

Profitability of islamic banking in Indonesia: The role of inflation and capital market dynamics

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Abstract: The limited profitability of Islamic banking in Indonesia amid macroeconomic volatility raises questions regarding the role of external factors, particularly inflation and capital market dynamics, in shaping bank performance. This study examines the impact of inflation and capital market conditions on the profitability of Islamic banking in Indonesia. Using monthly data on Indonesian Islamic banking Return on Assets (ROA), inflation, and the Jakarta Composite Stock Price Index (IHSG) from June 2014 to June 2025, this study employs linear regression model with Newey–West heteroskedasticity-and-autocorrelation-consistent (HAC) standard errorsto examine the relationship between macroeconomic factors and Islamic bank profitability in Indonesia. The findings reveal that inflation exerts a marginally significant negative effect on ROA, while the Composite Stock Price Index (IHSG) demonstrates a positive and significant influence, suggesting that Islamic banking profitability in Indonesia is more strongly driven by capital market conditions than by inflationary pressures.

Keywords: Islamic banking, profitability, inflation; IHSG, Return on Assets

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Introduction

Profitability is a fundamental indicator for evaluating the performance, resilience, and long-term sustainability of banking institutions. In the Islamic banking context, profitability reflects not only financial performance but also the effectiveness of fund management in compliance with sharia principles, which prohibit interest (riba) and instead promote profit-and-loss sharing, asset-backed financing, and risk-sharing arrangements (M. Iqbal & Molyneux, 2016; Ismail & Zulkhibri, 2024). Because Islamic banks operate through sharia-based mechanisms such as murabahah, musharakah, mudharabah, and ijarah rather than interest-based intermediation, their profitability may respond differently to macroeconomic conditions compared to conventional banks (Trinugroho et al., 2018).

Islamic banking in Indonesia has grown substantially, with total assets exceeding IDR 800 trillion by 2024 and a national market share of approximately 7–8 percent. Operating within a dual banking system alongside conventional institutions (Risfandy et al., 2022), Islamic banks remain exposed to external macroeconomic and financial market pressures. Despite this growth, the sector has experienced notable periods of profitability decline. OJK Sharia Banking Statistics show that aggregate ROA for Islamic commercial banks (BUS) fell from 1.86 percent in Q1 2020 to 1.40 percent by Q4 2020 a decline of 24.41 percent within a single year driven by the macroeconomic shock of the COVID-19 pandemic. More broadly, across the full study period (June 2014–June 2025), OJK data shows that bank monthly data reveal an ROA range of just 0.16 to 2.18 percent, highlighting the sector’s vulnerability to shifting macroeconomic conditions. Study document that macroeconomic variables including inflation and exchange rates significantly influence Islamic bank ROA in Indonesia (Della Priskila & Nurhasanah, 2021; Hidayat et al., 2020; A. Setyawati et al., 2025), while Sa’diyah & Nasrulloh (2025) confirm that both internal and external factors jointly determine profitability. These findings underscore that Islamic banking performance cannot be fully understood without examining the role of external determinants such as inflation and capital market dynamics.

Inflation is one of the most commonly examined macroeconomic determinants of bank profitability. Rising inflation erodes real purchasing power, weakens borrowers' repayment capacity, and can deteriorate asset quality (Apau et al., 2023). For Islamic banks specifically, the impact may differ from conventional institutions because financing contracts such as *murabahah* and *musharakah* are not directly indexed to policy interest rates (M. Iqbal & Molyneux, 2016; Rashid & Khalid, 2017), meaning that margin adjustment in response to inflationary shocks is more constrained. Empirical evidence on this relationship is, however, mixed. Hidayat et al. (2020) find a significant negative effect of inflation on Islamic bank ROA in Indonesia, consistent with findings from Hidayat et al. (2020), and Al Sharif (2023) in Jordanian Islamic bank, while (Bitar et al., 2018) found the same evidence across OECD-context conventional banking systems. In contrast, (Bilgin et al., 2021) report that the significance of inflation depends heavily on economic conditions and institutional context, while (A. Setyawati et al., 2025) find that Islamic banks exhibit partial resilience to moderate inflation through profit-sharing mechanisms. The divergence in these recent findings suggests that the inflation–profitability relationship in Indonesian Islamic banking remains an open empirical question, particularly over the post-2014 period that encompasses multiple inflation episodes (Mawardi et al., 2024).

