as Indonesia. Therefore, policies focusing on income redistribution, inclusive growth, and the development of underdeveloped regions played a significant role in accelerating EP reduction.

Regression analysis in this study revealed that the coefficient of the income inequality variable (Gini) in the aggregate model was -13.009, indicating a significant negative effect on the acceleration of EP convergence in Indonesia. This magnitude highlights inequality as the single most significant impediment to poverty reduction; a 1% rise in the Gini coefficient erases over a decade of progress in EP alleviation. This outcome signified that a 1% increase in income inequality reduced the speed of EP convergence by -13.009% (*ceteris paribus*). Additionally, the result confirmed that high-income inequality substantially hindered efforts to alleviate EP. This phenomenon is exacerbated in Indonesia's patronage-driven political economy, where oligarchic structures divert resources from poverty programs. This phenomenon occurred because unequal resource distribution restricted the poorest groups from improving their welfare while also limiting capital formation and investment across various sectors.

The results supported the studies by Labidi et al. (2023), Polacko (2021), and Ochi et al. (2024), which found that income inequality exacerbates poverty by causing unequal income distribution. This situation caused vulnerable groups to remain in low-income conditions and trapped individuals in a cycle of poverty. For example, Java-Bali regions, which account for 60% of GDP, receive disproportionate investment, leaving Eastern Indonesia underdeveloped. Garcia and Lee (2022) found, in a panel data analysis of 50 developing countries, that states with high inequality tend to experience stagnation in poverty alleviation. Therefore, the government should implement fair redistribution policies, expand access to education, healthcare, and decent employment for vulnerable groups, and strengthen effective social assistance programs to accelerate EP convergence in Indonesia.

During this study, the coefficient of the employment opportunity variable (Employment_Opportunity) in the aggregate model was -26.241. The outcome signified that the variable had a significant negative effect on accelerating the process of EP convergence in Indonesia. The strong negative coefficient highlights job creation as the most effective lever for poverty reduction, particularly in labor-abundant regions such as Sumatra and Sulawesi. This process showed that 1% increase in employment opportunities accelerated the process of EP reduction convergence by -26.241% (*ceteris paribus*). Equitable employment opportunities in the country had a substantial impact and significant potential to accelerate EP convergence and improve total societal welfare. Labor-intensive sectors such as agriculture and SMEs, which employ 70% of the Indonesian workforce, must be prioritized to maximize this effect.

Moreover, increased job opportunities enabled individuals from various societal strata to earn decent incomes, improve their skills, and access basic services, including education and healthcare. The result supported Okojie and Shimeles (2022), who found that EP convergence in urban regions was specifically driven by sustainable job creation. Saifuloh et al. (2019) showed that employment opportunities in various sectors and the creation of self-reliant labor can reduce poverty, although individual studies did not analyze the convergence process.

The coefficient of the education cost variable (Education_Cost) in the aggregate model was -1.872. The result showed that the variable had a significant negative effect on accelerating the process of EP convergence in Indonesia. This result suggests that reducing educational expenses, particularly for marginalized groups, enhances human capital formation, breaking intergenerational poverty cycles. This outcome shows that 1% increment in education costs accelerated the process of EP reduction convergence by -1.872% (*ceteris paribus*). The result supported Smith & Johnson (2023), who found that educational assistance costs significantly influenced EP convergence, particularly in rural regions, as access to education improved individual skills and productivity, reducing dependence on social assistance.

Similarly, Brown and Davis (2022) found, through panel data analysis, that educational interventions had cumulative effects, with regions receiving consistent educational assistance experiencing a 2.3% annual reduction in EP. In Indonesia, regions like Papua and East Nusa Tenggara, with education access rates below 50%, require urgent investment in school infrastructure and scholarships. Studies by Spada et al. (2023) and Xie et al. (2023) have shown that higher investment in quality education for all citizens, including those in EP, significantly contributes to accelerating the eradication of EP. Following this discussion, the results showed the importance of sustained investment in education to achieve sustainable development objectives. Quality education improved individual skills and knowledge, which enabled better employment opportunities as well as higher incomes, breaking the cycle of EP.

The coefficient of the health cost variable (Health_Cost) in the aggregate model was 0.707. The result showed that the variable had a significant positive effect on accelerating the process of EP convergence in Indonesia. This statement signified that 1% increase in

health costs slowed the process of EP reduction convergence by 0.707% (*ceteris paribus*). The result showed that despite the implementation of health assistance programs, out-of-pocket expenses increased the financial burden on poor households, particularly in remote regions. Additionally, the WHO (2023) stated that approximately 0.4% of the population in Indonesia (over 1 million people) experienced catastrophic health expenditures, forcing individuals into EP due to their inability to access essential healthcare services. For example, maternal healthcare costs in rural Indonesia force families to sell assets, deepening poverty. Djulius et al. (2022) confirmed that health assistance programs, including Jaminan Kesehatan Nasional (JKN) and Program Keluarga Harapan, have a positive impact on both long-term health and education quality. However, the effectiveness of the programs was hindered by unexpected health costs, which continued to pose a financial shock for low-income families. As health and social assistance were critical components of poverty alleviation policies, high health costs as well as inefficient distribution systems delayed the convergence process. Expanding JKN coverage and subsidizing transportation to healthcare facilities in remote areas could mitigate this issue. Moreover, policy reforms targeting structural determinants, such as strengthening universal health coverage and controlling out-of-pocket expenses, were essential to accelerate EP eradication.

During the analysis, the coefficient of the social cost variable (*Social_Cost*) in the aggregate model was -0.213. This value showed that the variable had an insignificant negative effect on accelerating the process of EP convergence in Indonesia. The outcome indicated that a 1% increase in social costs accelerated the process of EP reduction convergence by 0.213% (*ceteris paribus*). Similarly, the coefficient of the welfare cost variable (*Welfare_Cost*) in the aggregate model was -0.589, showing an insignificant negative effect. The outcome indicated that a 1% increase in welfare costs speeds up the process of EP reduction convergence by 0.589% (*ceteris paribus*). This phenomenon is supported by recent studies by Rahman and Suryadarma (2023), who explained that social and welfare budget allocations do not significantly correlate with EP reduction in middle-income countries, such as Indonesia.

The study argued that social programs were ineffective because the activities failed to address the structural causes of poverty, such as unequal access to healthcare, rising living costs, and inadequate financial protection. This result was consistent with studies by Lake et al. (2023), Barrientos (2019), Samuda and Suprihartiningsih (2023), Wu et al. (2024), and Anyanwu (2017), which found that high social and welfare costs often failed to reach their intended aims due to inadequate data screening mechanisms. Social and welfare assistance did not significantly impact the eradication of EP, despite high expenditures. The statement highlighted the need for policy reforms to ensure more targeted and effective delivery of social assistance.

The study provided a comprehensive understanding of factors influencing EP convergence in Indonesia and policy implications necessary to accelerate poverty alleviation. First, the results concerning how economic growth slowed EP convergence showed that non-inclusive growth and high income inequality were significant barriers to convergence. This result aligns with the growth paradox framework, which posits that

economic progress in developing economies intensifies spatial disparities as investments cluster in urban and extractive sectors, leaving rural areas behind in terms of infrastructure and market integration. This result signified that economic growth policies alone were insufficient without income redistribution and equitable access to resources. Second, increased employment opportunities and investment in education significantly accelerated convergence, showing the importance of sustainable job creation as well as improved access to quality education, particularly in underdeveloped regions.

These findings suggest that human capital interventions are not only curative but also preventive, disrupting intergenerational poverty cycles by enhancing social mobility, which is often hindered by local patronage structures in regions such as East Java and Nusa Tenggara. Third, despite the implementation of health and social assistance costs, the effectiveness was hindered by high out-of-pocket expenses as well as inefficiencies. This failure reflects a policy dilemma in archipelagic nations: fiscal decentralization exacerbates allocation inefficiencies due to uneven institutional capacity, as seen in the disparity of JKN healthcare implementation between Jakarta and Papua. Therefore, Indonesia needed to develop more comprehensive and integrated policies, such as strengthening universal health coverage, increasing funding for education and skills training, and implementing more targeted social assistance programs. A transformative approach is required, integrating ecological dimensions, for instance, reallocating fuel subsidies to green investments in poverty-prone areas like Central Kalimantan, which suffers from deforestation while empowering traditional institutions to enhance program accountability. The government should focus on advancing underdeveloped regions by promoting inclusive local infrastructure and economic investments in addition to the mentioned policies.

Figure 2. K-Means Cluster Analysis

Source: Calculation of Author

K-Means Cluster analysis of EP across 34 provinces in Indonesia in 2022 grouped the provinces based on economic growth, income inequality, employment opportunities, social costs, welfare, health, and education assistance. The clustering was performed using RStudio, grouping provinces with similar characteristics. Additionally, the number of clusters was determined using the silhouette method to ensure optimal clustering. The analysis revealed that provinces with similar characteristics tended to cluster together, indicating consistent patterns in the distribution of poverty across Indonesia. A previous study by Nasution et al. (2020) also found that the K-Means algorithm identified complex poverty patterns and assisted in designing more targeted policies. Figure 2 shows the final clustering results.

Table 3 shows the clustering result to facilitate the analysis of each cluster category. Based on the clustering outcomes, Cluster 3 had the most provinces, with a total of 16, while Cluster 1 had the fewest, consisting of only three provinces. Distribution of provinces across clusters included Cluster 1 (3 provinces), Cluster 2 (15 provinces), and Cluster 3 (16 provinces). The dominance of Cluster 3 (low EP) in Java-Bali and Sumatra reflects the success of centralized development policies. At the same time, Cluster 1 (high EP) is concentrated in eastern Indonesia, which faces geopolitical challenges, including resource conflicts in Papua and the geographic isolation of North Maluku.

Table 3. Clustering Results

Cluster	EP (%)	Number of Provinces	Category
1	1.52	3	High
2	0.97	15	Medium
3	0.54	16	Low

Source: Calculation of Author

During the study, Cluster 1 showed the highest EP rate in Indonesia, at approximately 1.52%, with Central Sulawesi at 0.27%, North Maluku at 0.71%, and Papua at 3.57%, respectively. Papua EP rate, 12 times higher than the national average (0.28%), underscores systemic failures in fiscal decentralization and the marginalization of indigenous communities, where 80% of special autonomy funds remain unabsorbed due to corruption and weak bureaucratic capacity. These data were shown in Figure 2, Appendix B, and Table B1. The K-Means clustering results indicated that the provinces were divided into three clusters based on EP levels, namely low, medium, and high. This clustering assisted the government in formulating policies to accelerate the reduction of EP to zero %, based on EP rates in each province. The process aimed to develop collaborative strategies among regional governments to improve community welfare, particularly in accelerating the convergence of EP to zero % in the country.

In Cluster 1, the implementation of pilot projects for EP focused on regions with the highest poverty rates, requiring immediate intervention. These pilot projects

emphasized the integration of programs, including improving access to education and healthcare, economic empowerment through skills training and job creation, as well as the provision of basic infrastructure to support daily life. The multilevel policies implemented in these projects involved close coordination among central, provincial, and district/city governments. By implementing this strategy, an effective model would be created, which could be replicated in other regions to accelerate the eradication of EP across Indonesia.

CONCLUSION

In conclusion, Indonesia has prioritized the eradication of EP as a major objective in achieving SDGs. This study showed that the accelerated eradication of EP in the country was highly achievable by 2024. Using a conditional β -convergence method with the System GMM model, the analysis found that a model incorporating social and economic variables accelerated the reduction of EP by 1.19% annually. This outcome implied that approximately 1.6 years were needed to achieve the objective of eradicating EP in Indonesia. Economic factors, including growth, income inequality, and employment opportunities, significantly impacted efforts to reduce EP. Similarly, social factors, such as education and access to healthcare, played a crucial role. Regions with the highest EP levels, such as Central Sulawesi, North Maluku, and Papua, recorded the highest poverty rate of 1.52%, which required urgent intervention.

Effective policy recommendations to accelerate the eradication of EP in Indonesia included the following factors. First, encourage inclusive economic growth accompanied by income redistribution and equitable access to resources to reduce inequality. Second, increase sustainable job opportunities and invest in quality education, particularly in underdeveloped regions, to accelerate poverty convergence. Third, strengthen universal health coverage by reducing out-of-pocket expenses and enhancing the effectiveness of social assistance through more targeted interventions. Fourth, prioritize the incorporation of development programs in underdeveloped regions, including improvements in basic infrastructure, skills training, and local economic empowerment. Building this discussion, implementing coordinated multilevel policies between central and local governments, specifically in priority regions such as Central Sulawesi, North Maluku, and Papua, would form replicable models to help eradicate EP by 2024 and support the achievement of the 2030 SDGs.

This study recommends that future studies adopt a more holistic approach to address EP, considering socioeconomic factors, as well as environmental, cultural, and public policy dimensions that influence poverty. Additionally, comparative studies with other countries sharing similar characteristics with Indonesia would be essential to enrich insights and strategies for EP eradication.

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Appendix B

Cluster 1	Cluster 2	Cluster 3
1. Southeast Sulawesi	1. Aceh	1. North Sumatra
2. North Maluku	2. Riau	2. West Sumatra
3. Papua	3. South Sumatra	3. Jambi
	4. Bengkulu	4. Lampung
	5. Bangka Belitung	5. Riau Islands
	6. Bali	6. Jakarta
	7. Central Kalimantan	7. West Java
	8. South Kalimantan	8. Central Java
	9. East Kalimantan	9. Yogyakarta
	10. North Kalimantan	10. East Java
	11. North Sulawesi	11. Banten
	12. South Sulawesi	12. West Nusa Tenggara
	13. Gorontalo	13. East Nusa Tenggara
	14. Maluku	14. West Kalimantan
	15. West Papua	15. Southeast Sulawesi
		16. West Sulawesi

Source: Author's Calculations

Sustainability and Loyalty in Halal Tourism: An Indonesian Perspective

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JEL Classification:

M31

O35

Q56

Z32

Received: 17 March 2025

Revised: 14 May 2025

Accepted: 17 May 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study introduces new behavioral dimensions, including environmental awareness, ethical service innovation, and tourists' decision control, in the formation of loyalty and advocacy behavior.

Research Objectives: This study examines the contribution of sustainability-oriented factors to Muslim tourist loyalty and recommendation behavior, with satisfaction and intention to revisit serving as mediating variables.

Research Methods: A quantitative approach was employed using a structured questionnaire distributed to 460 Muslim tourists. The data were analyzed using structural equation modeling to evaluate the causal relationships among the variables.

Empirical Results: Environmental awareness and tourists' ability to make ethical decisions have a significant influence on loyalty and word-of-mouth behavior. Ethical service innovation enhances customer satisfaction, which in turn contributes to loyalty. Satisfaction and revisit intention were found to be essential mediators in this relationship.

Implications: This study provides theoretical insights by integrating sustainability into halal tourism behavior models and offers practical recommendations for destination managers to develop emotionally engaging and environmentally responsible tourism services.

Keywords:

sustainable service innovation; sustainability awareness; perceived behavioral control; tourist loyalty; word of mouth

How to Cite:

Sukma, A., Chen, R., Rachmat, R. A. H., & Saputera, D. (2025). Sustainability and Loyalty in Halal Tourism: An Indonesian Perspective. *Etikonomi*, 24(2), 673 – 692. <https://doi.org/10.15408/etk.v24i2.45458>.

INTRODUCTION

Tourism is experiencing a paradigmatic shift from mass-market consumption to more sustainable, value-driven experiences. Within this transformation, halal tourism has emerged as a dynamic and rapidly growing segment, integrating Islamic ethical principles with environmental and socio-cultural responsibility (Hamaguchi, 2019; Sorokina et al., 2022). Unlike conventional tourism that focuses solely on service or leisure, halal tourism prioritizes Sharia-compliant elements—such as halal food, prayer facilities, and gender-sensitive services—while also responding to increasing demands for sustainability, community inclusion, and local authenticity (Alimusa et al., 2023; Fauzi & Battour, 2025). In Indonesia, the world's largest Muslim-majority country, halal tourism is growing rapidly, contributing over 40 trillion rupiahs in foreign exchange earnings in 2018 and recording an 18% increase in tourist arrivals (Jung et al., 2024; Layali & Suriani, 2022).

At the policy level, the Sustainable Development Goals (SDGs), especially Goal 11, call for a more inclusive, resilient, and sustainable approach to tourism. For halal destinations, this implies a shift from mere compliance with religious norms to broader innovation in sustainable services, technological adoption, and community-based tourism models (Mathivathanan et al., 2022; Sharma et al., 2021). Mahran et al. (2025), Ferraris et al. (2020), and Kumar et al. (2021) emphasized that tourism innovation must reflect both local identity and environmental stewardship to remain competitive and socially relevant.

Scholarly discourse on loyalty in halal tourism remains divided. One perspective prioritizes religious adherence and Sharia certification as the main predictors of tourist satisfaction and loyalty (King et al., 2019; Layali & Suriani, 2022). Another strand highlights psychological and behavioral factors, such as sustainability awareness and tourists' ability to make ethical travel decisions, as stronger predictors of loyalty and advocacy (Al-Ansi et al., 2019; Guyader et al., 2019; Subchi et al., 2024). These conflicting views highlight an important theoretical gap: the absence of an integrative model that captures both value-based and compliance-based drivers of loyalty in halal tourism.

Recent empirical studies lend support to this evolving view. Sarassina et al. (2023) found that tourists with high sustainability awareness exhibit stronger intentions to revisit and recommend destinations aligned with their environmental values. Seegebarth et al. (2023) demonstrate that perceived behavioral control has a significant influence on sustainable consumption when individuals feel empowered and supported (Domi et al., 2019; Font et al., 2021). However, such behavioral insights are still underutilized in halal tourism research, which often underrepresents constructs such as sustainability awareness, innovation, and behavioral control.

Moreover, mediating variables such as tourist satisfaction and revisit intention are acknowledged in tourism literature but rarely analyzed within a sustainability framework in halal tourism contexts (Qiu et al., 2023). Petrova et al. (2021) recognized the role of community-based tourism in enhancing satisfaction but failed to explain how such satisfaction leads to loyalty through behavioral mediators.

In light of these observations, this study identifies three clear research gaps. First, there is limited empirical integration of sustainability-oriented constructs—such as sustainability awareness, service innovation, and behavioral control—into behavioral loyalty models for halal tourism. Second, the mediating roles of psychological constructs such as perceived value, tourist trust, satisfaction, and revisit intention remain theoretically underexplored. Third, most halal tourism studies overlook the Indonesian context, where the industry is expanding rapidly but lacks integrative empirical models (Fang-ming et al., 2023).