Beyond inflation, capital market conditions represent a second major external factor shaping Islamic bank profitability. This study uses the Composite Stock Price Index (Indeks Harga Saham Gabungan, IHSG) as the proxy for capital market performance, rather than alternative indices such as the Jakarta Islamic Index (JII) or sectoral indices, for three reasons. First, the IHSG covers all equities listed on the Indonesia Stock Exchange, making it the broadest and most representative indicator of overall market sentiment and aggregate economic expectations (Hadad et al., 2011). Second, the IHSG is the most widely used reference index by domestic and foreign investors and serves as the primary barometer of Indonesia's financial system stability (Mawardi et al., 2024). Third, the IHSG reflects macroeconomic fundamentals including investment activity, corporate earnings, and business confidence that shape the real sector in which Islamic banks are most deeply engaged through asset-backed financing (Demirgüç-Kunt et al., 2020; Levine, 2005; Risfandy et al., 2022). A favorable IHSG environment thus signals conditions conducive to higher financing demand and improved asset quality in the Islamic banking sector. Recent evidence from (Bilgin et al., 2021) and (Zarrouk et al., 2016) supports this positive linkage between broader financial market development and Islamic bank profitability, though research specific to Indonesia remains limited.

Understanding these dynamics is of direct importance to two key audiences. For regulators, including Bank Indonesia and the Otoritas Jasa Keuangan (OJK), identifying the macro-financial drivers of Islamic bank profitability is essential for designing effective macroprudential policies, capital adequacy frameworks, and early warning systems (IMF, 2024). If profitability is found to be highly sensitive to capital market fluctuations, regulators may need to develop stress-testing protocols that incorporate equity market scenarios into Islamic banking supervision. For the Islamic banking industry itself, understanding how inflation and capital market movements affect ROA enables bank management to make more informed decisions on asset allocation, profit-margin setting, and risk management strategies. Failure to investigate these relationships leaves both regulators and practitioners without an evidence base for proactive policy design, potentially exposing the Islamic banking sector to preventable systemic vulnerabilities in periods of macroeconomic or financial market stress (Mawardi et al., 2024; Risfandy et al., 2022).

Despite the growing body of literature, several gaps remain. Studies on Islamic bank profitability in Indonesia predominantly use annual panel data at the bank level (Dodi et al., 2019; Wahyunitasari et al., 2024), which may fail to capture short-run and cyclical responses to macroeconomic shocks. Mawardi et al., (2024) and Oktoviana Banda Saputri (2021) note that both inflation and the IHSG exhibit substantial monthly variation in Indonesia, making high-frequency analysis necessary for capturing these dynamics. Second, the IHSG has rarely been included as an explicit explanatory variable in Islamic

banking profitability studies in the Indonesian context; most prior research focuses on interest rates, exchange rates, or internal bank variables (Borio et al., 2017; Della Priskila & Nurhasanah, 2021; Sitompul et al., 2021). Third, studies that do examine macroeconomic determinants often rely on standard OLS estimation, which is vulnerable to autocorrelation and heteroskedasticity in time-series data and may produce unreliable inference (Stock & Watson, 2020). These gaps collectively motivate the present study.

This study analyzes the responsiveness of Islamic banking profitability in Indonesia to inflation and capital market conditions using monthly time-series data from June 2014 to June 2025. The sample provides a longer time horizon and higher-frequency observations. Importantly, the study period spans multiple economic regimes, including the pre-pandemic period, the COVID-19 pandemic shock, and the post-pandemic recovery phase, as well as episodes of heightened inflationary pressure and financial market volatility. This comprehensive coverage enables a more robust assessment of Islamic banking profitability under both normal and adverse economic conditions. Profitability is measured by ROA, while the IHSG serves as the capital market proxy and monthly inflation data from BPS provide the macroeconomic indicator. To address the autocorrelation and heteroskedasticity commonly present in macroeconomic time-series, the study employs Newey–West HAC-consistent standard errors (Newey & West, 1986; Stock & Watson, 2020), an approach rarely applied in comparable Islamic banking studies in Indonesia but are critical for valid inference in macroeconomic time-series analysis (Stock & Watson, 2020).

Method

Research Design and Data

This study adopts a quantitative research design employing monthly secondary time-series data to examine how inflation and capital market conditions influence the profitability of Islamic banks in Indonesia. The research object is the Indonesian Islamic banking industry in aggregate, as reported in the official Islamic Banking Statistics published by the Financial Services Authority (Otoritas Jasa Keuangan, OJK). The observation period spans June 2014 to June 2025, yielding 133 monthly observations with no gaps in the time series. The use of monthly data is deliberate, as it enables the analysis to capture both short-run and medium-run dynamics in the relationship between macroeconomic conditions, capital market performance, and Islamic banking profitability—dynamics that would otherwise be obscured in lower-frequency data.

Variables and Data Sources

The dependent variable is Islamic banking profitability, measured by Return on Assets (ROA), defined as the ratio of net income to total assets and sourced from the Islamic Banking Statistics published by OJK. ROA is selected because it captures the efficiency with which Islamic banks generate profits from their total asset base and is widely employed as the primary profitability indicator in empirical banking and Islamic finance research (Hasan et al., 2020; Hassan & Bashir, 2005; Purwasih & Wibowo, 2021).

The independent variables consist of two macroeconomic indicators. First, Inflation, measured as the monthly rate of change in the Consumer Price Index (percent), is sourced from the Central Bureau of Statistics (Badan Pusat Statistik, BPS) and Bank Indonesia. It serves as the primary indicator of macroeconomic pressure, capturing price-level dynamics that may affect Islamic banks' operational costs, the real value of financing returns, and household purchasing power. Second, the Composite Stock Price Index (Indeks Harga Saham Gabungan, IHSG), measured by its monthly closing value and sourced from the Indonesia Stock Exchange (Bursa Efek Indonesia, BEI), serves as a proxy for capital market performance, reflecting aggregate investor sentiment and broader macroeconomic expectations in Indonesia. All data are drawn from official and publicly available institutional sources to ensure consistency and reproducibility.

Model Specification

To examine the impact of inflation and capital market conditions on Islamic banking profitability, the following linear regression model is estimated:

$$ROA_t = \alpha + \beta_1 Inflation_t + \beta_2 IHSG_t + e_t$$

where ROA_t denotes the profitability of Islamic banking measured by return on assets where ROA_t denotes the profitability of Islamic banking measured by Return on Assets in period t ; $Inflation_t$ represents the monthly rate of change in the Consumer Price Index; and $IHSG_t$ refers to the monthly closing value of the Composite Stock Price Index. The parameter α is the intercept term, while β_1 and β_2 are the regression coefficients capturing the marginal effects of inflation and capital market conditions on Islamic banking profitability, respectively. The error term e_t encompasses all unobserved factors affecting profitability in each period.

Diagnostic Procedures

Prior to estimation, a series of diagnostic tests were conducted to assess the statistical properties of the data and to determine the most appropriate estimation strategy.

1. Normality. The Shapiro–Wilk test was applied to all variables. Results indicate that ROA ($W = 0.891$, $p < 0.001$), IHSG ($W = 0.966$, $p = 0.002$), and Inflation ($W = 0.890$, $p < 0.001$) all significantly depart from normality. Accordingly, Spearman rank correlations are reported for the bivariate analysis in lieu of Pearson correlations, as the latter requires the assumption of normality.
2. Multicollinearity. Variance Inflation Factors (VIF) were computed following OLS estimation. Both IHSG and Inflation yielded a VIF of 1.01, producing a mean VIF of 1.01, effectively ruling out multicollinearity as a concern in the model specification.
3. Autocorrelation. The Durbin–Watson statistic for the baseline OLS model is 0.305, substantially below the conventional lower bound, indicating the presence of strong positive autocorrelation in the residuals. This is an expected feature of macroeconomic monthly time-series data, where economic conditions in one period are closely related to conditions in the preceding period. The OLS standard errors are therefore downward-biased, rendering conventional hypothesis tests unreliable.
4. Heteroskedasticity. Given the monthly frequency of the data and the considerable variation in IHSG values and inflation rates across the eleven-year observation window—spanning periods of economic expansion, financial stress, and the COVID-19 shock—heteroskedasticity in the residuals is an inherent and anticipated concern in this specification. Collectively, the confirmed presence of autocorrelation and the anticipated heteroskedasticity in the OLS residuals provide the empirical basis for adopting a robust estimation approach.