To address these gaps, this research makes three key contributions. First, it introduces sustainability awareness, ethical innovation, and perceived behavioral control into a unified framework for halal tourism loyalty. Second, it examines how value perception and satisfaction mediate behavioral outcomes, such as revisiting intention, loyalty, and word-of-mouth. Third, it grounds the model in the Indonesian halal tourism sector, contributing regional insights to a globally relevant discourse.

Accordingly, the objectives of this study are: (1) to analyze the effect of sustainable service innovation, halal service quality, destination image, and sustainability awareness on revisit intention, loyalty, and word-of-mouth; (2) to evaluate the mediating roles of perceived value, tourist trust, satisfaction, and perceived behavioral control; and (3) to offer strategic recommendations for tourism stakeholders seeking to align Islamic ethics with sustainability-driven innovation.

METHODS

This study employs a quantitative, explanatory research design using a cross-sectional approach to assess the causal relationships among sustainable service innovation, sustainability awareness, perceived behavioral control, and tourist loyalty within the Indonesian halal tourism sector. The theoretical framework is grounded in the Theory of Planned Behavior (TPB) and extended to incorporate sustainability-oriented constructs (Hasan et al., 2020; Rao et al., 2022). This design is well-suited for testing theoretical models, quantifying perceptions, and identifying behavioral predictors through standardized measurement. Data were collected via a structured online questionnaire disseminated through social media platforms, tourism communities, and academic mailing lists. The online format enabled broad geographic reach and efficient data collection, particularly in the context of post-pandemic travel recovery. A pre-test was conducted to ensure clarity, linguistic appropriateness, and content validity (Berhanu & Raj, 2020; Prasetyo et al., 2021).

The population of interest comprises Indonesian Muslim tourists who engaged in halal tourism activities within the past 12 months. A purposive sampling technique was employed to select respondents who had experience in visiting halal tourism destinations in Indonesia. The inclusion criteria were as follows: (1) Muslim identity, (2) age 18 years or above, and (3) having visited at least one halal-certified tourism destination in the past 12 months. This ensured that the respondents were relevant and had adequate knowledge to assess the

constructs under study. This sample size meets the minimum threshold recommended for Partial Least Squares Structural Equation Modeling (PLS-SEM), which requires a sample size of at least 10 times the number of the most complex structural paths in the model (Hair et al., 2019). The demographic profile of the sample—diverse in terms of gender, age, occupation, income, and travel frequency—enhances the generalizability of the findings within the context of the Indonesian halal tourism market.

Data were collected using a structured questionnaire administered through both online and offline platforms. Online distribution was facilitated via Google Forms and disseminated through social media channels, targeting individuals who had participated in halal tourism. Offline data collection was conducted at selected halal tourism destinations across Indonesia, where respondents were approached in person and provided with printed copies of the questionnaire. A pilot test involving 30 respondents was conducted prior to full-scale data collection to ensure the clarity and reliability of the questionnaire items. Based on the feedback received, minor revisions were made to enhance clarity and reduce potential ambiguity. To ensure the authenticity of responses, the questionnaire was preceded by an informed consent form detailing the research objectives, confidentiality assurances, and the voluntary nature of participation. Respondents were assured that their identities would remain anonymous and that their responses would be used exclusively for academic purposes.

The measurement of variables in this study is based on validated constructs from previous literature, using a 5-point Likert scale ranging from 1 (Strongly Disagree) to 5 (Strongly Agree). Sustainable Service Innovation was measured using six indicators adapted from Petrova et al. (2021) and Layali & Suriani (2022), covering eco-friendly practices, community engagement, and technological advancements. Halal Service Quality consisted of six items adapted from Alimusa et al. (2023) and Subchi et al. (2024), focusing on reliability, assurance, and halal compliance. Destination Image was measured using five indicators from Kuhzady et al. (2020) and Zouni et al. (2020), which capture cognitive, affective, and conative perceptions of the destination. Sustainability Awareness comprised four items adapted from Sarassina et al. (2023) and Noor et al. (2021), reflecting knowledge and behavioral intentions related to sustainable tourism practices.

Perceived value was assessed using four items derived from Hu et al. (2021) and Baker et al. (2020), encompassing functional, emotional, and economic value dimensions. The Tourist Trust included four items from Ferraris et al. (2020) and Petrova et al. (2021), which measured trust in service providers and the credibility of destination-related information. Tourist Satisfaction was measured using three indicators from Tešin et al. (2023) and Rasoolimanesh et al. (2022), focusing on overall satisfaction and satisfaction with specific service aspects. Perceived Behavioral Control consisted of four items adapted from Tsang et al. (2022) and Seegebarth et al. (2023), related to self-efficacy and resource availability.

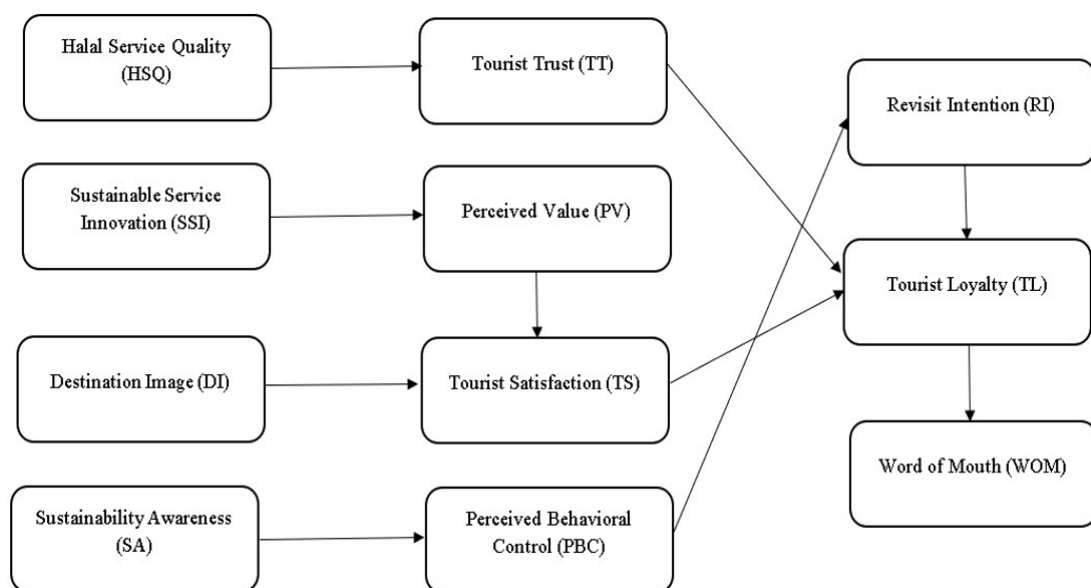
Tourist Loyalty was measured with three items from Layali & Suriani (2022) and Alimusa et al. (2023), assessing both behavioral and attitudinal loyalty. Revisit intention

was measured using four items adapted from Subchi et al. (2024) and Mohamed et al. (2022), addressing overall revisit intention, satisfaction influence, cultural and emotional connections, and word-of-mouth influence. Finally, Word of Mouth (WOM) was assessed using three items adapted from Sarassina et al. (2023) and Noor et al. (2021), which focused on tourists' intentions to share either positive or negative experiences.

Data were analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM) via SmartPLS 3.0. PLS-SEM was selected for its suitability in exploratory research, its ability to handle non-normal data, and its strong predictive capabilities. The analytical process consisted of two stages (Hair et al., 2021). First, the measurement model was evaluated to assess construct reliability using Cronbach's alpha and composite reliability, convergent validity through average variance extracted (AVE), and discriminant validity using both the Fornell–Larcker criterion and the Heterotrait–Monotrait (HTMT) ratio. Second, the structural model was tested by examining path coefficients, t-values, and p-values through bootstrapping with 5,000 samples. Model fit was further assessed using R^2 , f^2 , Q^2 , and the Standardized Root Mean Square Residual (SRMR) index (Hair et al., 2024).

This study proposes a framework that connects sustainability-driven services and destination quality to the behavioral outcomes of Muslim tourists. Sustainable service innovation, halal service quality, destination image, and sustainability awareness serve as independent variables. These influence perceived value, tourist trust, satisfaction, and perceived behavioral control as mediators. The framework then leads to revisiting the concepts of intention, tourist loyalty, and word-of-mouth behavior. The model reflects both direct and indirect relationships, capturing how value perceptions and emotional responses shape long-term engagement. It highlights that loyalty and advocacy in halal tourism are formed through a combination of service excellence, ethical awareness, and psychological empowerment.

Figure 1. Conceptual Framework



RESULTS AND DISCUSSION

Table 1 presents the demographic and behavioral characteristics of the respondents who participated in this study. A total of 460 valid responses were obtained from Muslim tourists with prior experience in halal tourism in Indonesia. The majority of respondents were male (52.17%), aged between 21 and 30 years (39.13%), and single (50%). Most held a bachelor's degree (54.35%) and were employed as professionals (39.13%). In terms of income, the most significant proportion of respondents earned between IDR 5–10 million per month (43.48%). Nearly all respondents were Indonesian nationals (93.48%) and identified as Muslim (95.65%).

Table 1. Attributes of Review Respondents

Respondent Attributes	Categories	Frequency (N)	Percentage (%)
Gender	Male	240	52,17
	Female	220	47,83
Age	< 20	30	6,52
	21 - 30	180	39,13
	31 - 40	140	30,43
	41 - 50	70	15,22
	> 50	40	8,7
Marital Status	Single	230	50
	Married	220	47,83
	Others	10	2,17
Educational Level	High School	100	21,74
	Bachelor's Degree	250	54,35
	Master's Degree	80	17,39
	Doctoral Degree	30	6,52
Occupation	Student	150	32,61
	Professional	180	39,13
	Entrepreneur	80	17,39
	Retired	20	4,35
	Others	30	6,52
Income Level	< IDR 5 million	160	34,78
	IDR 5-10 million	200	43,48
	> IDR 10 million	100	21,74
Nationality	Indonesian	430	93,48
	Others	30	6,52
Religion	Islam	440	95,65
	Others	20	4,35

Respondent Attributes	Categories	Frequency (N)	Percentage (%)
Frequency of Travel	Rarely (1-2 times/year)	140	30,43
	Occasionally (3-5 times/year)	200	43,48
	Frequently (>5 times/year)	120	26,09
Experience with Halal Tourism	Yes	350	76,09
	No	110	23,91
Awareness of Sustainable Tourism	Low	80	17,39
	Moderate	240	52,17
	High	140	30,44
Trust in Halal Certification	Low	50	10,87
	Moderate	260	56,52
	High	150	32,61
Satisfaction Level	Very Dissatisfied	10	2,17
	Dissatisfied	30	6,52
	Neutral	90	19,57
	Satisfied	200	43,48
	Very Satisfied	130	28,26
Loyalty Intention	Yes	380	82,61
	No	80	17,39

Source: Author's Calculation Results.

Regarding travel frequency, 43.48% reported traveling occasionally (3–5 times per year). A significant majority (76.09%) had prior experience with halal tourism, while 52.17% reported a moderate level of awareness regarding sustainable tourism practices.

When asked about trust in halal certification, most respondents reported a moderate level of trust (56.52%). Satisfaction levels were generally high, with 43.48% indicating satisfaction and 28.26% stating they were very satisfied with their halal tourism experiences. Furthermore, 82.61% of respondents expressed loyalty intentions, indicating a strong likelihood of revisiting or recommending halal tourism destinations.

Table 2 presents the results of the measurement model (outer model) analysis using the Partial Least Squares Structural Equation Modeling (PLS-SEM) framework. The evaluation follows established criteria, including outer loadings, Cronbach's alpha, composite reliability (CR), and average variance extracted (AVE). Outer loadings measure the strength of association between indicators and their respective constructs, with values above 0.70 indicating satisfactory indicator reliability. The results show that most indicators meet this criterion. For example, CRM1 (0.925), CRM3 (0.938), and CRM4 (0.923) exhibit strong loadings, demonstrating their substantial contribution to the Halal Service Quality (HSQ) construct. Although some indicators—such as CI1 (0.738) and CI2

(0.757) for the Destination Image (DI) construct—have comparatively lower loadings, they still exceed the minimum acceptable threshold.

Table 2. Analyses of the External Model

Construct / Item	Loadings	Alpha	CR	AVE
Halal Service Quality (HSQ)		0.958	0.966	0.827
Consistent provision of halal-certified products.	0,925			
Provision of halal procedure guidelines at service points.	0,811			
Staff competence in halal service provision.	0,938			
Transparency in communicating product halal status.	0,923			
Availability of proper worship facilities in tourist areas	0,926			
Timeliness in service delivery and food presentation	0,926			
Destination Image (DI)		0.790	0.855	0.541
Knowledge of the destination's main attractions.	0,738			
Availability of facilities that support Muslim travelers	0,757			
Feeling safe and comfortable while in the destination	0,744			
Emotional attachment to local culture.	0,703			
Intention to recommend the destination to others.	0,735			
Sustainability Awareness (SA)		0.956	0.968	0.884
Awareness of destination waste management efforts.	0,941			
Awareness of destination conservation initiatives.	0,939			
Intention to choose destinations with green practices	0,947			
Willingness to participate in conservation activities	0,933			
Sustainable Service Innovation (SSI)		0.949	0.959	0.796
Use of renewable energy in tourism operations.	0,919			
Provision of eco-friendly water management facilities.	0,906			
Community training for tourism services.	0,906			
Tourism-community partnership for sustainability.	0,851			
Use of digital apps for streamlined reservations.	0,860			
Safe and efficient cashless payment system	0,910			
Tourist Trust (TT)		0,867	0,909	0,716
Trust in the information provided by the destination	0,848			
Clarity and openness in the delivery of information	0,908			
Confidence in the credibility of the service provider	0,833			
Perceived provider integrity in quality maintenance.	0,791			
Tourist Satisfaction (TS)		0,717	0,841	0,638
Perceived provider integrity in quality maintenance.	0,776			
Satisfaction with the quality of service received	0,797			
Satisfaction with service quality.	0,822			

Construct / Item	Loadings	Alpha	CR	AVE
Perceived Behavioral Control (PBC)		0,783	0,857	0,600
Confidence in planning and executing the trip	0,817			
Ability to face challenges during the journey	0,788			
Availability of information about the destination	0,716			
Adequate facility support during the journey	0,776			
Perceived Value (PV)		0,897	0,928	0,764
Service quality that meets travelers' expectations	0,866			
Ease of accessing the facilities provided	0,876			
Travelers' perception of the price of services offered	0,875			
Availability of tour packages that offer value for money	0,878			
Revisit Intention (RI)		0,861	0,907	0,712
I intend to return to this destination in the future	0,913			
Planned or considered a return visit.	0,900			
Strong emotional connection to the destination.	0,828			
Likely to revisit with promotional offers.	0,720			
Word of Mouth (WOM)		0,819	0,894	0,740
Tendency to share positive experiences on social media	0,742			
Willingness to recommend the destination.	0,913			
Reluctance to spread negative information	0,913			
Tourist Loyalty (TL)		0,765	0,865	0,681
Intention to return to the same destination	0,860			
Frequency of return visits that have been made	0,833			
Propensity to recommend the destination to others	0,781			

Source: Author's Calculation Results.

Internal consistency reliability, as assessed by Cronbach's alpha, shows that all constructs surpass the recommended value of 0.70. Constructs such as HSQ (0.958), Sustainability Awareness (SA) (0.956), and Revisit Intention (RI) (0.861) demonstrate strong internal consistency, indicating that the items within each construct reliably measure the same underlying concept. These findings are further supported by composite reliability values, all of which exceed the 0.70 benchmark. For instance, HSQ and SA yield CR values of 0.966 and 0.968, respectively, confirming their reliability. Convergent validity is also confirmed through AVE results, with most constructs exceeding the acceptable threshold of 0.50. Constructs such as HSQ (0.827), SA (0.884), and RI (0.712) demonstrate that their indicators explain a substantial proportion of variance. The DI construct, while exhibiting a lower AVE of 0.541, remains within acceptable limits.

Overall, the measurement model demonstrates satisfactory reliability and validity. However, to further improve measurement quality—particularly for the DI construct—it

may be advisable to review or eliminate indicators with comparatively lower loadings. Furthermore, additional analysis, such as discriminant validity testing, is recommended to ensure that each construct is conceptually distinct from the others.

Table 3 presents the results of the discriminant validity analysis using the Fornell–Larcker criterion, which evaluates whether each construct in the model is empirically distinct from the others. Discriminant validity is established when the square root of the Average Variance Extracted (AVE) for each construct—represented by the diagonal values—is greater than its correlations with any other construct in the model. The analysis confirms that all constructs satisfy this criterion. For instance, the diagonal value for Destination Image (DI) is 0.735, which exceeds its correlations with other constructs, indicating adequate discriminant validity. Similarly, constructs such as Halal Service Quality (HSQ), with a square root of AVE of 0.909, Sustainability Awareness (SA), with 0.940, and Sustainable Service Innovation (SSI), with 0.892, also demonstrate satisfactory discriminant validity.

However, a few constructs exhibit relatively high inter-construct correlations that merit further scrutiny. For example, the correlation between Revisit Intention (RI) and Word of Mouth (WOM) is 0.912, which, while still below the square root of their respective AVEs, indicates a strong relationship that may suggest potential conceptual overlap. Similarly, the correlation between Sustainability Awareness (SA) and Perceived Value (PV) is 0.883; however, their discriminant validity remains acceptable as their AVE square roots are higher. Another notable correlation is observed between Tourist Satisfaction (TS) and Perceived Value (PV), with a correlation coefficient of 0.784.

Table 3. Result of Discriminant Validity

Variable	DI	HSQ	PBC	PV	RI	SA	SSI	TL	TS	TT	WOM
DI	0,735										
HSQ	0,777	0,909									
PBC	0,819	0,566	0,775								
PV	0,778	0,445	0,796	0,874							
RI	0,724	0,450	0,683	0,609	0,844						
SA	0,756	0,418	0,777	0,883	0,551	0,940					
SSI	0,566	0,571	0,472	0,473	0,493	0,443	0,892				
TL	0,646	0,489	0,676	0,454	0,744	0,398	0,511	0,825			
TS	0,726	0,558	0,738	0,784	0,586	0,717	0,567	0,539	0,799		
TT	0,670	0,512	0,695	0,721	0,666	0,594	0,514	0,523	0,805	0,846	
WOM	0,697	0,398	0,669	0,583	0,912	0,551	0,441	0,735	0,578	0,671	0,860

Source: Author's Calculation Results.

Table 4 presents the evaluation of the structural model based on effect size (f^2), coefficient of determination (R^2), and predictive relevance (Q^2), within the PLS-SEM framework. The effect size (f^2) measures the impact of an exogenous construct on an endogenous construct, with values of 0.02, 0.15, and 0.35 representing small, medium, and large effects, respectively. The results indicate that Sustainability Awareness (SA) has the highest effect size ($f^2 = 1.525$), signifying a substantial impact on its associated dependent variables. Similarly, Tourist Loyalty (TL) ($f^2 = 1.178$), Halal Service Quality (HSQ) ($f^2 = 0.356$), and Sustainable Service Innovation (SSI) ($f^2 = 0.288$) demonstrate strong effects, underscoring their critical roles within the model. In contrast, constructs such as Tourist Trust (TT) ($f^2 = 0.011$) and Tourist Satisfaction (TS) ($f^2 = 0.046$) exhibit relatively small effect sizes, indicating limited influence on their respective dependent variables.

The coefficient of determination (R^2) reflects the proportion of variance in the endogenous constructs explained by their predictors, with higher values indicating greater explanatory power. The findings reveal that Perceived Behavioral Control (PBC) has the highest R^2 value (0.876), suggesting that 87.6% of its variance is accounted for by the model. Other constructs, including Revisit Intention (RI) ($R^2 = 0.617$) and Tourist Loyalty (TL) ($R^2 = 0.575$), also demonstrate substantial explanatory power. In addition, the predictive relevance (Q^2) values, which assess the model's capability to predict observed values using a blindfolding procedure, are positive for all constructs—confirming the model's predictive strength. Notably, PBC ($Q^2 = 0.604$), TS ($Q^2 = 0.406$), and TL ($Q^2 = 0.385$) exhibit strong predictive relevance. Constructs such as Word of Mouth (WOM) ($Q^2 = 0.395$) and RI ($Q^2 = 0.319$) also show considerable predictive power.

Table 4. Effect Size (f^2), Determination (R^2), and Predictive Relevance (Q^2)

Variable	f^2							R^2	Q^2
	PBC	PV	RI	TL	TS	TT	WOW		
DI					0,097				
HSQ						0,356			
PBC			0,876					0,604	0,326
PV					0,349			0,224	0,169
RI				0,617				0,467	0,319
SA	1,525								
SSI		0,288							
TL							1,178	0,575	0,385
TS				0,046				0,649	0,406
TT				0,011				0,263	0,186
WOM								0,541	0,395

Source: Author's Calculation Results

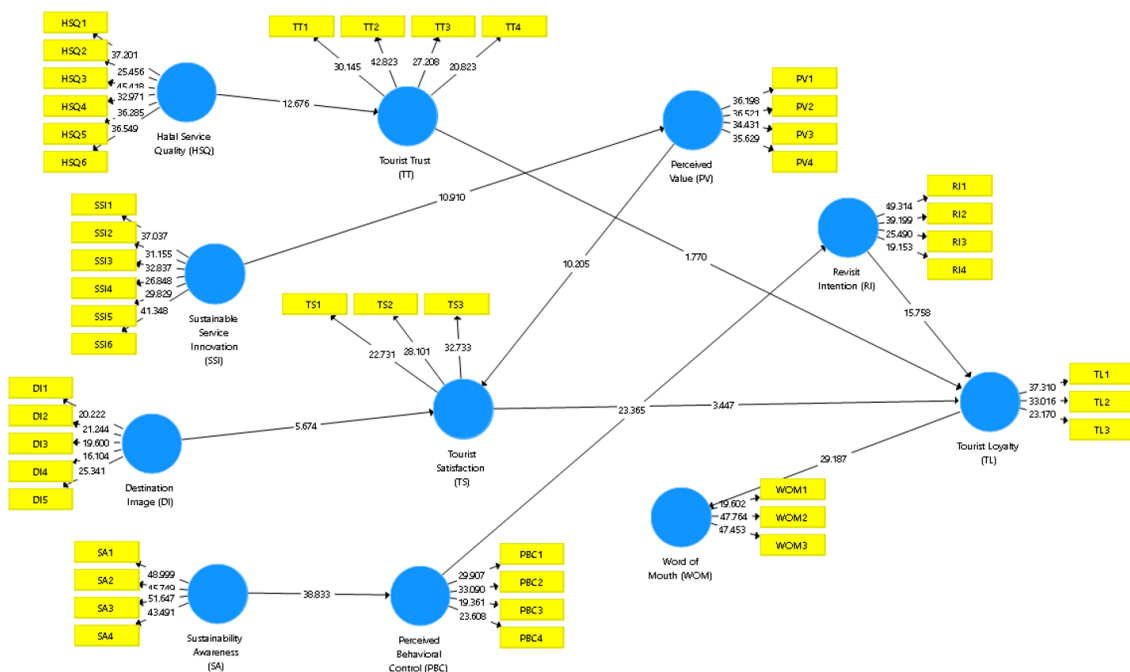
Overall, the structural model demonstrates strong explanatory and predictive capabilities. However, further investigation of constructs with smaller effect sizes is recommended to enhance the model's robustness and improve its predictive accuracy.

The structural model depicted in the figure illustrates the relationships among various latent constructs using Partial Least Squares Structural Equation Modeling (PLS-SEM). Each construct, represented by a blue circle, is measured by multiple indicators (in yellow), with corresponding outer loadings displayed adjacent to the indicators. All outer loadings exceed the recommended threshold of 0.70, indicating strong indicator reliability. The model includes path coefficients between constructs, reflecting the strength and significance of the hypothesized relationships.

For example, Sustainability Awareness (SA) exerts a significant influence on Perceived Behavioral Control (PBC), with a strong path coefficient of 38.833. In turn, PBC significantly affects Tourist Satisfaction (TS), with a path coefficient of 23.365. Additionally, Perceived Value (PV) strongly predicts Revisit Intention (RI) (path coefficient = 49.314), and RI has a substantial impact on Tourist Loyalty (TL), with a coefficient of 15.758. The model also underscores the mediating roles of constructs such as TS and Tourist Trust (TT) in shaping TL. Furthermore, significant associations between Word of Mouth (WOM) and TL suggest that positive experiences contribute to increased loyalty.

Overall, the structural model reveals statistically significant and theoretically meaningful relationships among constructs, confirming the proposed hypotheses and highlighting key drivers of tourist loyalty in the halal tourism context.

Figure 2. Bootstrapping analysis



As detailed in Table 5, Sustainability Awareness (SA) exhibited the strongest direct effect on Revisit Intention ($\beta = 0.403$, $t = 6.38$, $p < 0.001$) and a significant effect on Tourist Loyalty ($\beta = 0.278$, $t = 4.67$, $p < 0.01$). These findings are theoretically consistent with the extended Theory of Planned Behavior (TPB), which posits that value-driven attitudes influence behavioral intentions. This result also aligns with Sarassina et al. (2023), who found that Muslim tourists' environmental and ethical values are significant determinants of destination loyalty. The stronger influence of SA on intention compared to loyalty suggests that its effect is primarily channeled through motivational pathways.

Table 5. Bootstrapping Effect Results

Construct	Original Sample (O)	T Statistics (O/STDEV)	P Values
HSQ -> TL	-0,066	1,789	0,074
HSQ -> WOM	-0,048	1,796	0,073
DI -> TL	0,069	2,610	0,009*
DI -> WOM	0,051	2,610	0,009*
SA -> RI	0,531	18,680	0,000*
SA -> TL	0,367	11,651	0,000*
SA -> WOM	0,270	9,879	0,000*
SSI -> TL	0,062	3,196	0,001*
SSI -> TS	0,263	7,037	0,000*
SSI -> WOM	0,046	3,170	0,002*
TT -> WOM	-0,094	1,783	0,075
TS -> WOM	0,174	3,446	0,001*
PBC -> TL	0,472	12,065	0,000*
PBC -> WOM	0,347	10,067	0,000*
PV -> TL	0,132	3,454	0,001*
PV -> WOM	0,097	3,439	0,001*
RI -> WOM	0,508	12,549	0,000*

* means significant at 5%

Perceived Behavioral Control (PBC) was significantly related to both Tourist Loyalty and Word of Mouth (WOM). From a theoretical standpoint, this finding supports the TPB's assertion that perceived control facilitates volitional behavior, particularly in contexts where tourists must make active choices among alternatives. Empirically, the result is consistent with Seegebarth et al. (2023), who demonstrated that perceptions of control are predictive of sustainable consumer behavior. In the context of halal tourism, the capacity to select ethically aligned services appears to drive both behavioral loyalty and advocacy intentions.

Sustainable Service Innovation (SSI) was found to have a positive effect on Tourist Satisfaction, but not directly on Tourist Loyalty. This finding highlights the importance of distinguishing between affective and behavioral outcomes. While innovation enhances satisfaction—an emotional evaluation—it does not automatically translate into loyalty unless satisfaction acts as a mediating factor, as noted by Sharma et al. (2021). The result supports conceptual models that position satisfaction as a key mediator in service innovation frameworks, particularly within experiential sectors such as tourism.

As shown in Table 6, the analysis of indirect effects revealed that Revisit Intention significantly mediated the relationships between Sustainability Awareness (SA) and Tourist Loyalty (indirect $\beta = 0.154$, $p < 0.05$), as well as between Perceived Behavioral Control (PBC) and loyalty (indirect $\beta = 0.102$, $p < 0.05$). Similarly, Tourist Satisfaction mediated the relationship between Sustainable Service Innovation (SSI) and Word of Mouth (WOM) (indirect $\beta = 0.142$, $p < 0.05$). These findings are consistent with Layali and Suriani (2022), who emphasize that the pathway from cognitive antecedents to behavioral outcomes is frequently mediated by intention and satisfaction. Such mediational processes are also supported by extensions of the Theory of Planned Behavior (TPB), which proposes that affective and volitional mechanisms jointly influence behavioral responses.

Table 6. Specific indirect effects

Construct	Original Sample (O)	T Statistics (O/STDEV)	P Values
HSQ -> TT -> TL	-0,066	1,789	0,074
HSQ -> TT -> TL -> WOM	-0,048	1,796	0,073
DI -> TS -> TL	0,069	2,610	0,009*
DI -> TS -> TL -> WOM	0,051	2,610	0,009*
SA -> PBC -> RI	0,531	18,680	0,000*
SA -> PBC -> RI -> TL	0,367	11,651	0,000*
SA -> PBC -> RI -> TL -> WOM	0,270	9,879	0,000*
SSI -> PV -> TS -> TL	0,062	3,196	0,001*
SSI -> PV -> TS	0,263	7,037	0,000*
SSI -> PV -> TS -> TL -> WOM	0,046	3,170	0,002*
TT -> TL -> WOM	-0,094	1,783	0,075
TS -> TL -> WOM	0,174	3,446	0,001*
PBC -> RI -> TL	0,472	12,065	0,000*
PBC -> RI -> TL -> WOM	0,347	10,067	0,000*
RI -> TL -> WOM	0,508	12,549	0,000*
PV -> TS -> TL	0,132	3,454	0,001*
PV -> TS -> TL -> WOM	0,097	3,439	0,001*

* means significant at 5%

Overall, the results affirm the relevance of the extended TPB framework within the context of halal tourism and underscore the multidimensional influence of SSI, SA, and PBC on tourist loyalty and word of mouth. The model not only confirms key direct relationships but also highlights the essential mediating roles of revisiting intention and satisfaction in shaping these outcomes. These insights contribute to theoretical advancement in halal tourism behavior and offer practical guidance for destination managers aiming to foster loyalty through innovation and sustainability-driven strategies.

The findings of this study offer several significant insights that extend the existing understanding of tourist behavior in halal tourism. First, sustainability awareness was found to be a strong predictor of both revisit intention and tourist loyalty. This result suggests that Muslim tourists are increasingly aligning their travel preferences with destinations that reflect environmental ethics and sustainability values. This finding is consistent with Seegebarth et al. (2023), who highlight the growing relevance of sustainability in shaping consumer behavior within value-driven tourism contexts. Second, tourists' sense of behavioral control—their perceived ability to make autonomous, ethical travel decisions—also emerged as a strong influence on both loyalty and word-of-mouth intentions. This study supports the proposition that perceived control empowers tourists to act consistently with their ethical standards, thus reinforcing brand trust and long-term engagement. Similar conclusions were drawn by Font et al. (2021) in their examination of volitional factors in sustainable destination choices. Third, ethical service innovation, although it does not directly impact loyalty, plays a crucial role in enhancing tourist satisfaction. This result aligns with Rasoolimanesh et al. (2022), who argue that innovation in service delivery must evoke emotional and experiential satisfaction to be behaviorally impactful. In this study, satisfaction functioned as a key mediating mechanism between innovation and loyalty.

Furthermore, both tourist satisfaction and revisit intention demonstrated significant mediating effects, reinforcing the notion that loyalty in halal tourism emerges through both affective (emotional satisfaction) and cognitive (behavioral evaluation) pathways. These findings support an expanded view of behavioral models in tourism by demonstrating how value alignment—through sustainability and ethical awareness—drives both immediate outcomes (satisfaction and revisit) and long-term commitments (loyalty and advocacy). In contrast to earlier studies that focused primarily on Shariah compliance as the sole driver of loyalty, this research positions sustainability as a complementary force that enhances behavioral outcomes in ethically sensitive markets.

This study contributes to the literature by integrating sustainability-oriented constructs into the framework of halal tourism loyalty, bridging gaps in TPB-based models, and responding to recent calls for more holistic behavioral models. Practically, it offers insights for tourism providers to design strategies that combine Shariah compliance with environmental responsibility and consumer empowerment. To build long-term loyalty, tourism operators must embed sustainability not only in infrastructure but also in narratives, service experiences, and digital engagement. Transparent communication

about green practices, accessible halal-certified options, and empowering digital tools (e.g., mobile halal travel guides) can enhance both satisfaction and post-visit advocacy among Muslim tourists.

CONCLUSION

This study concludes that sustainability awareness and perceived behavioral control are key predictors of loyalty and word-of-mouth behavior in halal tourism. Ethical service innovation, while not directly influencing loyalty, enhances tourist satisfaction, which in turn leads to stronger loyalty outcomes. The mediating roles of satisfaction and revisit intention confirm that both emotional and cognitive pathways are essential in forming long-term behavioral engagement among Muslim tourists.

The findings contribute theoretically by extending behavioral frameworks in halal tourism to include sustainability and ethical decision-making. Practically, they suggest that halal tourism stakeholders—such as destination managers, policy-makers, and service providers—should integrate environmental responsibility and value-based service innovation into their strategic offerings. Transparent sustainability communication, culturally aligned service experiences, and digital tools that empower travelers can enhance tourist satisfaction and advocacy, ultimately strengthening Indonesia's position in the global halal tourism market.

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Clustering Indonesian Neobanking Users Through Extended UTAUT 3 for Retention Campaign Strategy

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JEL Classification:

G21

M31

C38

Received: 26 November 2024

Revised: 15 July 2025

Accepted: 20 August 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This study develops a behavior-anchored segmentation framework for Indonesian neobank users by extending the Unified Theory of Acceptance and Use of Technology (UTAUT-3) with trust and marketplace application usage, providing deeper insights into user behavior.

Research Objectives: The research aims to identify distinct neobank user segments and key behavioral drivers to support targeted strategies in digital financial services.

Research Methods: An extended UTAUT-3 model incorporating trust and marketplace usage was validated through Structural Equation Modeling (SEM). Balanced Iterative Reducing and Clustering using Hierarchies (BIRCH) clustering was applied to data from 386 active users, with segment validity confirmed using Elbow, Gap, and Silhouette methods.

Empirical Results: The results revealed that trust, habit, and marketplace usage emerged as primary drivers of engagement and user recommendations. This study identifies four user segments: transitioning explorers, urban occasionalists, rural digital enthusiasts, and cost-conscious digital natives.

Implications: Urban Occasionalists and Rural Digital Enthusiasts show strong potential for long-term growth. Targeted engagement and personalized retention strategies for these segments can enhance customer lifetime value and strengthen user advocacy.

Keywords:

clustering; loyalty; neobank; retention; user segmentation

How to Cite:

Rahmatulloh, F., Sumarwan, U., Hartoyo, & Sartono, B. (2025). Clustering Indonesian Neobanking Users Through Extended UTAUT 3 for Retention Campaign Strategy. *Etikonomi*, 24(2), 693 – 706. <https://doi.org/10.15408/etk.v24i2.42599>.

INTRODUCTION

Indonesia's digital landscape has experienced significant growth in recent years, with the number of internet users reaching over 202 million as of 2021 (Sari et al., 2023). This expansion has been particularly transformative in the financial industry, which is undergoing rapid change driven by digitalization and shifting consumer expectations. The development of neobanks, branchless, mobile-first financial service providers, has redefined banking in the country. Despite the rise in digital access, the penetration of neobank users remains low, accounting for only 6.93% of digital banking users. This condition highlights a significant gap between the potential for adoption and actual sustained engagement. While neobanks are especially appealing to younger consumers due to their positive digital experiences (Hopkinson & Klarova, 2019), understanding what drives continued use and advocacy remains a significant challenge. Despite the substantial user base of neobanks, these users may also exhibit lower engagement frequency compared to traditional banking customers. This infrequent usage can contribute to a higher churn rate, where users discontinue their engagement with the neobank application. This churn is predominantly attributed to users drawn by promotional incentives who utilize the neobank application for specific, limited transactions, thereby restricting user retention and long-term engagement.

To explain user behavior in adopting digital services, previous research largely relied on theoretical frameworks such as the Unified Theory of Acceptance and Use of Technology (UTAUT) by Venkatesh et al. (2003), its extensions UTAUT-2 (Venkatesh et al., 2012) and UTAUT-3 to explain behavior intention in digital service adoption (Bhatnagr & Rajesh, 2024; Farooq et al., 2017; Pinto et al., 2022). While these models are valuable for predicting behavior intention, they often fall short in translating those insights into practical strategies for user retention. Furthermore, critical constructs such as trust and cross-platform behavior, including marketplace usage, are frequently overlooked. These factors are increasingly relevant in Indonesia's integrated digital ecosystem, where users frequently engage with multiple platforms and services.