The confirmed violations of the OLS assumptions of homoscedasticity and non-autocorrelated errors necessitate an estimator that is robust to both conditions simultaneously. As (Ishaq et al., 2022) note, while OLS regression is widely used, its reliability is contingent upon the fulfillment of classical assumptions; when these are violated, OLS standard errors become unreliable even though the coefficient estimates themselves remain unbiased and consistent. Applying uncorrected OLS inference under such conditions therefore risks both Type I and Type II errors in hypothesis testing.

To address this, the present study employs the Heteroskedasticity and Autocorrelation Consistent (HAC) estimator proposed by Newey and West (1987). The Newey–West estimator corrects the variance–covariance matrix to account for serial correlation up to a specified lag and for arbitrary heteroskedasticity in the residuals, thereby producing robust standard errors without altering the underlying OLS point estimates (Ishaq et al., 2022; Newey & West, 1986; Ozili, 2018). This makes it particularly well-suited to monthly macro-financial time-series settings where both forms of misspecification are present. A lag length of 12 is specified, consistent with standard practice for monthly data that ensures adequate coverage of annual seasonal patterns, and in line with prior empirical

studies employing monthly Islamic banking data (Gazi et al., 2024; Mawardi et al., 2024; Ramadhani & Rizkan, 2021). The OLS R-squared ($R^2 = 0.618$) is reported as a descriptive measure of overall model fit; all hypothesis testing, however, is conducted exclusively on the basis of Newey–West corrected standard errors and t-statistics. All data processing and estimation are carried out using Stata 16.

Results and Discussion

The results and discussion section contains research findings obtained from the research data and hypotheses, the discussion of research results and comparison with similar theories and/or similar research. The results and discussion section can be divided into several sub-sections.

Descriptive Statistics

Table 1 presents the descriptive statistics for all variables over the observation period of June 2014 to June 2025 ($n = 133$). ROA averaged 1.42 percent ($SD = 0.58$), ranging from a low of 0.16 to a high of 2.18, reflecting considerable variation in Islamic banking profitability over the sample period. IHSG averaged 6,056.82 points ($SD = 850.29$), with a minimum of 4,223.91 and a maximum of 7,670.73, indicative of the broad capital market fluctuations experienced over the eleven-year window. Inflation averaged 0.27 percent per month ($SD = 0.41$), with values ranging from -0.76 to 2.46 , capturing both deflationary and inflationary episodes including the COVID-19 shock period.

Table 1. Descriptive statistics variables

Var	Obs	Mean	Std. Dev.	Min	Max
ROA	133	1.419	0.581	0.162	2.175
IHSG	133	6056.824	850.291	4223.910	7670.730
Inflation	133	0.271	0.408	-0.760	2.460

Source: OJK Islamic Banking Statistics; BPS; IDX (processed by authors, 2025).

Bivariate Correlations

Given that all variables significantly depart from normality (Shapiro–Wilk test, $p < 0.001$), Spearman rank correlations are reported in lieu of Pearson correlations. As shown in Table 2, IHSG exhibits a strong and statistically significant positive correlation with ROA ($\rho = 0.7793$, $p < 0.001$), suggesting that periods of capital market appreciation coincide with higher Islamic banking profitability. By contrast, Inflation is weakly and negatively correlated with ROA ($\rho = -0.1670$, $p = 0.055$), approaching but not attaining conventional significance at the 5 percent level. The correlation between IHSG and Inflation is negligible ($\rho = -0.0829$, $p = 0.343$), indicating that the two independent variables are orthogonal and do not confound each other in the multivariate model.