To address these gaps, this research extends the UTAUT-3 model by incorporating two additional constructs that are highly relevant to the Indonesian digital context: trust and marketplace usage. Trust plays a critical role in shaping user confidence in digital finance and reducing perceived risk (Kim & Koo, 2016; Rouibah et al., 2016), while marketplace usage reflects users' engagement across interconnected digital platforms (Chong et al., 2018). The extended model was tested using Structural Equation Modeling (SEM) to validate its constructs. The validated behavior indicators were then used in Balanced Iterative Reducing and Clustering using Hierarchies (BIRCH), a clustering method well-suited to large-scale behavior data.

The BIRCH clustering method is effective for identifying interpretable user profiles based on complex behavior patterns. In their seminal work, Zhang et al. (1997) demonstrate the effectiveness of BIRCH through experimental evaluations on various datasets, showing its scalability and competitive clustering quality compared to other clustering algorithms, such as DBSCAN and CLARANS. They also highlight the

advantages of BIRCH in terms of its ability to handle noise and outliers, its computational efficiency, and its suitability for data mining tasks in large databases. John et al. (2023) did research about people's awareness of online purchases and developed a customer segmentation model to improve decision-making processes in the retail market industry using several state-of-the-art (SOTA) clustering algorithms, namely, K-means clustering, the Gaussian mixture model (GMM), density-based spatial clustering of applications with noise (DBSCAN), agglomerative clustering, and BIRCH clustering. The research using BIRCH clustering analysis got a 0.64 silhouette score.

The novelty of this research lies in combining an extended UTAUT-3 framework with trust and marketplace behavior and applying a hybrid SEM–BIRCH approach to generate behavior-based user segments. This method not only predicts behavioral intention but also translates theoretical constructs into practical tools for retention and implementation. The objectives of this research are to extend UTAUT-3 with trust and marketplace usage to reflect user behavior in the Indonesian context better, to validate the extended model using SEM, to segment neobank users based on behavioral data using BIRCH clustering, and to propose targeted retention strategies for each identified segment. The contributions of this research are threefold. Theoretically, it enhances the explanatory power of UTAUT-3 by including trust and cross-platform behavior. Methodologically, it introduces a novel combination of SEM and BIRCH for behavior-based segmentation. Practically, it provides actionable insights for neobank providers to design segment-specific retention campaigns, especially for high-potential segments such as Urban Occasionalists and Rural Digital Enthusiasts. This research bridges the gap between behavioral theory and practical strategy, supporting long-term user engagement in the rapidly evolving digital banking sector in Indonesia.

METHODS

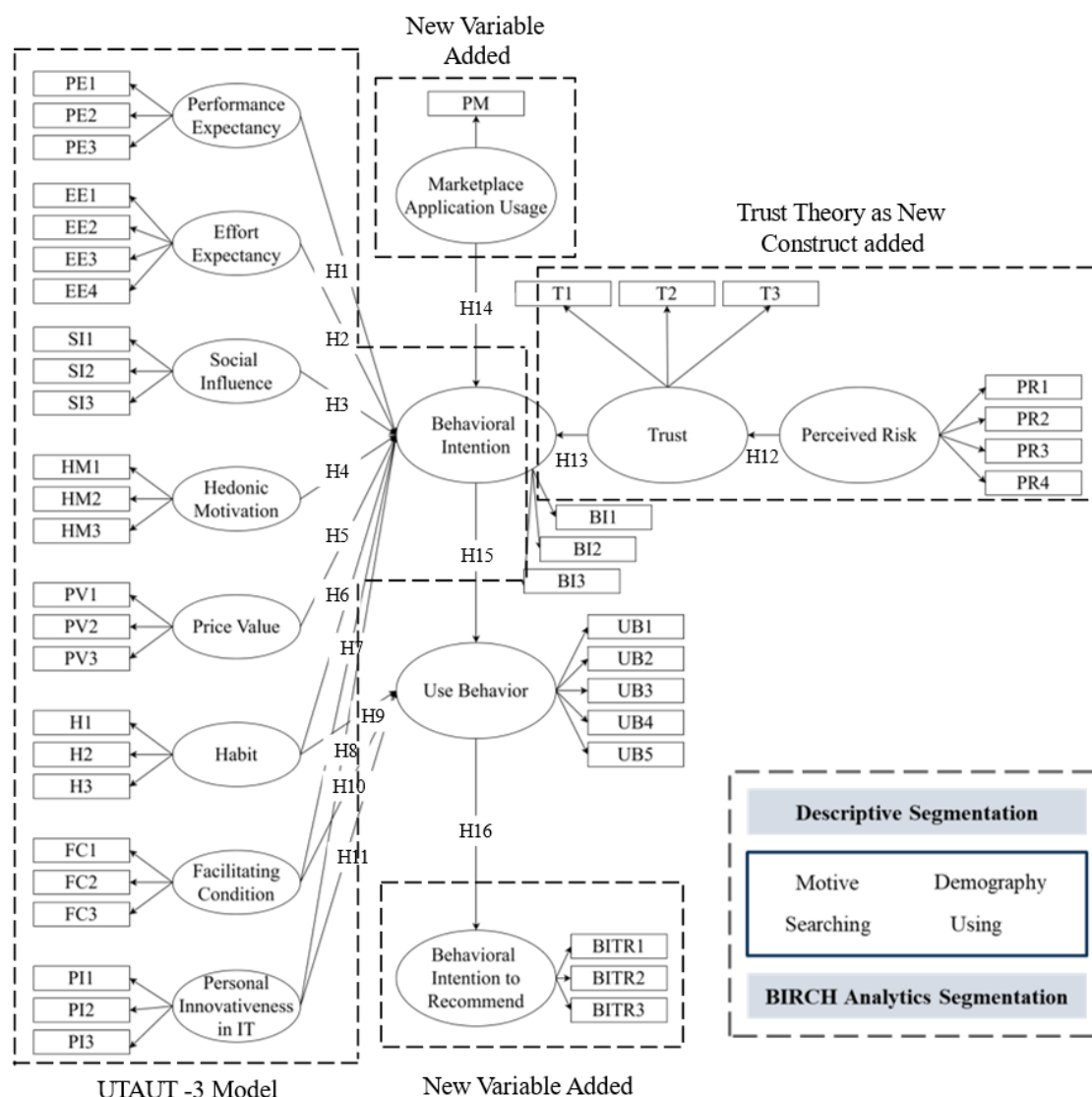
A quantitative method was employed to develop a segmentation framework that supports retention campaign strategies for Indonesian neobank users. The theoretical foundation was based on UTAUT-3, which was extended with two context-specific variables: trust and marketplace application usage. These additions reflect the role of users' confidence and digital ecosystem interaction in shaping neobank adoption behavior. Data were gathered through an online survey targeting active neobank users in three provinces: DKI Jakarta, West Java, and East Java, selected based on mobile internet penetration and digital financial activity. A total of 386 qualified respondents were selected using purposive sampling, with the sample size determined based on the Lemeshow formula, assuming a 95% confidence level ($Z = 1.96$). Each respondent had used neobank applications for a minimum of five times per month in the last three months. Respondents were users of applications such as Jago Bank, BNC, Sea Bank, Aladin Bank, or Allo Bank.

In this research, the Likert scale was used to measure the variables of Performance Expectancy, Effort Expectancy, Social Influence, Facilitating Conditions, Hedonic Motivation, Price Value, Habit, Trust, Perceived Risk, Financial Risk, Personal Information Risk, Behavioral Intention, Use Behavior, and Behavioral Intention to Recommend.

Meanwhile, the variable of using the marketplace application behavior is assessed using an ordinal scale. This research also incorporates sociodemographic and behavioral aspects related to marketplace and neobank application usage to inform user segmentation. The variables used in the sociodemographic and behavior aspects are explained in Table 1.

The conceptual framework, presented in Figure 1, illustrates how the operational variables and indicators of each construct interact within the research model, providing a structured overview of the hypothesized relationships examined in this research.

Figure 1. Conceptual Framework



The purpose of hypothesis testing is to determine if any independent variables have a significant influence on behavior intention and behavior intention to recommend Neobanking services. This testing also confirmed the indirect relationships between independent and dependent variables, mediated by intervening variables indicators (Hair et al., 2013). In addition, SEM verifies the significance of its latent variables.

After conducting Structural Equation Modeling (SEM) analysis, the next step involves performing Clustering and Segmentation. This process aims to categorize the subjects or data into distinct groups based on similarities in their characteristics or responses. User segmentation allows neobanking institutions to focus their efforts on developing centered marketing strategies for specific user segments with high potential for neobanking adoption. The final segments represent distinct behaviour-based neobank user groups, enabling the development of targeted retention campaign strategies.

Table 1. Operational of Sociodemographic and Behavior

Variables	Variables Definition	Data Type
Age (Wang et al., 2020)	Respondent's age	Interval
Gender (Wang et al., 2020)	Respondent's gender	Nominal
Income per Month (Rahi et al., 2019)	Respondent's monthly income	Interval
Education (Rahi et al., 2019)	Respondent's last education	Ordinal
Residence	Respondent's living place	Nominal
Neobanking Experience	Frequency of using neobank application	Ordinal
Webbrowsing Experience	Frequency of using marketplaces and digital payment application	Ordinal

RESULTS AND DISCUSSION

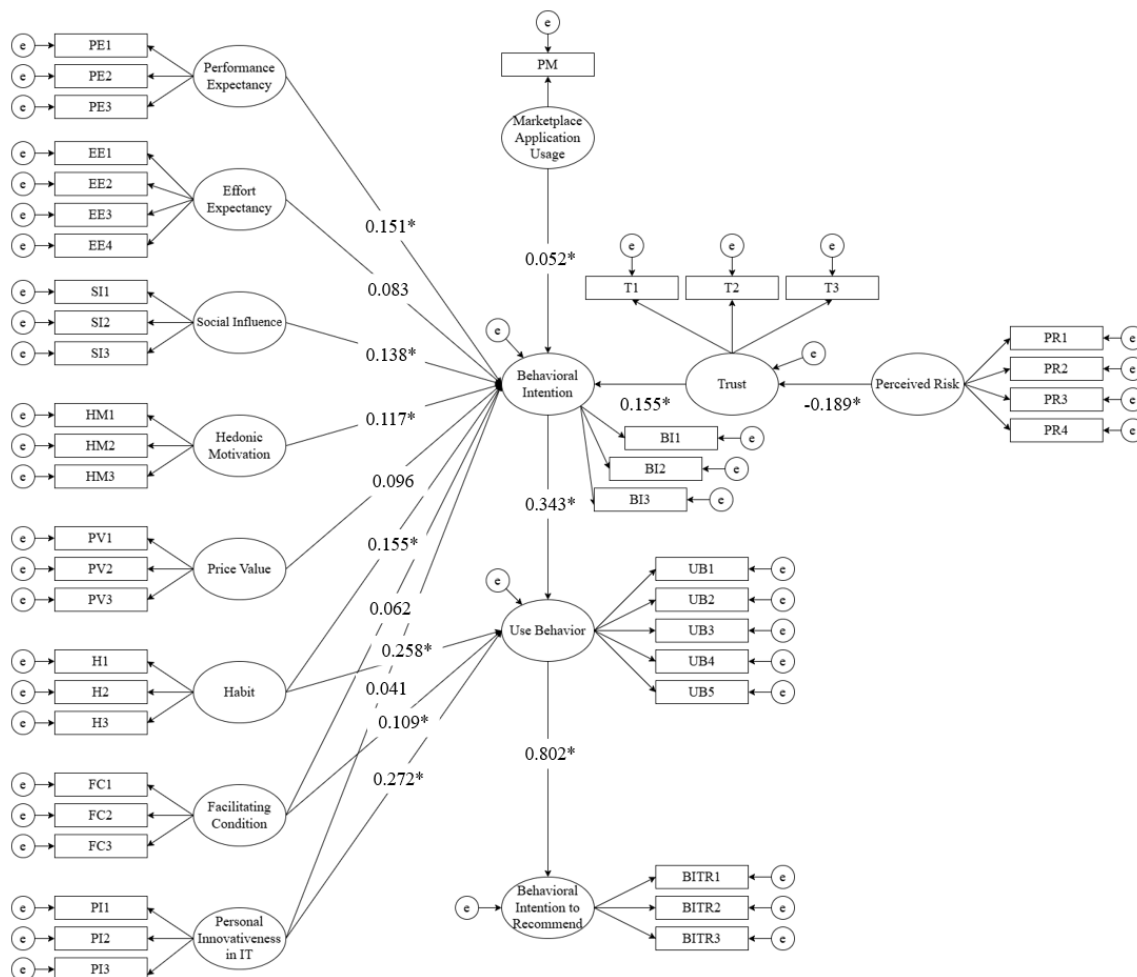
Structural Model and Key Behavior Drivers Behavior constructs derived from the extended UTAUT-3 model were first validated using Structural Equation Modeling (SEM). The analysis confirmed the significant influence of performance expectancy, habit, trust, and marketplace usage on behavior intention, use behavior, and recommendation intent. Specifically: Trust and habit emerged as the strongest behavior drivers, Marketplace usage positively influenced intention to use and recommend, use behavior strongly predicted recommendation. These findings reinforce the relevance of integrating trust and marketplace-related behavior into technology acceptance frameworks, particularly for digital financial services in emerging markets like Indonesia (see Table 2 and Figure 2).

Table 2. Result of Hypothesis Test

Hypothesis	Coeff	T-Values	P-Values	Conclusion
H ₁ (Performance Expectancy → Behavior Intention)	0,151	2,986	0,003	Accepted
H ₂ (Effort Expectancy → Behavior Intention)	0,083	1,502	0,134	Rejected
H ₃ (Social Influence → Behavior Intention)	0,138	2,385	0,017	Accepted
H ₄ (Hedonic Motivation → Behavior Intention)	0,117	2,342	0,020	Accepted
H ₅ (Price Value → Behavior Intention)	0,096	1,699	0,090	Rejected
H ₆ (Habit → Behavior Intention)	0,155	2,528	0,012	Accepted
H ₇ (Facilitating Condition → Behavior Intention)	0,062	1,160	0,247	Rejected

Hypothesis	Coeff	T-Values	P-Values	Conclusion
H ₈ (Personal Innovativeness in IT → Behavior Intention)	0,041	0,791	0,429	Rejected
H ₉ (Marketplace Usage → Behavior Intention)	0,052	2,621	0,009	Accepted
H ₁₀ (Trust → Behavior Intention)	0,155	2,985	0,003	Accepted
H ₁₁ (Perceived Risk → Trust)	-0,189	2,276	0,023	Accepted
H ₁₂ (Habit → Use Behavior)	0,258	5,422	0,000	Accepted
H ₁₃ (Facilitating Condition → Use Behavior)	0,109	2,424	0,016	Accepted
H ₁₄ (Personal Innovativeness in IT → Use Behavior)	0,272	5,104	0,000	Accepted
H ₁₅ (Behavior Intention → Use Behavior)	0,343	5,885	0,000	Accepted
H ₁₆ (Use Behavior → Behavior Intention to Recommend)	0,802	25,049	0,000	Accepted

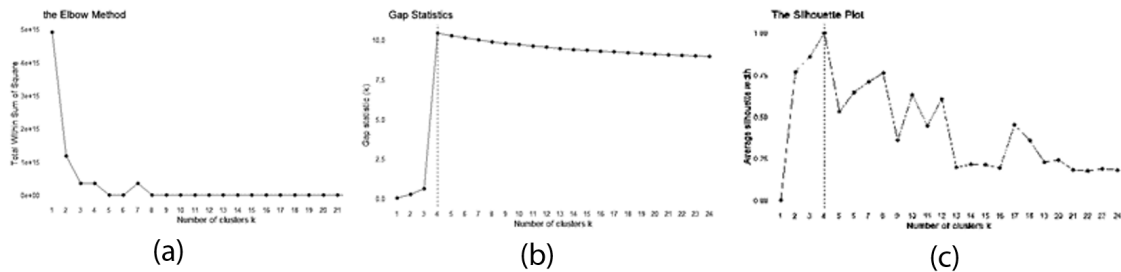
Figure 2. Result of SEM Model



The UTAUT-3 model demonstrated strong predictive power, explaining significant proportions of the variation in usage intention, neobanking usage, and intention to recommend. Key factors driving intention and adoption include performance expectancy,

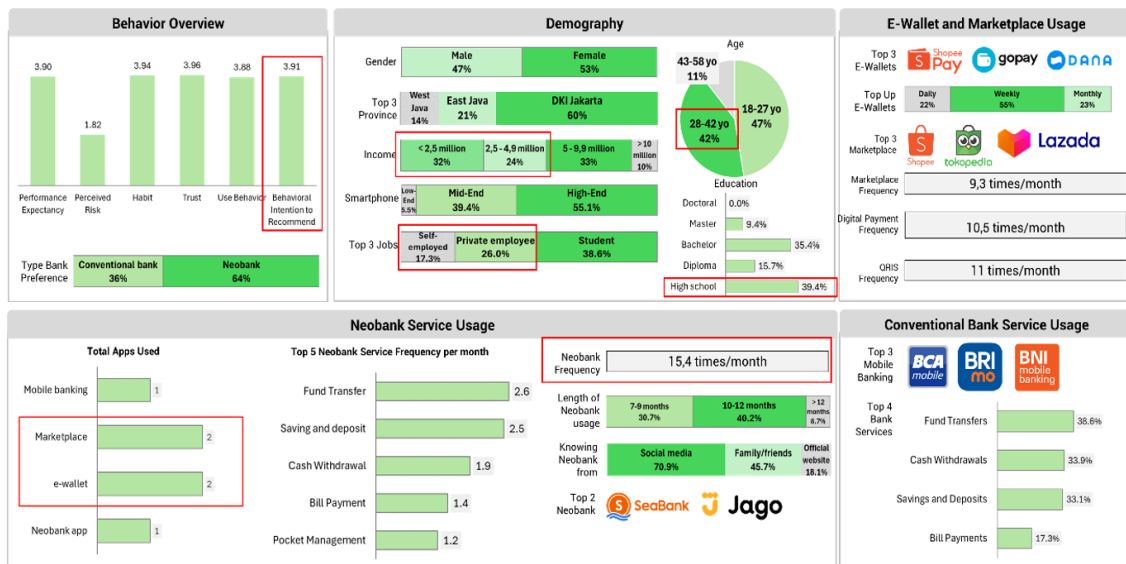
social influence, hedonic motivation, habit, and the integration of neobanking with marketplaces and trust.

Figure 3. Determination of Optimal Segment Using Analytics Approach
(a) Elbow Method (b) Gap Statistics (c) Silhouette Plot



Segmentation Using BIRCH Clustering. After validation, behavior scores were used as input for clustering via the Balanced Iterative Reducing and Clustering using Hierarchies (BIRCH) method. The number of clusters was determined through the Elbow Method, Gap Statistic, and Silhouette Plot, with four clusters selected based on interpretability and completeness of segmentation. Each cluster reflects distinct patterns of trust, marketplace usage, usage frequency, and intention to recommend, enabling tailored retention strategies.

Figure 4. Profile of Transitioning Explorer User Segment

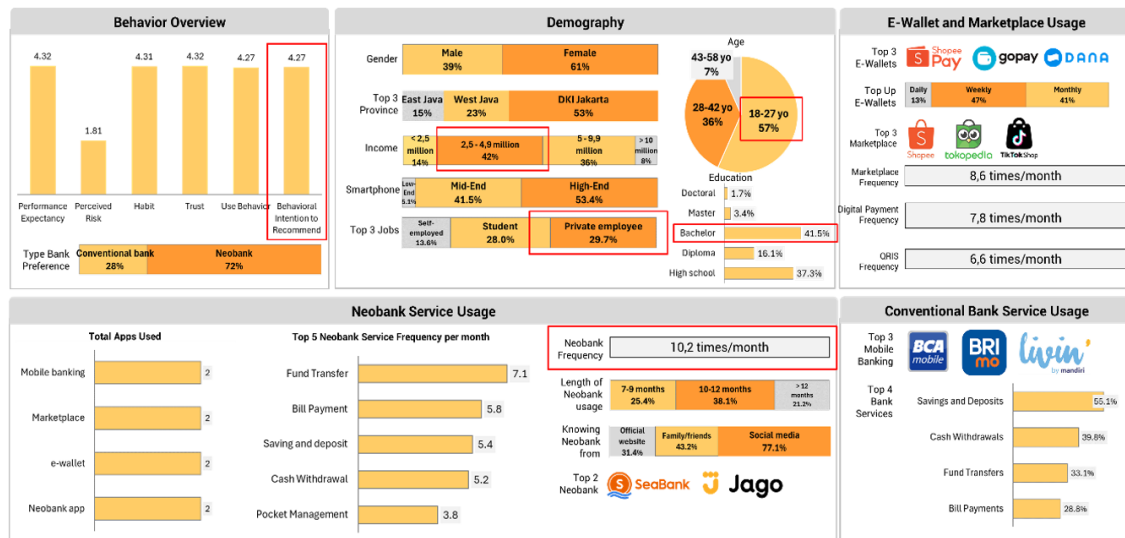


Four Segments are identified from the results of determining the optimal number of clusters as shown as follow. First, transitioning explorer (32.9%) Users are in the early phase of adoption (see Figure 4). The transitioning explorer engages with neobanking about 15 times/month, mainly through digital payments and QRIS. However, this

group has the lowest trust and intention to recommend. Most are urban-based, mid-income private, or self-employed individuals exploring platforms through social media promotions. The switching behavior suggests uncertainty about neobank value. Retention strategies should focus on onboarding support, trust-building messaging, and feature transparency.

Second, urban occasionalist (30.6%) Users use neobanking around 10 times/month with equal marketplace usage. The urban occasionalists are private employees with steady income (IDR 2.5–5 million), largely from Jakarta (see Figure 5). The engagement is casual, often motivated by convenience rather than necessity. Although familiar with the technology, the dependence remains low and these individuals represent reactivation potential through gamified engagement, social referral programs, and showing time-saving features.

Figure 5. Profile of Urban Occasionalist User Segment



Third, rural digital enthusiast (28.5%) A highly engaged segment, using neobanking 16 times/month and marketplaces 12 times/month. Users exhibit high trust, high usage, and the highest intention to recommend (see Figure 6). The rural digital enthusiasts are based in suburban/rural areas and view neobank as integral to financial activity. Users are ideal targets for loyalty programs, premium upgrades, and community-led advocacy initiatives.

Fourth, cost-conscious digital native (8.0%) Young, digitally active users with limited income, engaging in up to 21 neobank transactions/month. Despite high trust, users have low perceived value, and usage is significantly driven by promotions and QRIS payments (see Figure 7). The cost-conscious digital natives are loyal but sensitive to cost. Providers should focus on value clarity, bundled offers, and student-oriented savings features to enhance long-term retention.

Figure 6. Profile of Rural Digital Enthusiast User Segment

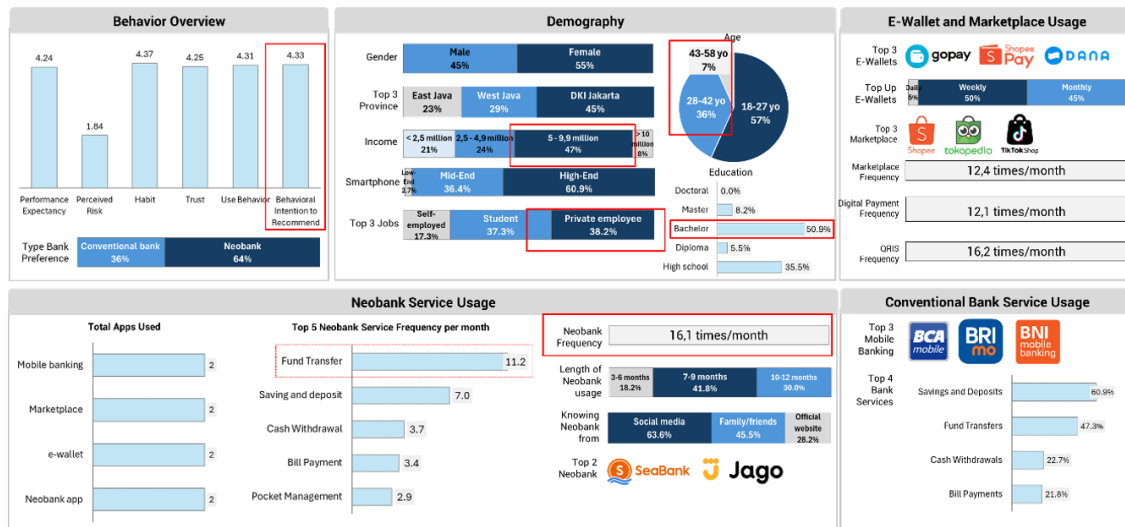
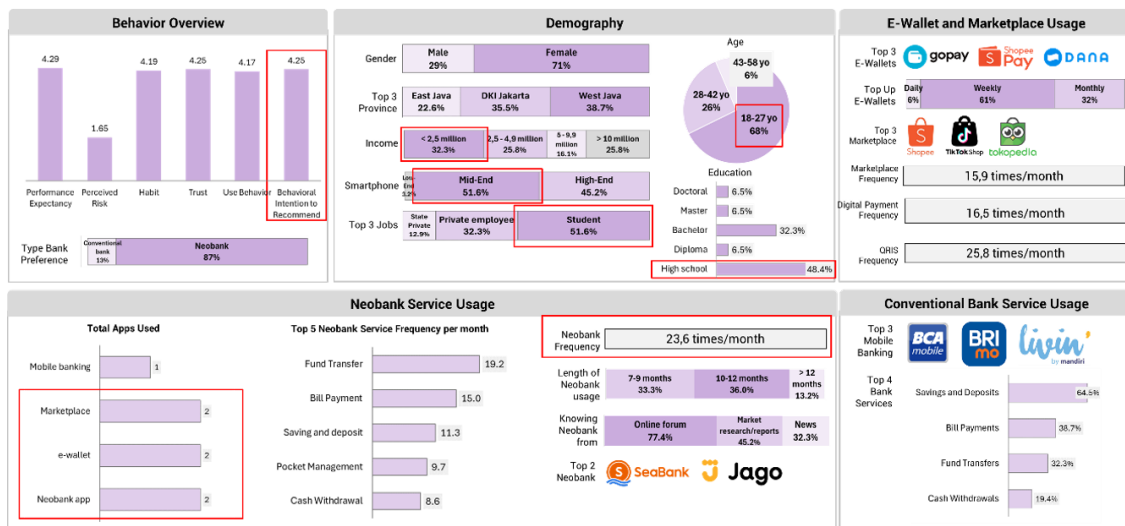


Figure 7. Profile of Cost-Conscious Digital Native User Segment



The results of this research revealed four distinct clusters of Indonesian neobank users, based on behavior constructs from an extended UTAUT-3 model: Transitioning Explorers, Urban Occasionalists, Rural Digital Enthusiasts, and Cost-Conscious Digital Natives. These clusters were formed based on an extended UTAUT-3 model, which included additional constructs, namely trust and marketplace usage. Unlike traditional segmentation based on demographics or transaction volume, this approach used validated behavioral indicators to capture how users actually engage with neobank services. These results contributed to the growing literature on digital banking behavior by offering a segmentation perspective rooted in trust, usage patterns, and engagement within the digital ecosystem.

Table 3. Segment Summary Characteristics

Segment Name	Population Size	Segment Profile
Transitioning Explorer User	32,9%	Using the neobanking application 15x/month and the marketplace 9x/month. Located in the urban area of DKI Jakarta, this individual is a mixed private and self-employed individual with an income of 2.5-5 million IDR/month. They are aware of the neobanking application through social media and have the lowest intention of recommending it.
Urban Occasionalist User	30,6%	Utilizing neobanking application 10x/month and 9x/month the marketplace application is utilized. A private employee who resides in the urban area of DKI Jakarta. They are aware of the neobanking application through social media, family, and friends, and monthly income ranges from 2.5 -5 million IDR.
Rural Digital Enthusiast User	28,5%	Utilizing the neobanking application on average of 16x/month, as well as 12x months for the marketplace. Resides in a rural area in the west and east of Java, employee of a private company. Aware of the neobanking application through social media with monthly income ranges from 5-10 million IDR
Cost-Conscious Digital Native User	8%	Using the neobanking applications 23 x/month and the marketplace 16x/month. Student from a rural area in West Java, with an income less than 2.5 million IDR/Month. Aware of the neobanking application through an online forum.

The confirmation of trust, habit, and marketplace usage as key drivers of behavior is consistent with previous research (Kim & Koo, 2016; Rouibah et al., 2016). The role of habit and convenience aligns with the work of Farooq et al. (2017) and Gunasinghe et al. (2020), who found these factors to be critical in driving behavioral intention in UTAUT-2 and UTAUT-3 models. However, this research goes further by linking these constructs not only to intention but also to actual usage, recommendation behavior, and behavior-based clustering, thus providing deeper insight into user lifecycle management.

Compared to prior UTAUT-based research, such as Venkatesh et al. (2003) and Alalwan (2020), which focuses on behavioral intention in the initial stages of technology adoption. This present research advances the discussion by connecting behavior predictors to actual usage, recommendation intention, and behavior-based segmentation for retention strategy design. In comparison, Bhatnagr and Rajesh (2024) introduced trust and perceived risk into their neobank adoption models, which were limited to the early stages of use. This research builds upon and extends these frameworks by applying a hybrid approach of SEM and BIRCH clustering, enabling the translation of behavioral constructs into strategic segmentation. In contrast to studies conducted in mature digital economies where social influence or facilitating conditions tend to dominate, this study shows that trust and habitual behavior are more influential in Indonesia's multi-platform, mobile-first ecosystem.

Each segment identified in this study presents unique strategic considerations. Rural digital enthusiasts demonstrated a high frequency of use and strong trust in neobanks, despite being located outside major urban centers and typically having moderate income levels. This result challenges prior assumptions, such as those suggested by Rahi et al. (2019), that higher income and education are correlated with deeper engagement. This research identified that Rural Digital Enthusiasts with moderate income but high trust and usage frequency were among the most loyal and engaged. Urban Occasionalists exhibit moderate engagement and trust, suggesting potential for increased loyalty through consistent communication and user-centered feature enhancements. The Transitioning Explorer segment confirms previous results about promotional behavior (Hopkinson & Klarova, 2019). However, this concept contradicts the view that digital-native users inherently build loyalty. This group exhibited low trust and minimal intention to recommend, showing that digital fluency does not guarantee engagement.

Methodologically, this research complements the work of John et al. (2023) and Pradana & Ha (2021) by implementing BIRCH clustering in a novel behavioral context. While many previous studies used demographic or psychographic clustering, this study used constructs validated through SEM, offering more robust, theory-grounded profiles that are also practical for business applications. This approach enhances the interpretability and utility of user segments, allowing service providers to develop more targeted and effective engagement strategies. Beyond user retention, this segmentation model offers value for product development, user experience (UX) design, and cross-platform service integration.

The results confirm that trust, habit, and marketplace usage are key differentiators across clusters. Behavior segmentation using BIRCH provides deeper insights than traditional demographics, enabling neobank providers to align retention strategies with actual user behavior. Urban Occasionalists and Rural Digital Enthusiasts should be prioritized for growth-focused campaigns, given their latent or demonstrated loyalty to the brand. Transitioning Explorers represent high churn risk and need focused onboarding and trust-building content. Cost-conscious digital natives offer frequent engagement but require careful communication of value and educational content. By aligning retention efforts with validated behavioral patterns, this segmentation framework provides an actionable path to sustain engagement, reduce churn, and foster long-term loyalty in Indonesia's growing digital banking market.

CONCLUSION

This research developed a behavior-anchored segmentation framework for Indonesian neobank users by extending the UTAUT-3 model with two contextually relevant constructs such as trust and marketplace application usage. These extensions were empirically validated through SEM and subsequently used in the BIRCH clustering algorithm to classify users into four distinct segments, such as Transitioning

Explorers, Urban Occasionalists, Rural Digital Enthusiasts, and Cost-Conscious Digital Natives. The results revealed the central role of trust, habit, and marketplace usage in influencing behavioral intention, actual usage, and recommendation behavior in the neobanking context. These variables also served to meaningfully differentiate users' clusters, providing critical insights for designing segment-specific retention campaign strategies.

From a managerial perspective, the research provides actionable recommendations. Urban Occasionalists and Rural Digital Enthusiasts exhibited high potential for sustained engagement and advocacy, while Transitioning Explorers posed a greater churn risk due to low trust and inconsistent usage patterns. The segmentation results suggested that neobank providers should adopt differentiated engagement methods based on behavior profiles. For Urban Occasionalists, strategies should focus on product familiarization, lifestyle-oriented personalization, and reactivation incentives. Rural Digital Enthusiasts, who showed high trust and frequent usage, represented an ideal target for loyalty programs, bundled services, and community-based referrals. However, Transitioning Explorers required structured onboarding, trust-building communication, and reinforced value delivery. Cost-conscious digital natives were highly sensitive to costs and would benefit from value-based messaging and student-centric offerings to strengthen retention.

The findings highlight the importance of strengthening digital trust ecosystems through effective regulation and infrastructure development. Regulatory bodies should enforce data privacy and security standards to ensure that users, especially those in rural or economically vulnerable groups, can trust the digital financial platforms they use. Promoting interoperability among platforms also helps reduce friction in multi-app digital ecosystems, thereby fostering a more inclusive financial environment. Targeted financial literacy programs, particularly for younger and cost-sensitive populations, can enhance users' understanding of digital financial tools and reduce the risk of disengagement caused by misinformation or unmet expectations. Policymakers can collaborate with neobanks and educational institutions to integrate digital banking education into broader digital literacy initiatives.

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Toward a Resilient Islamic Banking System: Insights from 14 Years of Research

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JEL Classification:

G21

G32

E44

E58

Z12

Received: 23 September 2024

Revised: 09 July 2025

Accepted: 23 August 2025

Available online: September 2025

Published regularly: September 2025

Abstract

Research Originality: This research is unique in that it consolidates macroeconomic and institutional studies to better understand how Islamic banks absorb and recover from financial shocks.

Research Objectives: To investigate the conceptual and empirical development of Islamic banking resilience over the past 14 years, concentrating on dominating variables and thematic clusters.

Research Methods: The research examines 42 peer-reviewed journal articles indexed in Scopus through a comprehensive systematic literature review (SLR) methodology utilizing bibliometric instruments.

Empirical Results: Internal factors like capital adequacy, liquidity, and profitability, as well as macroeconomic indices like GDP and inflation, influence resilience. The keyword “bank resilience” is underused, implying a lack of conceptual consistency in the literature.

Implications: An integrated view of resilience in Islamic finance and the requirement for specialized regulatory frameworks and resilience-based performance metrics customized to Islamic banking principles has substantial implications for researchers, policymakers, and regulators.

Keywords:

Islamic banking; resilience; systematic literature review; macroeconomic indicators; risk management

How to Cite:

Wiranatakusuma, D. B., Aprizal, A., Yusof, R. M., Primambudi, G., Wahab, N. A., Majid, N. H. A., & Arundaya, F. A. (2025). Toward a Resilient Islamic Banking System: Insight from 14 Years of Research. *Etikonomi*, 24(2), 707 – 732. <https://doi.org/10.15408/etk.v24i2.41440>.

INTRODUCTION

Research on the resilience of Islamic banking has garnered substantial attention from academics, research institutions, universities, and industry practitioners over the past 14 years, reflecting its pivotal role in maintaining financial stability (Biancone et al., 2020; Hashem & Abdeljawad, 2018; Hassan & Aliyu, 2018). The resilience of Islamic banking is crucial for withstanding financial crises and ensuring long-term sustainability, systemic stability, and stakeholder trust, while adhering to ethical financial principles that prohibit *riba* and *gharar*. In addressing macroeconomic shocks, pandemics, and geopolitical tensions, Islamic banks must provide operational continuity while boosting medium, small, and micro enterprises (MSMEs), infrastructure, and the social sector to protect depositor assets, enhance financial inclusion, and strengthen global stability and growth.