Spearman Correlation Analysis

To identify the initial relationships among the study variables and that Shapiro–Wilk tests confirm significant departures from normality for all three variables, Spearman's rank correlation is employed to assess bivariate associations. Results are presented in Table 2. The correlation results provide preliminary insights into the direction and strength of associations between Islamic banking profitability, inflation, and capital market conditions.

Table 2. Spearman Correlation Analysis

	ROA	IHSG	Inflation
ROA	1.0000		
IHSG	0.7793 (0.0000)	1.000	
Inflation	-0.1670 (0.0547)	-0.0829 (0.3431)	1.000

The correlation between ROA and the IHSG is positive and strong, with a Spearman coefficient of 0.779, statistically significant at the 1 percent level (p -value = 0.000). This result indicates that improvements in stock market performance are closely associated with higher profitability in the Islamic banking sector. The strength of this relationship suggests that favorable capital market conditions, which often coincide with robust economic activity and investor confidence, play a crucial role in supporting Islamic bank performance. A rising stock market may reflect improved corporate earnings and business prospects, which can stimulate financing demand and enhance asset quality in the banking sector.

In contrast, the correlation between ROA and inflation is negative but weak, with a Spearman coefficient of -0.167 , significant at the 10 percent level (p -value = 0.055). This finding implies that higher inflation tends to be associated with lower Islamic banking profitability, although the magnitude of the relationship is relatively small. The weak correlation suggests that inflation is not a dominant factor in explaining variations in ROA and that its impact may be mediated by other variables such as operational efficiency, financing structure, or regulatory interventions.

The correlation between the IHSG and inflation is negative and very weak, with a coefficient of -0.083 , and is not statistically significant (p -value = 0.343). This result indicates that during the study period, inflation dynamics were not closely linked to movements in the Indonesian stock market. This lack of association may reflect the effectiveness of monetary policy in stabilizing inflation independently of capital market fluctuations, or the influence of global financial factors on stock prices that are not directly related to domestic inflation.

Taken together, the correlation analysis suggests that Islamic banking profitability is more strongly associated with capital market conditions than with inflationary pressures. These preliminary findings are consistent with the subsequent regression results and reinforce the importance of financial market dynamics in shaping Islamic bank performance.

Estimation Results

The impact of inflation and capital market conditions on Islamic banking profitability is estimated using a linear regression model with Newey–West heteroskedasticity-and-autocorrelation-consistent (HAC) standard errors. This approach produces reliable statistical inference by simultaneously addressing the autocorrelation and heteroskedasticity confirmed in the diagnostic tests.

Table 3. Regression with Newey-West standard errors

ROA	Coef.	Newey-West Std. Err.	t	p-value
IHSG	0.0005221	0.0000793	6.58	0.000
Inflation	-0.1735499	0.1003215	-1.73	0.086
Cons	-1.696731	0.5410566	-3.14	0.002
Prob > F	0.0000			
R-square****	0.6181			

Note: *** $p < 0.001$; ** $p < 0.01$; * $p < 0.10$. ****The R-squared value of 0.6181 is derived from the baseline OLS estimation. All hypothesis testing is conducted on the basis of Newey–West corrected standard errors and t-statistics. with lag = 12; N = 133.

The regression results in table 3 indicate that the model is jointly significant ($\text{Prob} > F = 0.0000$), confirming that inflation and IHSG together constitute a meaningful explanatory framework for Islamic banking profitability. The OLS R-squared of 0.618 indicates that approximately 61.8 percent of the total variation in ROA over the June 2014–June 2025 period is explained by these two macroeconomic variables. This level of explanatory power is notably high for a parsimonious two-variable model applied to monthly macro-financial data, suggesting that capital market conditions and inflationary dynamics are not merely statistically associated with Islamic banking profitability but are substantively important drivers of it. The remaining 38.2 percent of variance is attributable to factors not captured in the current specification, such as bank-specific characteristics, regulatory changes, or other macroeconomic variables, which represent avenues for future research.

At the individual variable level, the IHSG displays a positive coefficient of 0.0005221 and is highly significant at the 1 percent level ($p = 0.000$). Inflation exhibits a negative coefficient of -0.1735 and is marginally significant at the 10 percent level ($p = 0.086$).