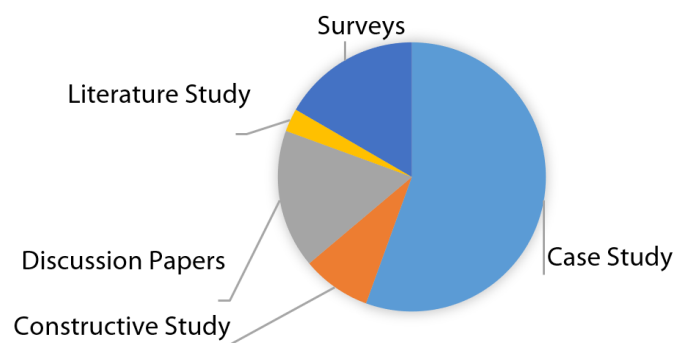
Financial stability is essential for allocating funds towards long-term economic resilience and sustainable development. Financial intermediaries, such as banks, mobilize and allocate resources, influencing economic growth and macroeconomic performance (Ghosh et al., 2020; Tok & Yesuf, 2022; Wiranatakusuma, 2018). In bank-based economies, the resilience of banking institutions is essential and necessitates continuous monitoring and supervision (Krishnamurti & Lee, 2014). The financial system is vulnerable to many threats and systemic crises. The 2008 financial crisis and the COVID-19 epidemic illustrated that disruptions within a single bank, especially those that are interconnected, can rapidly spread and significantly affect the economy. The resilience of the financial system, including Islamic banking, has become increasingly important. Resilience is a complex concept that encompasses the ability of financial institutions to respond to and recover from external shocks while maintaining their fundamental operations. Resilience is a dynamic process that develops through adaptation, learning, and systemic boost aimed at achieving stability and sustainability (Ahmad et al., 2022; Alam et al., 2019; Bai & Elyasiani, 2013; Bakoush et al., 2022; Bourkhis & Nabi, 2013; Farooq & Zaheer, 2015). Building resilience in Islamic banking requires Islamic compliance and the integration of strategic financial management practices.

Internal and external forces determine bank resilience. Internal factors, including supervisory policies, service innovation, and bank structure, affect adaptability and operational continuity (Khan et al., 2020). Externally, macroeconomic conditions and compliance with Islamic legal principles serve as influential factors in the context of Islamic banking. Additional external determinants include the profit-sharing system, patterns of bank ownership, and the nature of governance and management relationships unique to Islamic financial institutions (Riaz et al., 2017; Setyawati et al., 2019). The study of resilience within the banking sector has attracted widespread scholarly attention. For instance, Abiwodo et al. (2023) offer a comprehensive mapping of resilience in conventional banking, financial stability, and Islamic finance, while Belouafi et al. (2015) contribute foundational perspectives on Islamic financial systems. Systematic literature reviews have also explored specific dimensions of Islamic banking, including the role of corporate social responsibility (Zafar & Sulaiman, 2019) and banking efficiency (Idris & Ahmad, 2020). Notably, research on the resilience of Islamic banking has seen a marked

increase over the last 14 years, reflecting its growing relevance in discussions on financial system stability (Barau et al., 2023; Farooq & Zaheer, 2015; Hassan & Aliyu, 2018). These studies employ a wide range of methodological approaches, broadly categorized into empirical and conceptual frameworks. Empirical approaches encompass case studies, constructive studies, discussion papers, and surveys, providing context-specific, data-driven insights (Banaeianjahromi & Smolander, 2016). Case studies have been used to assess institutional resilience to financial crises, the COVID-19 pandemic, and systemic hazards across institutions, regions, and regulatory settings. This research has shed clarity on how Islamic banks weather external shocks and stay stable.

Research on the resilience of Islamic banking employs various methodologies to develop innovative frameworks, models, and instruments. Constructive studies often employ software, modeling, and theoretical methodologies to enhance resilience, as exemplified by solvency stress testing, innovative behavior, and value-based banking. Discussion papers provide essential analyses of emerging concerns, such as the impact of COVID-19 on Islamic banking. Survey methodologies collect primary data regarding elements such as customer satisfaction, emotional intelligence, and corporate social responsibility, providing insights into attitudes and behaviors. Literature reviews consolidate previous studies, pinpoint deficiencies, and offer conceptual and bibliometric frameworks, establishing a basis for forthcoming research in Islamic banking resilience.

Figure 1. Overview of the Proportion of Empirical Research and Literature on Islamic Banking Resilience



Source: Author Analysis by Excel 365

Furthermore, existing literature reviews on Islamic banking have predominantly concentrated on specific thematic areas such as Islamic-compliant customer behavior, Islamic social reporting practices, the application of the *maqāṣid al-sharī'ah* framework in banking operations, governance structures within Islamic financial institutions, and the impact of monetary policy on Islamic banking performance (Andespa et al., 2024; Wijayanti et al., 2023; Mahyudin, 2022; Zuhroh, 2022; Savon & Yousfi, 2025). Despite prior research providing significant insights, no research has methodically charted the evolution of Islamic banking resilience from both internal and external viewpoints. This study addresses that deficiency by providing a thorough conceptual and thematic analysis

through bibliometric techniques. It delineates critical trends, disparate study domains, and neglected policy matters, thus augmenting the comprehension of the evolution of resilience in Islamic banking and establishing a robust foundation for forthcoming research and policy development.

Research on the resilience of Islamic banking indexed in Scopus primarily employs empirical methodologies—such as case studies, surveys, and data-driven analyses—while insufficiently addressing conceptual and theoretical foundations, thus constraining a thorough comprehension of the field's intellectual evolution. This study aims to enhance the conceptual foundation of Islamic banking resilience research by conducting a comprehensive review of publishing trends, subject clusters, and existing frameworks. The study employs bibliometric tools and literature mapping techniques to identify prevalent analytical models, emphasize resilience indicators, and reveal methodological biases influencing contemporary discourse. This method consolidates disparate viewpoints and facilitates the creation of standardized, Islamic-compliant conceptual frameworks, which are essential for enhancing future research, policymaking, and the strategic function of Islamic banking in fostering sustainable and ethical finance. Figure 1 illustrates that empirical studies, particularly those examining the factors that influence resilience, remain prevalent in the academic field (Nugroho et al., 2020; Suripto, 2023). These studies consistently demonstrate that Islamic banks tend to exhibit greater resilience than their conventional counterparts, particularly during periods of financial stress (Farooq & Zaheer, 2015; Hashem & Abdeljawad, 2018). Empirical findings also point to macroeconomic indicators such as gross domestic product (GDP), inflation, capital adequacy ratio (CAR), and non-performing financing (NPF) as significant determinants of Islamic banking resilience (Maliha & Marlina, 2019; Setyawati et al., 2019), given their close connection to financial and economic stability.

Besides case studies, empirical research on Islamic banking resilience has used surveys, experimental investigations, and peer-reviewed scholarly articles, highlighting the sector's rising focus on resilience. Numerous survey-based research studies have highlighted the crucial human and organizational elements that affect Islamic banking resilience. For example, employee emotional intelligence (Jannah & Primadineska, 2022), along with trust and organizational commitment (Wahyudi, 2014), has been found to play a significant role in shaping institutional resilience. Meanwhile, constructive investigation has led to new frameworks and models that link resilience to Islamic financial principles. These studies emphasise value-based banking and solvency stress testing, which uses asset quality and the capital adequacy ratio (CAR) to evaluate Islamic banks under duress (Chattha & Archer, 2016; Tok & Yesuf, 2022).

The discussion paper format has also highlighted conceptual markers of Islamic banking resilience. Corporate resilience, financial performance, and innovative employee behavior have been examined in relation to how Islamic banks adapt and function during crises and systemic disruption (Abdel-Baki & Leone Sciabolazza, 2014; Suhandiah et al., 2023). Additionally, literature-based studies have highlighted the influence of macroeconomic indicators—such as inflation, GDP, and interest rate volatility—on the

resilience of Islamic banking (Hussain et al., 2016). Although less common, these reviews offer valuable insight into the external economic conditions that affect the capacity of Islamic banks to withstand shocks and maintain operational stability.

This study provides a comprehensive examination of Islamic banking resilience research over the past 14 years, utilizing bibliometric tools such as VOSviewer and Excel 365 to identify key themes, research trends, and methodological approaches, while addressing the deficiencies in conceptual clarity and theoretical coherence within the discipline. Through the integration of systematic review and visual analysis, the study elucidates internal and external resilience factors, identifies underexplored domains, and provides evidence-based policy recommendations to foster the establishment of cohesive, Islamic-compliant resilience frameworks—thereby enhancing academic discourse and guiding policymakers.

METHODS

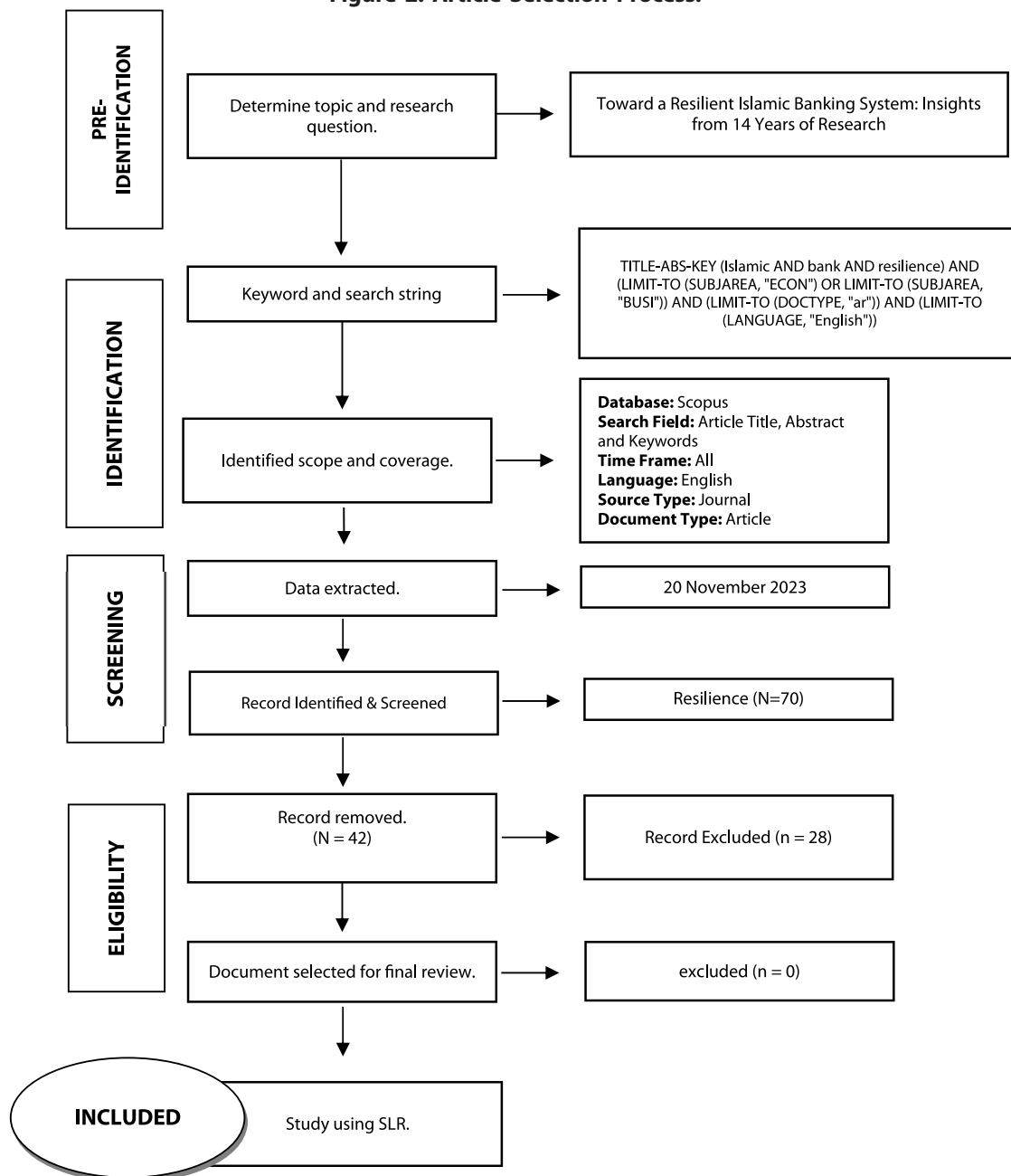
This study utilizes a qualitative research design that integrates a Systematic Literature Review (SLR) and a Systematic Mapping Study (SMS) to investigate the resilience of Islamic banking within the domains of economics, business, finance, and accounting. The search, directed by a specific research topic, was conducted in the Scopus database (as of November 20, 2023), utilizing the keywords “Islamic banking” and “resilience,” and was restricted to English-language, peer-reviewed journal articles in pertinent subject areas. The original search yielded 70 records, from which 42 were excluded following screening, leaving 28 articles eligible for full-text analysis. The final analysis encompassed 42 peer-reviewed publications, meticulously selected in accordance with Rowe’s (2014) recommendation that 20–50 articles are adequate for narrative and integrative reviews, thereby ensuring comprehensive coverage.

The systematic literature review facilitated a comprehensive synthesis of themes, theoretical frameworks, and empirical findings (Iden & Eikebrokk, 2013; Khatib et al., 2021; Xiao & Watson, 2019), whereas the systematic mapping study offered a macro-level perspective by classifying research focus, methodologies, and trends (Petersen et al., 2008; Aprizal et al., 2025). Zuhroh (2022) was performed to extract and interpret data from structured abstracts and entire texts. The literature was analyzed to discern resilience variables, conceptual frameworks, methodological trends, and geographic emphasis. This comprehensive methodology outlines thematic and methodological advancements, identifying gaps and underexplored domains, thereby facilitating theoretical consolidation and informing future research and policy trajectories. Figure 2 outlines the sequential technique, ensuring transparency and the inclusion of high-quality, Scopus-indexed papers.

The SLR method provides a structured and comprehensive review of the literature to address the main research questions, identify key conceptual and empirical gaps, and propose informed directions for future investigation. To enhance transparency, rigor, and replicability, the review process follows the Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA) framework, as recommended in systematic review standards (Petersen et al., 2008). In parallel, the systematic mapping analysis expands the scope of

inquiry beyond traditional review practices. Unlike conventional SLRs that focus on depth, SMS enables broader categorization and clustering of themes, providing a macroscopic view of the intellectual landscape of Islamic banking resilience. The mapping analysis captures methodological patterns, thematic concentrations, and regional research distributions—insights that are essential for strategic forecasting and agenda-setting in future scholarship (Zuhroh, 2022). The initial phase of the research involved identifying core research questions, which were informed by prior studies on early warning systems, financial stability, and sustainability in Islamic banking. This foundational step helped shape the criteria for article inclusion and guided the thematic coding process throughout the content analysis.

Figure 2. Article Selection Process.



Source: Wiranatakusuma et al. (2024)

In the second phase, pertinent literature was retrieved from Scopus using ScienceDirect, with the search term “Islamic banking resilience” in the “Reference” column, yielding 70 papers: the third phase involved selecting English-language, peer-reviewed journal papers and refining the dataset to 42 high-quality publications. During the fourth phase, papers were evaluated for eligibility according to the following criteria: publication between 2010 and 2023, inclusion in Scopus, thematic relevance to Islamic banking resilience, and sufficient content for qualitative coding and bibliometric analysis (see Figure 1). The chosen articles were organized with Mendeley and exported in RIS format for analysis. Instruments, including VOSviewer, Microsoft Excel 365, and Publish or Perish, were utilized. VOSviewer facilitated the visualization of co-authorship networks and theme clusters, whilst Excel assisted in manual classification, trend analysis, and chart creation. Publish or Perish supplied citation metrics and authorship information for quantitative validation. The study achieved methodological rigor and thorough synthesis through the integration of various tools and methods. The integration of SLR and SMS frameworks facilitated the detection of prevailing themes, research trends, and conceptual deficiencies. This comprehensive technique, which constitutes approximately 10–15% of the text, enhances the transparency, replicability, and trustworthiness of the findings.

RESULTS AND DISCUSSION

This study significantly enhances the field of Islamic banking resilience by employing a comprehensive approach that incorporates both internal and external factors, surpassing earlier research, such as Farooq & Zaheer (2015) and Hassan & Aliyu (2018), which primarily concentrated on internal metrics, including efficiency and profitability. The research offers a more comprehensive and policy-relevant analysis by highlighting the previously underestimated importance of macroeconomic determinants and policy connections. The bibliometric mapping indicates that research on Islamic banking resilience is fragmented, characterized by weak keyword correlations and a lack of topic consistency, underscoring the absence of a cohesive theoretical framework. It identifies significant deficiencies in the literature, including the oversight of external shocks and systemic risks, and provides a more strategic framework for further research. Moreover, the study examines the historical, geographic, and disciplinary evolution of the discipline, revealing that resilience is often narrowly regarded as an internal or operational matter, with a limited focus on macro-level issues. This study underscores the importance of resilience in maintaining financial stability, effective risk management, and adaptive policymaking, offering crucial insights for academics, policymakers, and regulators seeking to enhance Islamic banking institutions in pursuit of global sustainability and stability objectives.

Articles on Islamic banking resilience fluctuated between 2010 and 2012, but grew rapidly from 2013 to 2017. After a modest reduction in 2018, publications rebounded, peaking in 2022 with 8 out of 42 papers (Figure 3). Between 2010 and 2017, intellectuals and professionals became increasingly interested in global economic issues affecting emerging and Muslim-majority countries. The ability of Islamic banking

to recover from economic shocks and sustain prosperity was highlighted in research. From 2018 to 2022, publication trends focused on resilience variables, including governance, ownership frameworks, liquidity, social capital, and risk management. The complex dynamics of Islamic banking, including stability, profitability, and systemic risk, are attracting attention.

Figure 3. Publications on Islamic Banking Resilience in Scopus Indexed Journals for the Last 14 Years

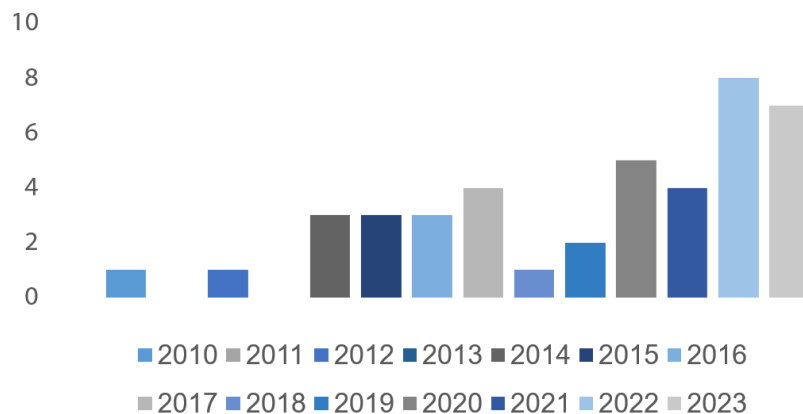


Figure 3 illustrates the distribution of Scopus-indexed Islamic banking resilience articles from 2010 to 2023. This study found two main phases. Publications were limited and irregular between 2010 and 2016, suggesting the subject's early academic interest. A significant change in 2017 signaled a growing interest in this area. Publication rates increased from 2020 to 2023, peaking at 9 and 8 pieces in 2022 and 2023. This rise aligns with global economic risks, such as the COVID-19 pandemic and systemic risk concerns, emphasizing the need for Islamic banking to be resilient in crisis and to adopt a long-term strategy. The rising trend supports interdisciplinary research on resilience in Islamic finance. Most research comes from countries with strong Islamic finance sectors. Indonesia is leading, followed by Malaysia with 12 publications and Pakistan with 7. Also contributing were France, England, Saudi Arabia, the United States, India, Italy, and Oman, though in smaller amounts. France and England's involvement highlights the issue's global reach, extending beyond Muslim-majority countries. Institutional analysis (Figure 5) highlights key contributors, including Indonesian universities Universitas Airlangga and Universiti Kebangsaan Malaysia, which demonstrate a regional commitment to Islamic banking research. These findings support academic interest in resilience in Islamic financial institutions and its strategic importance.

Some researchers are interested in the resiliency of Islamic banking. International institutions, such as the International Monetary Fund (IMF), are addressing this issue on a global scale. IMF involvement suggests that the resilience of the Islamic finance system is a global financial stability and policy concern. This growing body of academic and multinational research emphasizes resilience as a key aspect of Islamic banking's resilience

and sustainability during global economic crises. Other researchers are interested in the resiliency of Islamic banking. International institutions, such as the IMF, are globalizing this issue. IMF involvement suggests that the resilience of the Islamic finance system is a global financial stability and policy concern. This growing body of academic and multinational research emphasizes resilience as a key aspect of Islamic banking's resilience and sustainability during global economic crises. The Islamic banking resilience study involves many academic fields.

Figure 4. Map of Islamic Banking Resilience Document Articles in Scopus Indexed Journals for the Last 14 Years

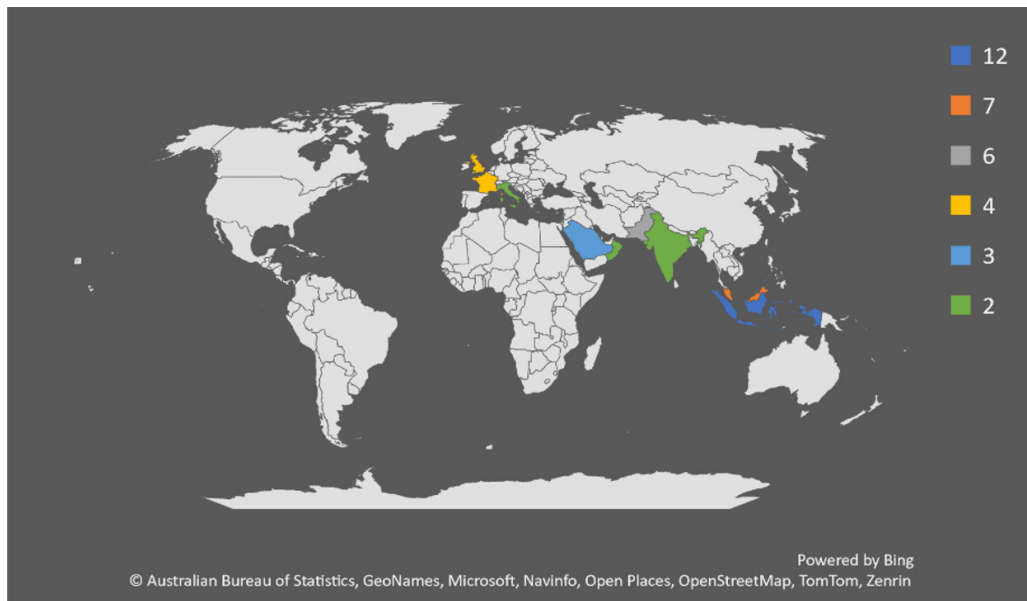


Figure 5. Top Ten Affiliated Articles on Islamic Banking Resilience Documents in Scopus Indexed Journals for the Last 14 Years.

- | | |
|--|--------------------------------------|
| ■ Universitas Airlangga | ■ Universitas Kebangsaan Malaysia |
| ■ International Monetary Fund | ■ Universitas Indonesia |
| ■ Universite de la Manouba | ■ Universitas Islam Sunan Kalijaga |
| ■ Islamic Research and Training Institue | ■ Sekolah Tinggi Ilmu Manajemen YKPN |
| ■ Bait Al-Mashura Finance Consultation | ■ MY Business School |

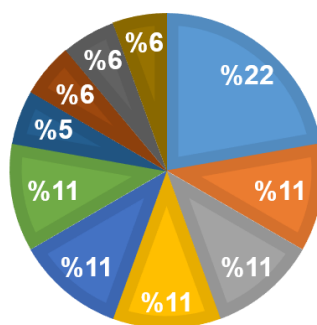


Figure 6. Number of Articles on Islamic Banking Resilience in Scopus-Indexed Journals Based on Scientific Field in 14 Years

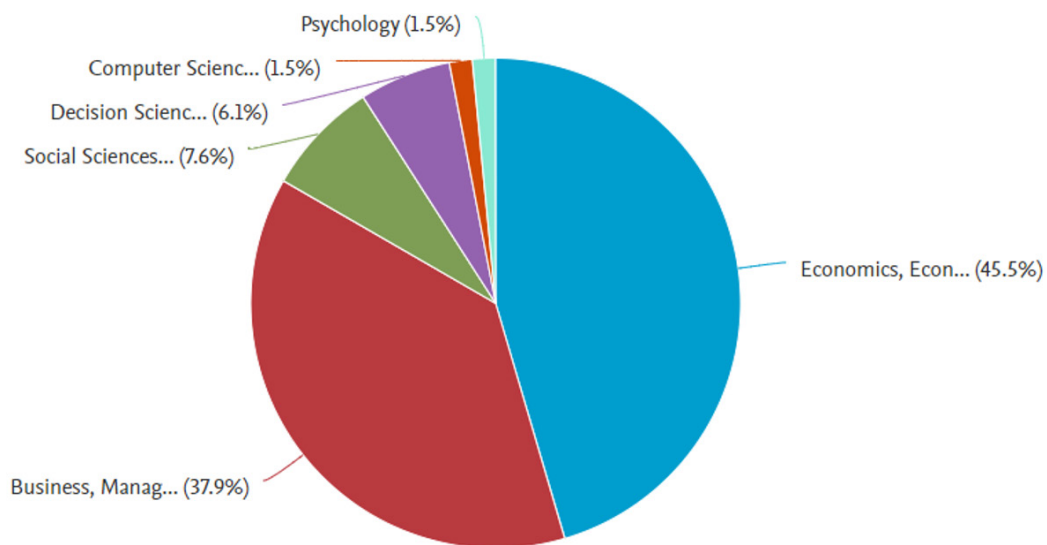
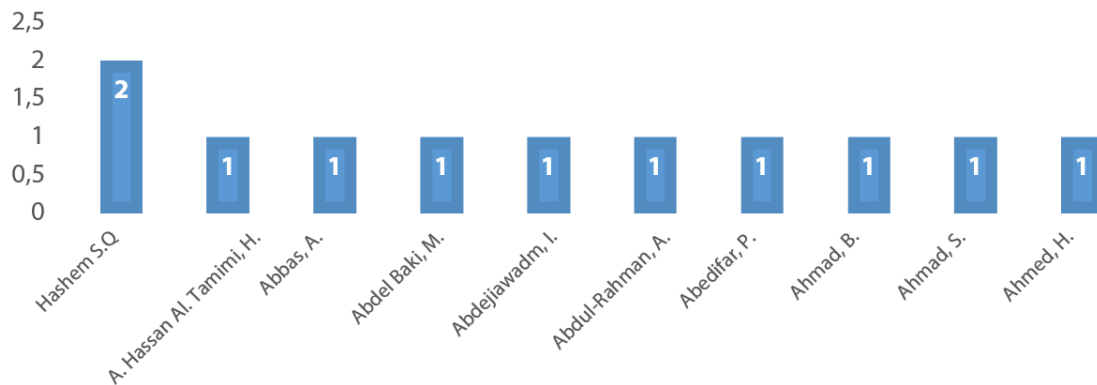


Figure 6 illustrates these studies, which include economics, econometrics, finance, business, management, and accounting, as well as social sciences, decision sciences, computer science, and psychology. To illustrate its conceptual diversity, science can be classified into two groups. Economics, finance, business, management, accounting, and social sciences study financial stability, institutional performance, governance, and policy effects in the first cluster. Second, decision science, computer science, and psychology demonstrate an increasing interest in data-driven, behavioral, and cognitive Islamic banking resilience. This group studies predictive analytics, risk modeling, uncertainty-based decision-making, and stakeholder psychology. These findings demonstrate that Islamic banking resilience research uses quantitative and qualitative scientific approaches. This diverse academic engagement highlights the complexity of resilience and the necessity for cross-disciplinary methods in Islamic banking.

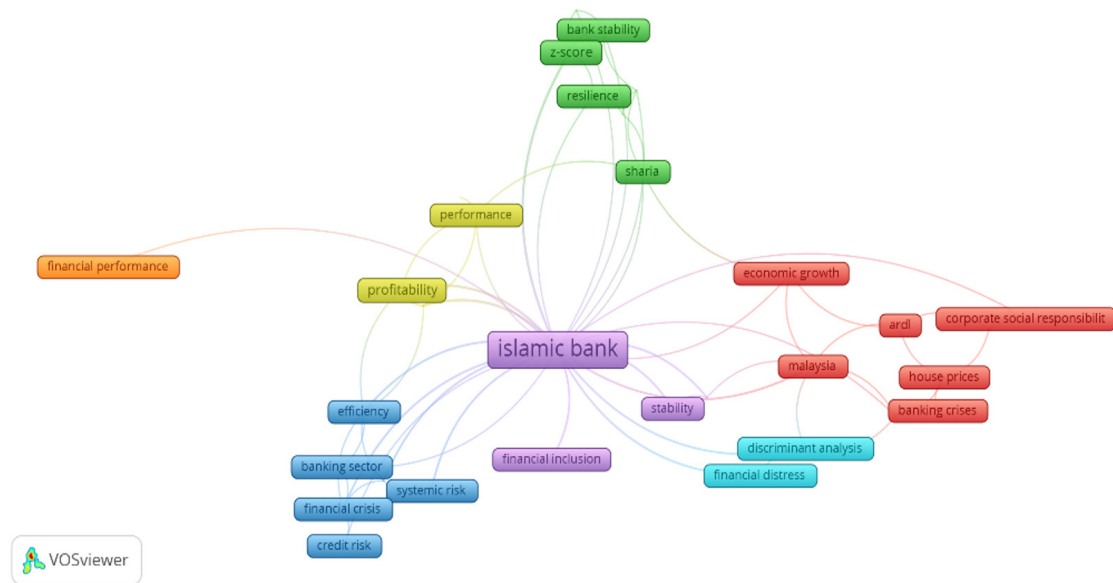
Figure 7 identifies key contributors to Islamic banking resilience research over the past 14 years. Hashem and Abdeljawad (2018) emerged as the most prolific authors, each with two publications, while most others contributed only once. It reflects limited sustained author-level engagement in the field. VOSviewer analysis revealed ten author clusters, suggesting emerging but fragmented research networks based on co-authorship, affiliations, or thematic focus. This pattern highlights both a challenge and an opportunity. The lack of recurring contributors indicates the field is still developing and lacks a dedicated scholarly core. However, the presence of multiple clusters signals growing interest and potential for expansion. Advancing this area will require fostering long-term scholarly engagement, encouraging collaborative research, and building institutional networks centered on Islamic banking resilience.

Figure 7. Top Ten Prolific Authors of Islamic Banking Resilience Articles in Scopus Indexed Journals in the Last 14 Years



VOSviewer, a powerful bibliometric analysis tool, leverages data from the Scopus database to visualize and interpret thematic structures within scholarly literature. In this study, the tool identified seven distinct clusters of co-occurring keywords, each representing a thematic grouping within the field of Islamic banking resilience. These clusters offer valuable insights into the intellectual landscape of the field and the interconnections between various research themes (Figure 8). Thematic analysis of Islamic banking resilience research reveals seven distinct clusters, illustrating the field's diversity and interdisciplinary character. Cluster 1 (Red) emphasizes econometric modelling and macro-financial variables, specifically within Gulf Cooperation Council (GCC) nations, incorporating concepts such as autoregressive distributed lag (ARDL), economic growth, and the stability of Islamic banks. Cluster 2 (Green) emphasizes technical resilience metrics, including the capital adequacy ratio, Z-score, and surplus liquidity, highlighting regulatory and stability indicators. Cluster 3 (Blue) offers a comparative analysis of Islamic and conventional banks, focusing on themes such as credit risk, efficiency, and systemic risk during financial crises. Cluster 4 (Yellow) focuses on operational and financial performance, encompassing profitability, liquidity, and the effects of COVID-19. Cluster 5 (Purple) associates Islamic banking with financial inclusion and stability, highlighting its developmental function. Cluster 6 (Light Blue) employs methodological instruments, such as discriminant analysis, to evaluate resilience characteristics, whereas Cluster 7 (Orange) focuses on financial performance as a metric of output-based resilience. The proximity and color-coded clusters demonstrate thematic co-occurrence and conceptual connectedness, indicating that Islamic banking resilience is a dynamic and expanding area of research. This mapping validates the thoroughness of the literature. It directs future research and policy by pinpointing gaps, particularly in behavioural finance and sustainable integration, underscoring its importance for financial stability, development strategy, and risk governance.

Figure 8. Network Visualization of Islamic Banking Resilience



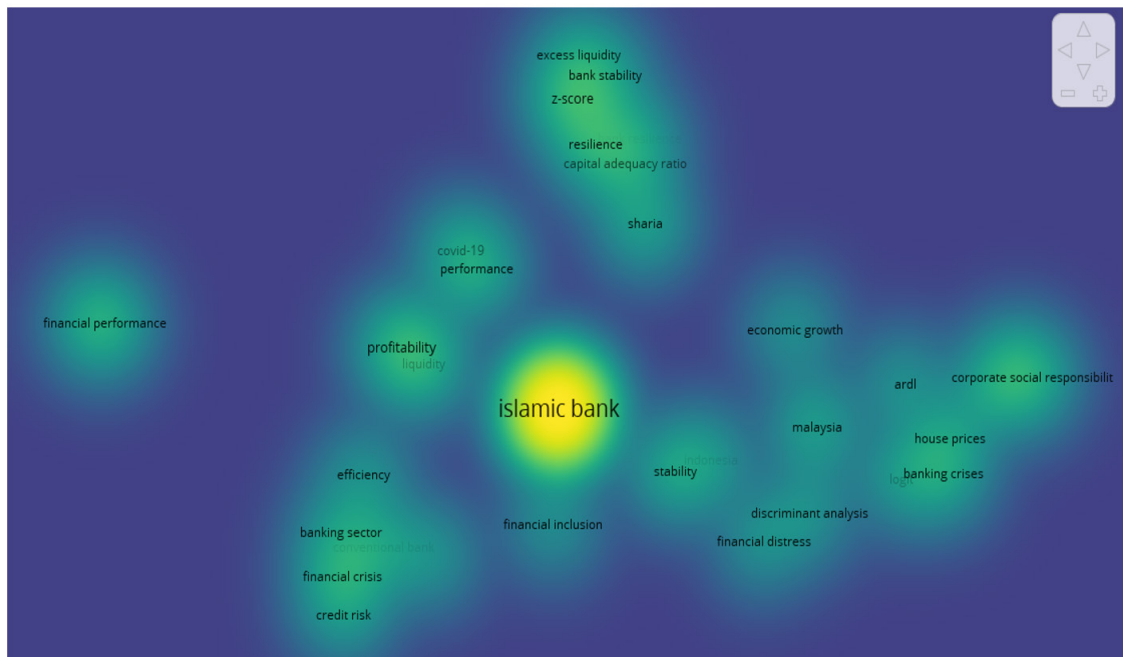
Source: Authors' Analysis by VOSviewer

Figure 9, produced with VOSviewer, illustrates a density visualization of keyword occurrences in the literature on Islamic banking resilience. Warm hues (yellow) emphasize commonly examined subjects such as Islamic banking, stability, profitability, and financial performance, reflecting a pronounced emphasis on institutional efficiency and financial robustness. Conversely, subjects such as economic growth and financial inclusion are depicted in cooler tones, indicating they are inadequately examined. This graphic elucidates essential research goals and deficiencies. Although financial measurements predominate, larger developmental factors—such as inclusivity and economic impact—are still constrained. Considering the ethical and community-oriented principles of Islamic banking, the integration of resilience with financial inclusion offers a significant avenue for future research. This integration can facilitate the achievement of Sustainable Development Goals (SDGs) and inform more equitable financial policies. The map highlights the necessity of broadening the resilience discourse beyond mere performance to include social and ethical dimensions that accord with the principles of Islamic finance.

Table 1 outlines the most frequently cited publications in Islamic banking resilience, highlighting their impact and alignment with the thematic clusters presented in Figure 8—namely, resilience, financial crisis, stability, profitability, liquidity, and systemic risk. The highly cited works, such as Hassan and Aliyu (2018), Farooq and Zaher (2015), Pappas et al. (2017), Salman and Nawaz (2018), and Rizvi et al. (2020), uniformly examine fundamental subjects including bank stability, crisis performance, and efficiency assessments relative to traditional banks. Keyword mapping substantiates these tendencies, indicating the prevalent use of phrases such as Islamic banks, stability, profitability, and performance—thereby delineating the conceptual parameters of the subject. The density of citations about particular themes and authors indicates a developing literature and an

increasing consensus on definitions and evaluation criteria for resilience. The correlation between citation data and thematic clusters substantiates the research landscape and provides strategic direction for future studies. It aids scholars in refining theoretical frameworks and identifying underexplored yet significant topics, such as climate-related hazards or fintech within Islamic banking. These significant studies provide policymakers and practitioners with valuable insights to develop more resilient, inclusive, and Islamic-compliant financial systems.