The Effect of Inflation on Islamic Banking Profitability

The negative coefficient on Inflation ($\beta_1 = -0.1735$, $p = 0.086$) indicates that rising price levels tend to exert downward pressure on Islamic banking profitability, though the effect is only marginally significant at the 10 percent level. In terms of economic magnitude, a one percentage point increase in the monthly inflation rate is associated with a decrease of approximately 0.174 percentage points in ROA, holding capital market conditions constant. Given that the mean ROA in the sample is 1.42 percent and the standard deviation of Inflation is 0.41 percent, this implies that a one-standard-deviation increase in monthly inflation is associated with a decline in ROA of roughly 0.071 percentage points, equivalent to approximately 5 percent of the mean ROA. While statistically modest, this effect is not negligible from a managerial standpoint, particularly during episodes of elevated inflation such as those observed in the post-COVID-19 recovery period.

From an economic perspective, inflationary pressure can erode Islamic banking profitability through several channels. Rising prices increase operational costs, compress real household income, and weaken borrowers' repayment capacity, potentially leading to lower financing demand and deteriorating portfolio quality (Z. Iqbal et al., 2026; Ranjbari et al., 2026). In the Indonesian context, these dynamics are particularly relevant given the reliance of Islamic banks on retail and micro-segment financing, where borrowers are more sensitive to cost-of-living pressures (Risfandy et al., 2022).

In the context of Islamic banking, inflation may also influence the performance of trade-based and profit-sharing contracts. Fixed-margin contracts such as *murabahah* may become less profitable if cost increases are not fully anticipated, while profit-and-loss sharing arrangements may transmit inflationary pressures from the real sector to bank earnings (Alqahtani & Mayes, 2018; Čihák & Hesse, 2010; Santosa et al., 2020; I. Setyawati et al., 2022). However, the relatively weak statistical significance of inflation suggests that its impact on Islamic bank profitability is limited.

Nevertheless, the relatively weak statistical significance of inflation in this study suggests that its impact on Islamic banking profitability in Indonesia is limited in practice. This finding may reflect several moderating factors. First, Indonesia's inflation during the sample period was generally moderate and managed within Bank Indonesia's inflation targeting framework, averaging 0.27 percent per month and rarely reaching extreme values. Second, the profit-sharing mechanisms intrinsic to Islamic banking allow returns to partially adjust in line with the performance of underlying economic activities, providing a natural buffer against inflationary shocks that would otherwise erode fixed-return assets (Belkhaoui et al., 2020; Gholami et al., 2021). Third, the increasing share of fee-based and service income in Indonesian Islamic banks' revenue structures may reduce their sensitivity to financing-margin compression during inflationary episodes (Trinugroho et al., 2018). These findings are consistent with

prior studies that identify inflation as a non-dominant or context-dependent determinant of Islamic bank profitability in emerging economies (Ramadhani & Rizkan, 2021; A. Setyawati et al., 2025).

The Effect of the Composite Stock Price Index (IHSG) on Islamic Banking Profitability

The IHSG exerts a positive and highly significant effect on Islamic banking profitability. A rising IHSG generally reflects a favorable macroeconomic environment characterized by increased investor confidence, stronger economic growth prospects, and heightened investment activity (Sumaryana et al., 2024; Tinungki et al., 2025), and these conditions tend to stimulate real sector performance, which in turn supports the core intermediation function of Islamic banks. In the Indonesian context, periods of capital market strength have been associated with increased business activity, higher financing demand, and improved asset quality in the Islamic banking sector, all of which feed directly into profitability (Risfandy et al., 2022; Trinugroho et al., 2018).

From an economic perspective, the positive relationship between the IHSG and Islamic bank profitability can be explained through several transmission channels. First, an expanding stock market often coincides with increased business activity (Bhowmik & Wang, 2020) and corporate profitability (Celestin, 2019) which can raise demand for Sharia-compliant financing (Belkhaoui et al., 2020). Firms experiencing growth are more likely to seek financing for expansion, working capital, and investment projects, thereby increasing financing volumes for Islamic banks. Second, favorable capital market conditions are typically associated with improved financial stability and lower default risk (Beck et al., 2013; Danquah & Osei Adu, 2025; I. Setyawati et al., 2022) which enhances the quality of banks' financing portfolios and supports profitability. Third, a strong stock market reflects positive economic sentiment that can influence household and business behavior, contributing to higher savings mobilization and more stable funding for banks (Celestin, 2019; Tan & Floros, 2012).