Figure 9. Density Visualization Islamic Banking Resilience



Source: Authors' Analysis by VOSviewer 2023

Table 1. Top 5 Articles about Islamic Banking Resilience with the Highest Citations

Document Title	Author	Source	Cited By
A Contemporary Survey of Islamic Banking Literature	Hassan & Aliyu (2018)	Journal of Financial Stability	289
Are Islamic Banks More Resilient During Financial Panics?	Farooq & Zaheer (2015)	Pacific Economic Review	237
A Survival (Stability) Analysis of Islamic and Conventional Banks	Pappas et al. (2017)	Springer	190
Islamic Financial System and Conventional Banking: A Comparison	Salman & Nawaz (2018)	Arab Economic and Business Journal	163
Role of Islamic Banks in Indonesian Banking Industry: An Empirical Exploration	Rizvi et al. (2020)	Pacific-Basin Finance Journal	125

Source: Author Analysis by Scopus Database, Publish & Perish, and Excel 365

Table 2 shows that Islamic banking resilience research focuses on efficiency, profitability, liquidity, and financial performance. These studies analyze resilience using

operational measures, offering little institution-specific perspective. Despite Riaz et al. (2017) and Setyawati et al. (2019) finding that macroeconomic variables, such as inflation, GDP growth, and exchange rate volatility, are crucial for understanding Islamic banking resilience within broader economic frameworks, the analysis fails to represent this. The term “bank resilience” is infrequently used and carries negative connotations with “efficiency” and “profitability.” It suggests that while resilience components are addressed, few studies explicitly use or identify these frameworks as resilience. These findings suggest that research on Islamic banking resilience is still in its early stages of development and lacks a comprehensive conceptual and methodological framework. Future studies should define and quantify resilience, combine macroeconomic variables, use sophisticated modeling, and emphasize “bank resilience” as a key concept. It will help set a research agenda, improve cross-study comparability, and make the literature more policy-relevant and practical.

Table 2. Selected Keywords Regarding Islamic Banking Resilience

Keyword	Occurrences	Total Link Strength	Keyword	Occurrences	Total Link Strength
Islamic Bank	35	44	Bank Resilience	2	4
ARDL	9	9	Bank Stability	2	4
Efficiency	2	7	Banking Sector	2	4
Liquidity	3	7	Economic Growth	2	4
Profitability	4	7	Financial Distress	2	4
Financial Crisis	3	6	Stability	3	4
Islamic Compliant	3	5	Resilience	3	3
Excess Liquidity	2	3	Financial Inclusion	2	5
Financial Performance	3	3	Systemic Risk	2	3
GCC Countries	2	3	Financial Inclusion	2	2
Banking Crises	3	2	COVID-19	2	2
Credit Risk	3	2	Performance	3	5

Source: Author Analysis by VOSviewer

In the current global financial landscape, resilience within the financial sector has emerged as a critical priority for countries worldwide, especially in light of recurring economic disruptions and systemic shocks. Within this context, Islamic banking resilience is of paramount importance, as it plays a pivotal role in sustaining economic activity and preserving financial stability during periods of stress, such as financial crises, pandemics, or geopolitical disturbances.

Islamic banking can be deemed resilient when it satisfies three essential conditions: first, it absorbs shocks without government dependence. A resilient Islamic bank must possess the internal strength to absorb economic or financial shocks without relying on

government bailouts or extraordinary fiscal support. This independence reflects institutional robustness and reduces the risk of moral hazard, thereby contributing to systemic stability.

Second, rapid recovery and operational continuity. Beyond merely withstanding crises, resilient Islamic banks should demonstrate the capacity to recover swiftly from adverse events such as financial crises or economic recessions. It includes the ability to resume normal operations, ensure service delivery, and continue supporting economic activities, such as lending to businesses and facilitating payment systems, even under pressure.

Third, robust risk management, capital adequacy, and liquidity buffers. Resilience also depends on the presence of robust risk governance frameworks, including prudent risk identification, effective mitigation strategies, and sufficient capital reserves and liquidity holdings. These features ensure that Islamic banks can fulfill their obligations, maintain public confidence, and perform critical financial functions—such as mobilizing deposits, allocating credit, and processing transactions— even in times of stress.

Farooq and Zaheer (2015) and Yanikkaya et al. (2018) concur that a resilient Islamic financial institution can withstand shocks and contribute to financial system stability. Therefore, Islamic banking resilience is the ability of an Islamic bank or banking system to absorb shocks and external pressures, recover efficiently, and continue operations during recessions, systemic financial disruptions, and operational crises. According to Hassan and Aliyu (2018), Setyawati et al. (2019), and Yanikkaya et al. (2018), financial strength, governance quality, and Islamic banking's ethical-financial principles, such as risk-sharing and asset-backing, may make Islamic banks more stable than conventional banks. Islamic banks must be resilient for institutional survival and to contribute to macroeconomic stability in nations where Islamic banking is significant. In an era of frequent global disruptions, Islamic banking operations must be resilient to maintain trust, promote economic recovery, and achieve sustainable financial development. Additionally, Islamic finance requires regulatory frameworks, supervisory tools, and stress-testing processes customized to its principles and characteristics.

Table 3. The Importance of Achieving and Maintaining Banking Sector Resilience

No	Reasons
1	Stability in Financial and Economic System
2	Building Trust or Confidence towards Investor and Consumer
3	Risk Management
4	Protecting against Losses
5	Economic Diversification
6	Regulatory Compliance
7	Financial Intermediation, Profitability, and Efficiency
8	Policy Implication

Source: (Hassan & Aliyu, 2018; Setyawati et al., 2019; Yanikkaya et al., 2018) Analysis by Author

Built on the results of a review of several Islamic banking resilience literature studies, resilience studies are deemed important for several reasons (Table 3). Stability in financial and economic systems, building trust or confidence (investor and consumer), risk management, protecting against losses, economic diversification, regulatory compliance, financial intermediation, profitability and efficiency, and policy implications. (Hassan & Aliyu, 2018; Setyawati et al., 2019; Yanikkaya et al., 2018).

First, stability in financial and economic system. The resilience of Islamic banking is crucial for sustaining financial and economic stability, especially in times of crisis. It allows banks to mitigate internal risks and endure external shocks, including market volatility, economic recessions, and geopolitical conflicts. Resilient Islamic banks maintain public trust and facilitate economic recovery by consistently providing critical services, including credit, liquidity, and transactional support. Inability to absorb shocks can precipitate systemic crises and prolonged instability. According to Abdel-Baki and Leone Sciabolazza (2014), Khémiri and Alsulami (2023), and Mohammed et al. (2020), resilience serves as a strategic asset that promotes sustainable growth and protects economies from financial disturbances.

Second, building trust or confidence towards investors and consumers. Islamic banking's resilience fosters trust among investors, consumers, shareholders, and communities during external shocks, such as financial crises or the COVID-19 pandemic. Banks that manage risks and offer stable returns are perceived as reliable, attracting deposits and investments (Pratama & Rizal, 2019). Trust, as noted by Azmi et al. (2023), is vital for ensuring liquidity—the lifeblood of Islamic banks. A resilient system maintains operations, credit flows, and financial stability. Conversely, weak, undercapitalized banks risk eroding confidence, triggering withdrawals, liquidity crises, and systemic instability. Therefore, resilience is essential both strategically and operationally to sustain stakeholder trust and long-term financial stability.

Third, risk management. The resilience of Islamic banking arises from robust governance and proactive risk management, which are integral to strategic planning. By proactively identifying and mitigating risks, Islamic banks can withstand shocks, expedite recovery, and reduce interruptions. Abedifar et al. (2017) emphasize that the asset-backed and risk-sharing frameworks of Islamic banks improve their capacity to manage systemic crises. Ahmad et al. (2022) assert that resilience enhances risk management and financial stability via capital buffers, liquidity reserves, and stress testing. These practices safeguard stakeholders and preserve critical services. Ultimately, proficient risk management sustains trust, credibility, and operational viability in a swiftly evolving global market.

Fourth, protecting against losses. Banks act as custodians of public funds, making their resilience vital to prevent losses and economic disruption. In Islamic banking, resilience is even more critical due to its unique risk-sharing contracts. Adequate capital buffers and prudent risk-weighted asset management are essential for absorbing shocks and maintaining solvency. Barau et al. (2023) emphasize the importance of protecting unrestricted investment account holders (URIAH), who bear the profit and loss without ownership rights and face greater risks, particularly in areas where investor protections

are weak. Strengthening Islamic banking resilience safeguards URIAHs, builds trust, and ensures ethical, inclusive, and stable financial outcomes for all stakeholders.

Fifth, economic diversification. The distinctive characteristics of Islamic banking, including the ban on interest and reliance on asset-based financing, enhance financial diversification and mitigate speculative risk by associating transactions with tangible economic activities. This paradigm facilitates areas such as healthcare, education, and infrastructure, hence augmenting economic resilience and development. In times of crisis, Islamic banks with robust capital and risk management systems continue to provide essential services, thereby supporting SMEs, employment, and consumer demand. Their resilience embodies ethical ideals, endorsing social and environmental objectives via community funding, waqf, and sustainable investments (Albaity et al., 2023; Wahyudi, 2014). Consequently, the resilience of Islamic banking promotes enduring stability, inclusivity, and sustainability.

Sixth, regulatory compliance. Regulators mandate that banks demonstrate financial resilience, often through stress testing, which assesses a bank's ability to withstand economic shocks. Resilient banks adhere to these criteria to avoid sanctions and reputational damage. It is consistent with Islamic concepts such as ethical investment and risk-sharing for Islamic banks. Mohammed et al. (2020) state that stress testing improves stability and strengthens compliance by facilitating real-sector funding and mitigating risk. Structural characteristics—such as asset-backed lending and the restriction of *riba* and *gharar*—enhance resilience (Tok & Yesuf, 2022; Al-Muharrami & Hardy, 2013). The combination of regulation with Islamic principles provides a stable, ethical, and crisis-resistant banking sector.

Seventh, financial intermediation, profitability, and efficiency. Banks enhance capital allocation, investment, and economic growth by transferring funds from depositors to borrowers. Business growth, job creation, and household spending depend on this intermediary function. This role is damaged when banks lack resilience. Liquidity shortages, credit limits, and capital depreciation can disrupt financial intermediation, slowing investment flows and economic activity. Poor risk management, economic shocks, or inefficiencies can lead to prolonged operational losses, which negatively impact a bank's profitability and efficiency. Vulnerabilities impact the bank's performance, stakeholder confidence, access to funding, and systemic risk.

In contrast, resilient banks can operate smoothly under pressure. Strong governance, capital buffers, risk management, and operational efficiency define these institutions. As noted by Faizulayev et al. (2020) and Setyawati et al. (2019), resilience enables banks to deliver sustainable profitability and operational efficiency, which in turn benefits both shareholders and customers. Resilient banks are more likely to generate consistent returns, honor depositor obligations, and provide credit even during economic downturns—thus reinforcing their role as a stabilizing force in the economy. In summary, resilience is vital not only for mitigating risks and surviving crises but also for ensuring that banks can continue to fulfill their economic and social functions effectively. A resilient Islamic banking sector fosters trust, promotes inclusive growth, and contributes to the long-term stability of the financial system.

Eight, regulatory supervisory framework. Islamic banking's resilience can help policymakers and regulators develop effective policies for Islamic financial institutions. Understanding how Islamic banks manage shocks and maintain stability helps regulators develop policies that enhance economic and financial resilience. Resilience studies develop an Islamic-compliant regulatory system that safeguards financial stability and adheres to the ethical and structural principles of Islamic finance. It includes profit-and-loss sharing, *riba*, and asset-backed transactions. As noted by Abedifar et al. (2017), Ahmad et al. (2022), and Mohammed & Muhammed (2017), resilience-focused analysis can be used to construct prudential-based incentives that discourage excessive risk-taking. Policymakers can improve risk governance, banking responsibility, and sustainability by aligning regulatory measures with resilience patterns. The study of Islamic banking resilience informs strategic evidence-based policymaking. It promotes stable, ethical, and risk-aware regulatory systems that preserve the financial system and encourage Islamic banking.

Table 4. List of Articles on Factors That Can Influence Islamic Banking Resilience

No	Name & Year	Title	Results
1	Yanikkaya et al. (2018)	How profitability differs between conventional and Islamic banks: A dynamic panel data approach	Inflation, Gross Domestic Product, Interest Rate, Exchange Rate, Bank Size (Total Assets)
2	Nugroho et al. (2020)	The resilience of the Indonesian banking system and macroeconomic fluctuation: Islamic versus conventional banking	Gross Domestic Product, Inflation, Exchange Rate, Composite Stock Price Index (CSPI)
3	Otaviya & Rani (2020)	Productivity and its determinants in Islamic banks: Evidence from Indonesia	Gross Domestic Product, BI Rate
4	Setyawati et al. (2022)	Stability and resilience of Islamic banking system: A closer look at the macroeconomic effects	Capital Adequacy Ratio, Non-Performing Financing, Gross Domestic Product, Exchange Rate, Return on Assets
5	Cahyono et al. (2021)	Determinants of Indonesian conventional and Islamic bank depositor trust during the COVID-19 pandemic	Interest Rate, Industrial Production Index, Inflation, Profit Sharing
6	Suripto (2023)	Comparing the resilience of Islamic and conventional banking to the financial crisis in the Association of Southeast Asian Nations	Capital Adequacy Ratio, Return on Assets, Loan Deposit Ratio, Non-Performing Loans, Non-Performing Financing
7	Pratama & Rizal (2019)	The resilience of Islamic banks in facing the economic dynamics in Indonesia	Exchange Rate, BI Rate
8	Areeba Khan et al. (2019)	Islamic vs. conventional commercial banking: The resilience avant-garde	Ownership Type, Return on Assets, Capital Adequacy Ratio, Bank Size, Non-Performing Loan, Non-Performing Financing, Return on Equity
9	Maliha & Marlina (2019)	Why are Islamic banks relatively more resilient to crisis?	Financing to Asset Ratio, Capital Adequacy Ratio, Inflation, BI Rate, Industrial Production Index, Export, M2, Exchange Rate
10	Talba et al. (2019)	The perception on the contribution of Islamic banks and Islamic windows towards the growth of the Nigerian economy	Loan Service, Deposit Service

Source: Author Analysis by Microsoft Excel 365

An examination of 20 research studies reveals that both macroeconomic and bank-specific factors significantly impact the durability of Islamic banks. Principal drivers encompass GDP, inflation, currency rates, bank size, capital adequacy ratio (CAR), non-performing financing (NPF), return on assets (ROA), central bank rates, non-performing loans (NPL), liquidity, interest rates, the industrial production index, and credit. These metrics provide a comprehensive framework for evaluating the ability of Islamic banks to withstand financial shocks. GDP and inflation are the most significant external factors. An increase in GDP, indicative of overall economic activity, boosts banking demand, enhances borrowers' repayment ability, and stimulates investment, therefore fortifying bank resilience (Yanikkaya et al., 2018). Inflation presents intricate hazards by diminishing buying power and elevating the likelihood of default. Nugroho et al. (2020) and Otaviya & Rani (2020) indicates that Islamic banks exhibit greater susceptibility to inflation compared to regular banks. The research highlights the need to connect resilience metrics with the structural and institutional framework of the banking sector. Table 4 emphasizes that resilience necessitates consideration of both macroeconomic variables and internal banking parameters such as the Capital Adequacy Ratio (CAR) and liquidity. Policymakers should integrate GDP and inflation trends into stress testing, while Islamic banks must employ proactive risk management methods to enhance long-term stability and mitigate susceptibility to inflation shocks.

The size of a bank and its capital adequacy ratio (CAR) are two critical internal characteristics that profoundly affect the resilience and sustainability of Islamic banking. A larger bank, assessed by total assets or operational reach, typically gains advantages from economies of scale, diversified portfolios, and enhanced resource efficiency, all of which bolster resilience. Nonetheless, augmented size also introduces heightened operational complexity, necessitating the development of sophisticated governance and risk management frameworks. Areeba Khan et al. (2019) and Danisman et al. (2021) suggests that major banks face heightened liquidity requirements, and inadequate liquidity management can compromise their resilience. A high Capital Adequacy Ratio (CAR) indicates robust capital reserves that enable Islamic banks to withstand losses, comply with regulatory requirements, and maintain depositor confidence, particularly during economic recessions (Maliha & Marlina, 2019; Banna & Alam, 2020). From a legislative and managerial standpoint, bank size and Capital Adequacy Ratio (CAR) should inform supervisory frameworks, capital strategies, and macroprudential policies, especially for systemically significant institutions. As Islamic banks expand, they must synchronize their growth with robust risk governance and liquidity policies. Moreover, comprehending the interaction between these internal characteristics and external macroeconomic influences is essential for formulating successful resilience solutions. In dual-banking systems, augmenting size and capital adequacy ratio (CAR) bolsters the ability of Islamic banks to manage crises and foster enduring financial stability.

CONCLUSION

This study demonstrates that both internal elements, such as capital and risk, and external factors, including GDP and inflation, influence the resilience of Islamic banking. Nevertheless, macroeconomic variables are frequently disregarded. The research used bibliometric analysis, revealing a fragmented field characterized by insufficient cross-bank comparisons and ambiguous language. It underscores the necessity for cohesive frameworks and Islamic-compliant stress testing to enhance governance, promote ethical finance, and ensure the long-term viability of Islamic banks.

This study highlights the need to enhance the resilience of Islamic banking for regulators, financial institutions, and scholars. It necessitates comprehensive policies, enhanced risk management, and uniform research methodologies. Strengthening resilience promotes crisis stability, ethical finance, financial inclusion, and long-term sustainability within Islamic and dual banking systems.

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 - a. **Title.** The title should be short, clear, and informative, but does not exceed 12 words.
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6. 6. Table format should contain only heading and contents. Please provide the top and bottom lines, along with the line(s) that separate the heading and the contents. Example:

Table 1. The Growth of Third Party Fund, Financing and Asset (Billion rupiah)

	2012	2013	2014	2015	2016	2017
Fundraising	52.271	76.036	115.415	147.512	174.018	186.608
Financing	46.886	68.181	102.655	147.505	179.284	187.886
Asset	66.090	97.519	145.467	195.018	229.557	244.197

Source: Islamic banking statistics, Bank of Indonesia

7. The manuscript is prepared in a quarto paper, single-sided, and double-space format. A new paragraph should start 5 characters from the left margin, using 12-size, garamond font type.
8. The manuscript is written in proper English, either British or American English, but not the combination of both.
9. The top and bottom margins are 1 inch.
10. The title is written using capital letters of 14 font size, centre position.
11. Sub titles are written using capital letters, started from the left margin.
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13. References should be those of the last ten years publication, unless they are key references.
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Example:
 - a. Mareta (2018) concludes that there is an impact of
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 - c. Wagner (in McCain, 1990) states that ...
 - d. The definition of flypaper effect is ... (Wagner, 1976).
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