Although Islamic banks do not engage extensively in equity trading compared to conventional financial institutions, the IHSG remains a critical indicator of overall financial system stability and economic sentiment. The Islamic banking sector is deeply interconnected with the real economy through asset-backed financing and profit-and-loss sharing arrangements. Consequently, improvements in capital market performance signal broader economic strength that indirectly benefits Islamic banks. The significant coefficient of the IHSG thus underscores that Islamic banking profitability is not insulated from macro-financial dynamics, but rather responds to changes in the broader financial environment.

This finding is consistent with previous studies that document a positive association between stock market development and bank performance, particularly in sharia banks (Amzal, 2016; Saputri & Hannase, 2021). In such contexts, capital markets serve as an important complement to the banking sector, and their performance reflects the overall health of the economy (Osuma & Ohonba, 2025). For Indonesia, where the financial system has become increasingly integrated and market-oriented, the strong linkage between IHSG movements and Islamic bank profitability highlights the growing role of financial markets in shaping banking outcomes.

Overall, the results of this study demonstrate that Islamic banking profitability in Indonesia is more responsive to capital market conditions than to inflationary pressures. While inflation exhibits a negative effect on ROA, its influence is relatively weak and only marginally significant. In contrast, the IHSG emerges as a key external determinant of Islamic bank profitability, exerting a strong and statistically significant positive effect.

These findings reinforce the view that financial market stability and development play a crucial role in supporting the performance of Islamic banks (Bilgin et al., 2021; Levine & Zervos, 1998). The relatively limited impact of inflation suggests that Islamic banks in Indonesia possess a degree of resilience against price-level fluctuations, possibly due to the adaptive features of their business models. Profit-sharing mechanisms and prudent financing practices may help mitigate the adverse effects of

inflation on profitability. However, the strong sensitivity of ROA to capital market conditions implies that Islamic banks are increasingly exposed to financial market cycles and investor sentiment.

The empirical evidence also suggests that Islamic banking should not be viewed in isolation from the broader financial system. Despite operating under Sharia principles and avoiding interest-based transactions, Islamic banks remain embedded in the macro-financial landscape (Ahmed, 2010; Risfandy et al., 2022). Capital market performance, as reflected by the IHSG, serves as an important barometer of economic conditions that influence financing demand, asset quality, and overall bank performance.

Conclusion

This study examines the effects of inflation and capital market conditions on Islamic banking profitability in Indonesia using monthly time-series data from June 2014 to June 2025, estimated with the Newey–West HAC estimator. Two principal findings emerge. Inflation exerts a negative but economically modest and only marginally significant effect on ROA ($\beta = -0.1735$, $p = 0.086$), suggesting that while price-level pressures are not irrelevant, they do not constitute a primary driver of Islamic bank profitability within the study period, a finding likely shaped by Indonesia's broadly stable inflation environment and the adaptive nature of profit-sharing contract structures. The IHSG, by contrast, exerts a positive and statistically robust effect on ROA ($\beta = 0.0005221$, $p < 0.001$), with a one-standard-deviation increase in the index associated with approximately 31 percent of mean ROA, confirming capital market performance as the dominant macroeconomic determinant in this specification.

These findings carry practical implications for both bank management and prudential oversight. The strong sensitivity of Islamic bank profitability to capital market cycles suggests that macroprudential frameworks should formally incorporate financial market indicators alongside traditional banking health metrics. At the same time, the limited scope of this study (two macroeconomic variables at the industry aggregate level) means that the findings should be interpreted within their boundaries. Future research should extend the analysis to include additional macroeconomic variables such as GDP growth, exchange rates, and the BI Rate, incorporate bank-level panel data to capture heterogeneity across individual institutions, and examine whether the relationships identified here are stable across different sub-periods, including episodes of financial stress.

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